Community Financial Advisors[SM]
A Division of The Community Bank

Quarterly Investment Report

January 2016

SUMMARY: ***U.S. stocks had a rough year in 2015, with both the Dow Jones Industrial Average and the S&P 500 achieving positive returns only after dividends are included. NASDAQ returned a more respectable 7%, but that was less than half of its 2014 showing. But U.S. stocks did outperform their foreign counterparts, at least in dollars; in local currency terms, however, U.S. equities lagged the gains in China and Europe. Japan was one of the best-performing markets, returning more than 9% in both dollar and yen terms. Bonds barely broke even while commodities were down sharply across the board, led by the continued rout in oil prices. The Federal Reserve raised interest rates for the first time since 2006 and now appears on a course to increase rates steadily over the next several years even as other central banks continue to ease monetary policy.***

U.S. stocks had one of their worst years in several years in 2015 but still managed to outperform most of the rest of the world – except Japan – largely due to the strength of the dollar overseas. The Dow Jones Industrial Average ended the year down 2.2% in terms of price, its first losing year since 2008, but managed to eke out a 0.2% gain once dividends are included. That compares to a 10% total return for the index in 2014. The S&P 500 lost 0.7%, its first drop in price since 2011, but ended up 1.4% in total return thanks to dividends. But that's still a far cry from its 13.7% gain the previous year. NASDAQ, meanwhile, was the standout performer, rising 5.7% on a price basis and 7.0% after dividends, although that was less than half its 14.7% return in 2014. Small-cap stocks were by far the worst performers in the U.S. last year, as the Russell 2000 dropped more than 4% and the S&P 600 small-cap index lost an even 2.0%; both indexes gained more than 5% in 2014.

Nevertheless, the fourth quarter turned out to be the best quarter of the year for U.S. equities, although clearly not good enough to boost the full year's performance much, as all of the gain came back in October. The Dow and S&P 500 both gained more than 7% in Q4 while NASDAQ returned more than 8%, rebounding sharply from the third quarter, which was one of the worst quarters for global stocks in several years. But stock prices were down in both November and December, with the three major indexes all down on the order of 2% last month. Foreign stocks were also sharply higher in Q4, at least in local currency terms, led by a 16% jump in the Shanghai composite index and an 11% rise in German stocks.

Not surprisingly, energy stocks were by far the biggest losers among the S&P 500 last year. Energy stocks dropped

Global Investment Returns In U.S. Dollars				
	Q4 2015		YEAR 2015	
	Stocks	Bonds	Stocks	Bonds
U.S.	**6.6%**	**-0.6%**	**0.7%**	**0.5%**
Canada	-5.1%	-2.8%	-24.2%	-13.5%
Mexico	-1.2%	-0.8%	-14.4%	-4.7%
Japan	**9.3%**	**0.6%**	**9.6%**	**0.8%**
Pacific ex Japan	8.3%	4.5%	-8.5%	-9.5%
Australia	10.0%	3.1%	-10.0%	-8.8%
China	4.0%	0.8%	-7.8%	3.6%
Hong Kong	6.0%	N/A	-0.5%	N/A
Europe	**2.5%**	**-2.2%**	**-2.8%**	**-9.3%**
France	1.7%	-2.7%	-0.1%	-9.6%
Germany	7.7%	-3.0%	-1.9%	-9.9%
Italy	-2.3%	-0.2%	2.3%	-4.9%
Netherlands	3.1%	-2.8%	1.3%	-9.9%
Spain	-2.6%	-0.3%	-15.6%	N/A
Switzerland	2.0%	-2.5%	0.4%	1.0%
U.K.	0.7%	-3.5%	-7.6%	-5.0%
World	**5.5%**	**-0.9%**	**-0.9%**	**-3.2%**
World ex U.S.	3.9%	-1.3%	-3.0%	-6.0%

Sources: MSCI Stock & Barclays Bond Indexes as of 12/31/2015

more than 21% after losing nearly 8% the prior year, when they were the only sector to finish in the red. In 2015, however, half of the S&P's 10 sectors lost money. Consumer discretionary stocks, which include the auto sector, were the best performers, returning more than 10% in price gains and dividends. Health care and consumer staples were the only other two sectors to return more than 6%.

