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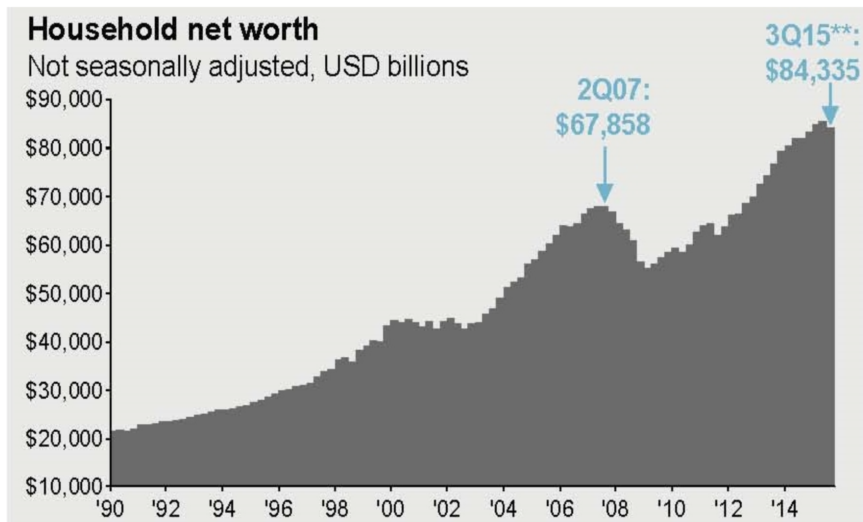
Market Review & Update

WINTER 2016

Barring any last minute surprises, the equity markets will end 2015 essentially flat. And you know what, that's not a bad thing at all. Why you ask? The underlying US metrics were actually improving throughout the year, hence the Fed move. Consider this analogy. The market ran a marathon. The market finished the 26 mile distance. That's quite an accomplishment even under normal conditions. Now consider that it finished the race while carrying a 50 pound weight! Now that's an admirable accomplishment. In this case, the weight was the rapid decline in oil and the strength of the dollar, with overall GDP hampered by the now famous Q1 of zero growth. Volatility notwithstanding, a flat finish to the year was a blessing. In perspective, it should be viewed as a sign of strength and resilience.

Figure 1: Consumers in Better Shape

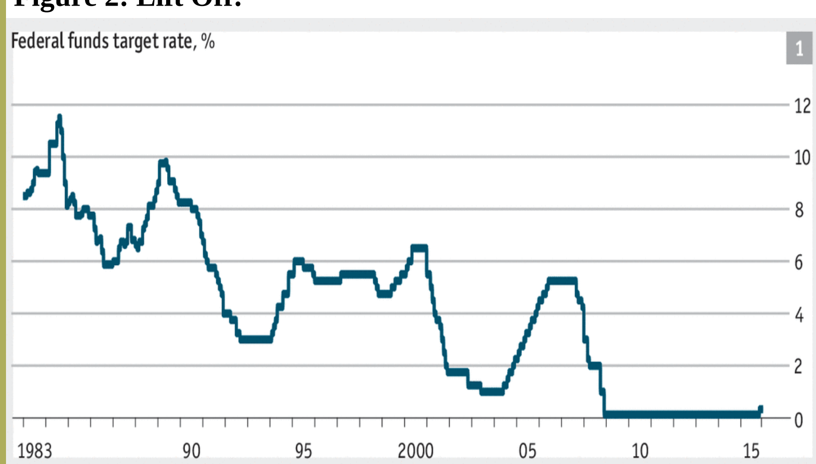


Source: BEA

So, where are we now? Domestic data continues to be reasonably strong. Major moves in the price of a barrel of oil and the strength of the dollar are now behind us. And, 2016 earnings are destined to rise. While estimates vary, Jeremy Siegel, the noted Wharton economist, sees a 10% rebound in earnings and profitability. Nothing in his forecast is a surprise with both consumers and businesses flush with cash. And with oil and the dollar largely in the rear view mirror, it is difficult to envision a negative US scenario, absent some exogenous impacts from abroad. Overseas central bankers have every tool at their disposal aimed toward growth.

Uncertainty that led to enhanced volatility is little surprise, especially given that the market players are on the threshold of an event in which they have ZERO experience, a Fed rate hike path. While in the vast minority, we have the experience of purchasing 14% municipal bonds when T-Bills were trading at 20%! There may even be a "WIN" button in a drawer somewhere here. Bonus points if you remember that "Whip Inflation Now" was Paul Volcker's calling card during the period embracing 1980. Since many have never witnessed a Fed rate hike, it should be said here that, historically, the 12 months after the Fed initiates an interest rate

Figure 2: Lift Off!

