Retirement Income Solutions

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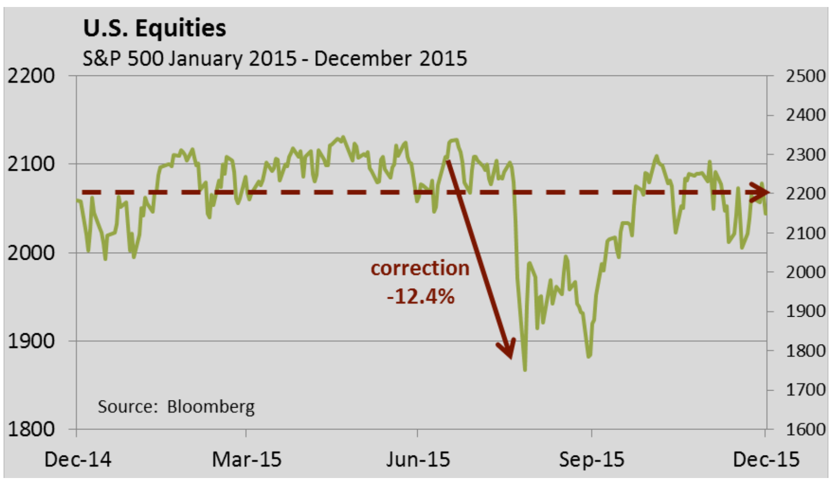
Balancing Act

January 2016

Summary

It was a tough year for financial markets. After a flat first eight months of the year, stocks fell by 12% in August and September. Equity markets recovered most of that drawdown by the end of December, ending the year roughly flat. It was a long way to travel to end up back where investors started. This "violently flat" year should be viewed as a pause in the midst of an advancing secular bull market. Such conditions are not uncommon since investors constantly evaluate the outlook for financial markets. Today's balancing act seems to fit that description. Many U.S. economic statistics are positive, including low unemployment, low inflation, low interest rates, and steady GDP growth. However, those positive factors are quite evenly balanced with concerns over outside influences (China, oil, and the Fed).



- ✧ There were few good options in financial markets in 2015. Large cap stock returns were essentially zero for the year. **Diversifying into international or bond investments did not add much value to portfolios either**. In fact, 2015 was the first time in over 40 years when U.S. stocks, international stocks, and bonds all returned less than 5% in the same year.
- ✧ As expected, investors have seen a **rougher ride in stocks**. Volatility was much higher in 2015, with days realizing a one percent swing (up or down) representing almost one in three trading days.
- ✧ Although the U.S. economy continues to plug along, a trifecta of outside forces has weighed on financial markets in recent months. The continued economic slowdown in China, plunging oil prices and a less-friendly Federal Reserve have been destabilizing forces.
- ✧ Around the world, central bank policy is diverging. The Fed increased interest rates for the first time since 2006, while most other central banks around the world are maintaining or accelerating easy monetary conditions. A slow pace of hikes will likely benefit markets more than a fast return to "normal."

Looking forward, financial markets have many concerns to digest. However, if U.S. markets can withstand those external stresses, stocks may be volatile, but the economy should avoid a recession that would entail a bear market (over 20% decline) in stocks.

- ✧ Weak returns are often a pause inside of a longer-term advance. Patience in such markets often pays off since **weak stock market years are typically followed by double digit stock market returns**.
- ✧ The **presidential election influences are challenging for 2016**. Although there are few data points to consider, the eighth year of a presidential term has not been positive for stock returns. Of the four cases since 1950, only one had positive stock returns, and the median return is a loss of 6.6%.
- ✧ In many ways, **2015 looks like a sequel to both 1998 and 2011**. In all three periods, solid economic growth in the U.S. was overshadowed by global financial stresses, resulting in a stock market pullback. Oil fell sharply, and the Fed reversed course. The two cases prior to 2016 resulted in strong stock market growth in the next year, but sequels are seldom as good as the original script.
- ✧ Stock market corrections tend to be shallower when the economy is not in a recession. Since 1950, 20 of 23 corrections not associated with a recession fell by less than 20%.
- ✧ 10% corrections in stocks happen on average every 9 months. The past four years since 2011 has been remarkably stable (with zero corrections over 10%), so it would not be surprising if the next few years saw a much higher frequency of such declines.

The Year in Numbers

0 In 2015, the total return for the Dow Jones Industrial Average was zero. Taken to one decimal place, the Dow earned 0.2%.

2 The average interest rate on a 10-year Treasury bonds averaged just over two percent in 2015. Other than 2012, this is the lowest yield in the history of the index (since the 1960s).

4 The summer of 2015 saw the first stock market correction exceeding 10% in four years. The last was in August and September of 2011.