Foreign Stocks

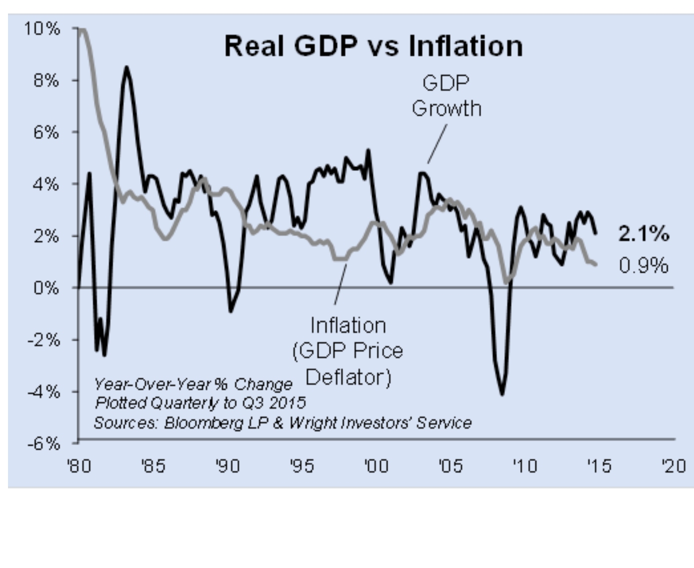
Yet despite their mostly mediocre returns, U.S. stocks did outperform most of their foreign counterparts last year, although only because of the rising dollar. The MSCI Europe ex U.K. index, which largely tracks the euro zone, lost 0.6% in dollar terms. That was nearly all attributable to the more than 11% gain in the dollar against the euro, which closed the year at $1.086, down from $1.21 at the end of 2014. In local currency terms, however, European markets far outperformed the U.S. The Stoxx Europe 600 gained 10% despite losing more than 5% in December, while Germany's DAX index rose nearly 10% in 2015. Italy's MIB gained 16%. European markets got a boost from promises of more stimulus from the European Central Bank, which lowered its deposit rate to negative 0.3% from minus 0.2% and said it will continue to buy sovereign bonds until at least March 2017, past the original September 2016 deadline. At the same time, ECB President Mario Draghi promised that the bank would "no doubt" do more if necessary, adding that "there is no particular limit to how we can deploy any of our tools."

The one major market that the U.S. failed to beat last year was Japan, where stocks gained more than 9% in both dollar and yen terms. The yen was largely flat against the dollar in 2015, one of the few major currencies to hold its own against the greenback. (Compare that to the Canadian loonie, which sank more than 19% against its American counterpart). Elsewhere in Asia, the MSCI China index lost 7.8% in dollar terms, although in local currency terms Chinese stocks fared pretty well during a very volatile year. The Shanghai index ended the year up more than 11% following a 16% gain in the fourth quarter. Between January 1 and June 12 last year, the Shanghai index soared 60%, only to come crashing down during the next three months, plunging by more than 40% before rebounding by 17% by Christmas. But Hong Kong's Hang Seng index was down 4% last year while emerging markets lost nearly 15%.

Bonds and Commodities

Bonds would have had negative returns in 2015 were it not for coupon interest payments. The Barclays U.S. Bond Market Aggregate, which is largely composed of Treasury bonds, managed a return of 0.5%, well down from its 6% return the prior year. Nevertheless, interest rates ended the year higher than they began it. One of the biggest increases in yield was for the two-year Treasury note, which jumped nearly 40 basis points to end the year at 1.05%, near a five-year high. It was up 50 bps just since October. The yield on the note surged as it became clearer that the Federal Reserve was going to go ahead and raise short-term interest rates for the first time since before the world financial crisis in 2006, which it eventually did on December 16. The benchmark 10-year note ended the year at 2.27%, up 10 bps for the year, while the 30-year bond closed at 3.02%, up 27 bps. But government bonds easily beat corporates, which outperformed Treasuries the year before. The Barclays U.S. Credit index fell 0.8% last year after returning 7.5% in 2014. It was a particularly difficult year for high-yield bonds, which usually trade more like stocks, as they lost 4.5% after gaining 2.5% the previous year. Bank loans also finished in the red, losing 0.7%.

In Europe, sovereign bond yields were mostly higher on the year despite the ECB's mammoth bond-buying program.