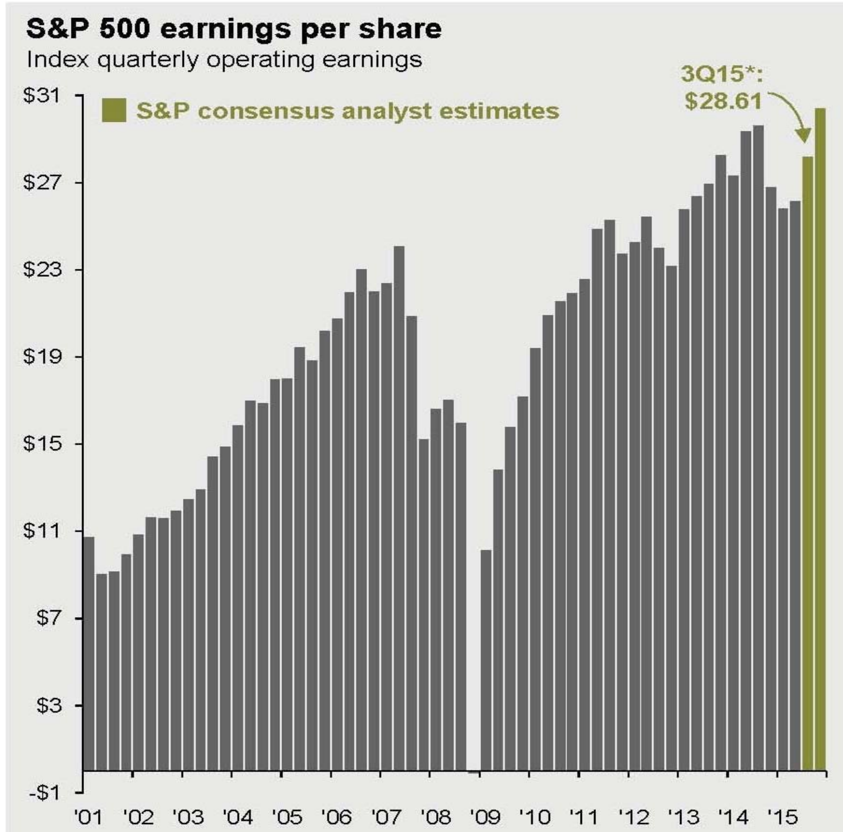


Source: Federal Reserve Board

increase has produced a universally positive result for the S&P 500.

So, while the volatility was annoying, a flat year creates a greatly increased probability of a positive result in 2016. The noted market analyst, Tom Lee's research at Fundstrat sees the odds of a 10% or greater move for the markets in 2016 following a flat 2015 at 5 to 1. Likewise, Tobias Levkovich at Citi see his research indicating a 96% probability of a positive 2016. His accuracy has ranked him as the top strategist on Wall Street for nearly 20 years. We agree that the metrics argue for more positives and that negative sentiment only adds to that conclusion. As an aside, we have noticed what might be a pattern in this market, since the recovery commenced in 2009. In the 2009/2010 period market returns totaled more than 40%. Then came a rest, a period where earnings catch up with valuations. In the 2013/2014 period we saw the markets surpass 50%. So, given the flat growth in the first quarter of this year we're really not surprised that we've stayed flat. We see no fundamental data that would suggest that this pattern could not repeat. And, the aforementioned projections support that. We sit approximately 3% from the all-time high on the S&P 500. With higher earnings anticipated in 2016, breaking to new highs in this environment should not come as a surprise. In addition, an important factor to consider is valuations. You hear the occasional analyst cite a high market price-earnings ratio. If you take the time to dig a little deeper you will quickly see that the energy and commodity sector have been the contributors to the P/E issue, a quick drop in earnings in those sectors immediately raises their P/E. If you strip those sectors out, all the other sectors are currently in line with, or below, their long term averages. And, if you then consider what an average P/E should be in an environment of historically low global interest rates, equities stick out as the most reasonable alternative currently, as P/E ratios should move inversely to interest rates, which spur more growth as they decline.

Figure 3: Higher 2016 Earnings



Sources: Compustat, Factset, Standard & Poor's, JP Morgan Asset Management

For those and many more reasons we look forward to the New Year and beyond. In previous issues we referenced research from The Economist indicating that a billion people will rise above the poverty level by 2030, creating a long term trend of increasing consumption. As individuals have access to greater resources, they ultimately increase their spending on goods and services, which will tangentially benefit long term investors. Our best to you for 2016!

We'll talk to you soon…