7 Short-term interest rates have been pegged at zero for seven years. The Fed moved interest rates to zero in 2008.

9 In December 2015, the Fed raised short-term interest rates. The last time the Fed raised interest rates was nine years ago in 2006.

12 During the correction in August 2015, stocks fell by 12%. The prior correction (a negative move over 10%) occurred four years ago (2011) when stocks fell by 19%.

23 The U.S. dollar has strengthened significantly over the past 18 months. Since June 2014, the U.S. dollar appreciated by 23% against a trade-weighted basket.

40 The price of a barrel of oil fell to $37 at the end of 2015. The year-end price is 40% lower than the peak in the spring of 2015 and a drop of over 60% from the peak of 2014 when prices exceeded $100 per barrel.

72 Stock market volatility increased significantly in 2015. The number of days in which equity markets changed by more than one percent (up or down) grew to 72, almost one in three trading days.

Nowhere to Hide

The concept of diversification in investor portfolios is important since it smooths investment returns and helps prevent emotional decision making. When investors are invested in multiple sectors of the market, negative years in one sector are typically offset (at least somewhat) by a positive year in another sector. In this way, diversification can stabilize portfolios and provide a smoother, less-volatile experience.

Unfortunately, diversification did not help investors much in 2015. In fact, it was the first year since 1974 that a major asset class did not generate at least a 5% investment return (see table, right). Finding the right area to invest was difficult last year.

Color key (see table, right)
Returns over 5%
Returns between -5% and +5%
Returns less than -5%

In full disclosure, there were some (narrower) investments that had strong returns in 2015. For instance, technology stocks (represented by the Nasdaq Index) returned almost 6% last year. However, the broad indices are the most applicable to this analysis.

Below is a brief summary of the years in which U.S. stocks struggled and how the diversifiers performed.

Years with Poor U.S. Stock Returns (losses greater than 5%)

Year	Diversifier	Return
2008	Solid bond returns	5.2%
2002	Solid bond returns	10.3%
2001	Solid bond returns	8.4%
2000	Solid bond returns	11.6%
1977	Strong international returns	14.6%
1974	None	n/a
1973	None	n/a

Years with Weak U.S. Stock Returns (between +5% and -5%)

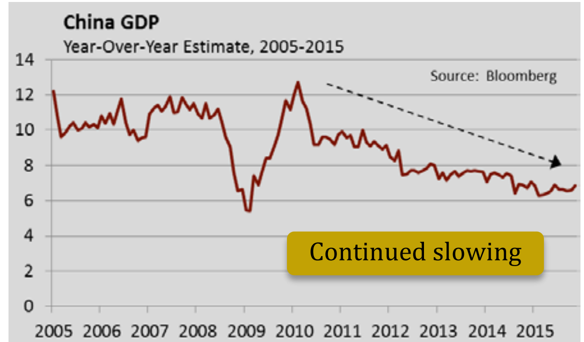
Year	Diversifier	Return
2015	None	n/a
2011	Solid bond returns	7.8%
2005	Strong international returns	14.0%
1994	Strong international returns	6.2%
1990	Solid bond returns	9.0%
1981	Solid bond returns	6.2%
1970	Solid bond returns	17.7%

Year	US Stocks	Int'l Stocks	Bonds
2015	1.4%	0.0%	0.5%
2014	13.5%	-4.1%	6.0%
2013	32.0%	23.1%	-2.0%
2012	15.9%	17.7%	4.2%
2011	2.1%	-11.1%	7.8%
2010	14.8%	8.1%	6.5%
2009	25.9%	31.7%	5.9%
2008	-36.6%	-41.8%	5.2%
2007	5.6%	11.8%	7.0%
2006	15.6%	26.8%	4.3%
2005	4.8%	14.0%	2.4%
2004	10.7%	20.5%	4.3%
2003	28.3%	38.5%	4.1%
2002	-22.0%	-15.3%	10.3%
2001	-11.9%	-20.8%	8.4%
2000	-9.0%	-13.7%	11.6%
1999	20.9%	27.5%	-0.8%
1998	28.3%	20.6%	8.7%
1997	33.1%	2.5%	9.7%
1996	22.6%	6.6%	3.6%
1995	37.1%	11.6%	18.5%
1994	1.3%	6.2%	-2.9%
1993	9.9%	30.5%	9.7%
1992	7.4%	-13.9%	7.4%
1991	29.9%	10.2%	16.0%
1990	-3.2%	-24.7%	9.0%
1989	31.2%	9.2%	14.5%
1988	16.3%	26.7%	7.9%
1987	5.7%	23.2%	2.8%
1986	18.5%	66.8%	15.3%
1985	31.1%	53.0%	22.1%
1984	6.0%	5.0%	15.1%
1983	22.3%	20.9%	8.4%
1982	20.4%	-4.6%	32.6%
1981	-4.8%	-4.8%	6.2%
1980	31.5%	19.0%	2.7%
1979	18.2%	1.8%	1.9%
1978	6.4%	28.9%	1.4%
1977	-7.2%	14.6%	3.0%
1976	23.6%	-0.4%	15.8%
1975	36.9%	31.2%	11.2%
1974	-26.0%	-25.6%	1.3%
1973	-14.5%	-16.8%	2.9%
1972	18.7%	33.3%	6.3%
1971	14.1%	26.1%	9.9%
1970	3.5%	-14.1%	17.7%