The benchmark 10-year German bund ended the year at 0.64%, up 10 bps, while comparable Spanish government bonds were up 16 bps to 1.77%. But Italian bonds outperformed, as did the country's stock market, with yields on 10-year government bonds falling 29 bps to 1.60%.

Led by plunging energy prices, commodities had poor returns across the board in 2015. Crude oil dropped more than 30% after falling nearly 46% the previous year, with West Texas Intermediate, the U.S. standard, falling to $37 a barrel at year end with no signs of bottoming out. OPEC, led by Saudi Arabia, continued to keep the spigots open to drive high-cost competitors, such as U.S. shale oil producers, out of the market. Likewise, heating oil prices dropped 40% for the second straight year while natural gas fell 19% on top of the previous year's 32% decline. But the damage spread to other commodities. Copper fell by nearly 25%, while gold dropped more than 10%. Agriculture prices were also sharply lower, led by a 20% decline in wheat.

U.S. Economy

The U.S. economy continued to grow at the same lackluster pace it has been unable to bust out of for most of the post-recession recovery. The third and final revision for third-quarter GDP showed the economy grew at an annualized rate of just 2.0%, nearly half the rate of the second quarter's 3.9% pace. Likewise, the Chicago Fed's national activity index for November came in at a negative 0.30, signaling below-average growth. Durable goods orders for November were unchanged, although that was better than the 0.5% decline the Street was expecting but down from the prior month's 2.9% increase. Excluding the volatile transportation sector, orders were down 0.1%. Leading economic indicators rose a better-than-expected 0.4% in November, down from the 0.6% rise the previous month but ahead of the 0.2% forecast. A pair of reports on economic growth in the Northeast continued to underwhelm. The New York Fed's general business conditions index remained in negative territory for the fifth straight month in December at minus 4.59, although that was the strongest reading of the five. The Philadelphia Fed's index dropped into negative territory for the third month in the past four, registering minus 5.9 after climbing into positive territory in November. Construction spending fell 0.4% in November, the first drop since June 2014.

The economy remained bifurcated, with growth in the manufacturing sector lagging far behind the services sector – a fortunate thing, since the latter sector comprises more than two-thirds of GDP. After falling to 48.6 in November, its first reading below the 50 mark denoting contraction in nearly three years and its lowest level since June 2009, the Institute for Supply Management's manufacturing index fell even further in December to 48.2. By contrast, the non-manufacturing index registered 55.3 in December. The gap between the two indexes has averaged almost eight points over the past six months, the widest over a similar period since 2001. Industrial production fell 0.6% in November, the biggest monthly drop in more than three years and its third straight monthly decline, while factory orders fell 0.2%.

Housing

Housing remained one of the bright spots of the economy, but even that sector is starting to show signs of losing steam, which may only exacerbate now that the Fed appears set on a course to raise interest rates steadily over the next couple of years. Sales of existing homes plunged nearly 11% in November to an annual rate of 4.76 million units, the biggest monthly decline in more than five years and the lowest volume since April 2014. The National Association of Realtors called the drop an anomaly as many closings were delayed as mortgage lenders adjusted to new federal consumer disclosure rules that went into effect in October. But pending home sales, a leading indicator of future sales, fell 0.9% in November to 106.9, the third decline in the past four months. Lawrence Yun, chief economist of the NAR, which produces the index, said the sector is starting to face some "headwinds," including home prices that have risen "too sharply" in several markets, declining inventories of homes for sale, and weakening economic signals. But the market for newly-built homes remained fairly robust. Sales of new homes rose 4.3% in November to an annual rate of 490,000, while housing starts rebounded by more than 10% in November after dropping 12% the prior month, climbing to an annual rate of 1.17 million.

The Consumer

But consumer sentiment and spending ended the year on a high note. The Conference Board's consumer confidence index rose nearly four points in December to close the year at 96.5, while the University of Michigan's consumer sentiment index ended 2015 at 92.6, its highest level since last July. The average reading for all of 2015 was 92.9, the highest since 2004. November retail sales rose 0.2%, the biggest gain in four months although less than expected. Personal spending and incomes both rose 0.3% in November. Auto sales hit an annual record. Carmakers sold 17.5 million vehicles in 2015, a 6% increase over 2014, beating the previous record of 17.4 million in 2000. On the inflation front, consumer prices were unchanged in November and up only 0.5% compared to a year earlier; producer prices rose 0.3% compared to the prior month but were down 1.1% compared to the year earlier.

Investment Outlook

Following such lackluster returns in 2015, it's probably not much of a surprise that 2016 opened with such a shaky start, with global stock markets opening deeply in the red. Investors were unnerved on the first day of trading by more evidence of a hard landing in China, whose relatively weak economic growth has taken most of the blame for the near freefall in commodity prices. That was quickly followed by rising tensions between Iran and Saudi Arabia. In the past, a potential outbreak of violence between two such oil giants would have caused energy prices to skyrocket. But in today's market it has had the opposite effect, with Iran likely to pump more oil to raise foreign currency while the Saudis do the same to lower prices and thereby inflict financial pain on competitors.

While those events and others yet to come will probably move markets this year, the central banks of the world are likely once again to play a major role in investment decisions as they have since the Great Recession ended. But what's different today is that the U.S. Federal Reserve and its counterparts in Europe, China and Japan seem set on divergent courses. As widely telegraphed by Fed Chair Janet Yellen over the past several months, the Fed on December 16 raised short-term interest rates for the first time since June 2006. The Fed's monetary policy committee voted unanimously to raise the federal funds rate 25 basis points to a range of 0.25% to 0.50%, up from 0% to 0.25%. To help reduce the sting of the increase, the Fed was quick to note that "monetary policy remains accommodative" despite the rise. Moreover, it said it expects economic conditions "will evolve in a manner that will warrant only gradual increases" after that. Looking ahead, the Fed said it expects its benchmark rate to rise to 1.375% by the end of this year, then to 2.375% by the end of 2017 and 3.25% in three years. That implies four 25-bp increases in each of the next two years and three or four after that. By sharp contrast, the ECB and the central banks in China and Japan remain extremely accommodative, but so far with little to show for the effort. Japan and the euro zone are barely growing at all, while the Chinese economy hasn't been able to meet already lowered expectations.

The U.S. Economy 2013–2016

		% Change In			End of Period Rates	
		Real GDP*	PCE Core Deflator*	Profits from Operations#	90-Day T-Bills	10-Tear T-Notes
2013	Q1	1.9%	1.7%	5.5%	0.1%	1.8%
	Q2	1.1%	1.2%	5.2%	0.0%	2.5%
	Q3	3.0%	1.4%	5.7%	0.0%	2.6%
	Q4	3.8%	1.7%	7.0%	0.1%	3.0%
2014	Q1	-0.9%	1.4%	7.3%	0.0%	2.7%
	Q2	4.6%	2.0%	8.9%	0.0%	2.5%
	Q3	4.3%	1.4%	9.3%	0.0%	2.5%
	Q4	2.1%	1.0%	6.5%	0.0%	2.2%
2015	Q1	0.6%	1.0%	5.5%	0.0%	1.9%
	Q2	3.9%	1.9%	2.2%	0.0%	2.4%
	Q3	2.0%	1.4%	-0.7%	0.0%	2.0%
	Q4 e	2.1%	1.4%	-1.2%	0.2%	2.3%
2016	Q1 e	2.4%	1.5%	-0.2%	0.7%	2.5%
	Q2 e	2.6%	1.6%	3.0%	0.9%	2.6%
	Q3 e	2.5%	1.6%	8.1%	1.1%	2.7%
	Q4 e	2.5%	1.7%	13.0%	1.3%	2.8%

e: Bloomberg Consensus Estimates; *: Annual Rates; #: Year-Over-Year Change in S&P500 EPS
Sources Bloomberg LP, Wright Investors' Service

Such a situation means 2016 will be another challenging year for investors, if not more so than last year. Should the Fed keep to its stated course of raising rates gradually, it's likely to keep continued upward pressure on the dollar, which, as we saw last year, makes it difficult for American investors to make money in overseas markets even when prices are rising. Here at home, rising interest rates, no matter how gradual or slight they may be, could have an adverse effect on an economy that is heavily challenged to grow much beyond 2%, especially in those sectors, like housing and auto sales, which have outperformed but only because of their heavy reliance on historically low borrowing costs. As a result, Wright continues to advise clients to hold a well-diversified portfolio of quality stocks and bonds, including both domestic and foreign securities.

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