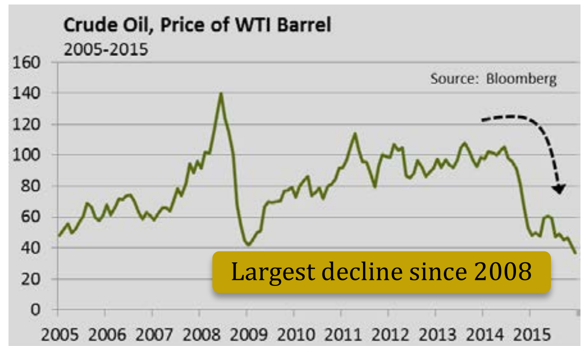
Source: Bloomberg

Economic Conditions

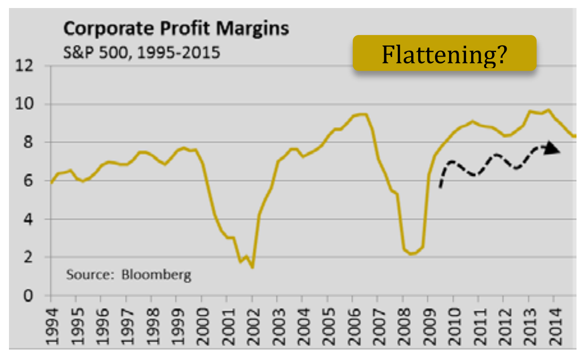
The state of the global economy is somewhat mixed, as external forces (China, oil, and the Fed) put pressure on modest growth in the U.S.



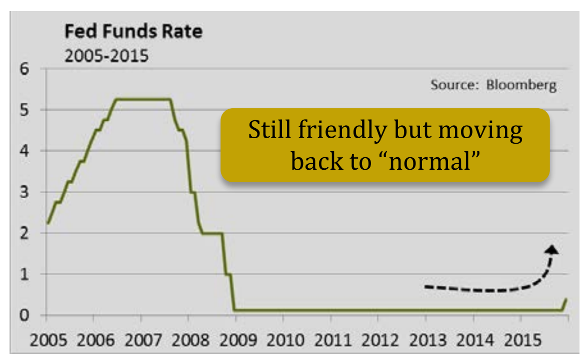
One of the key areas weighing on financial markets is China's economy, which has been the single largest contributor to global growth over the past 10 to 15 years. It has grown so quickly that it is difficult to continue growth at the same pace. After many years of double-digit growth, the Chinese economy slowed to 6.5% in 2015. Although that growth rate is high compared to economic growth in the U.S. and Europe, concerns over China's ability to transition from manufacturing powerhouse to servicing its growing middle class continue to weigh on financial markets.



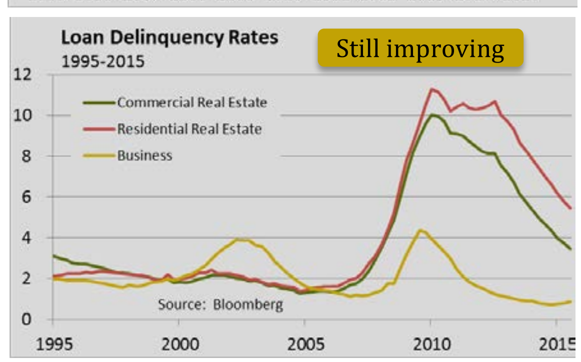
The decline in oil prices was dramatic in 2015. After exceeding $100 per barrel in 2014, the price of crude oil dropped to $37 by the end of 2015. Although consumers and many businesses benefit from lower oil prices in the long run, the short-run impact is negative since energy companies represent a sizeable portion of the economy (capital spending and employment). In terms of market capitalization, roughly 12% of the S&P 500 index is made up of energy companies.



Global economic weakness and less-friendly monetary policy have put pressure on corporate profitability in the U.S. After achieving record profit margins in recent years, S&P 500 companies have flattened.



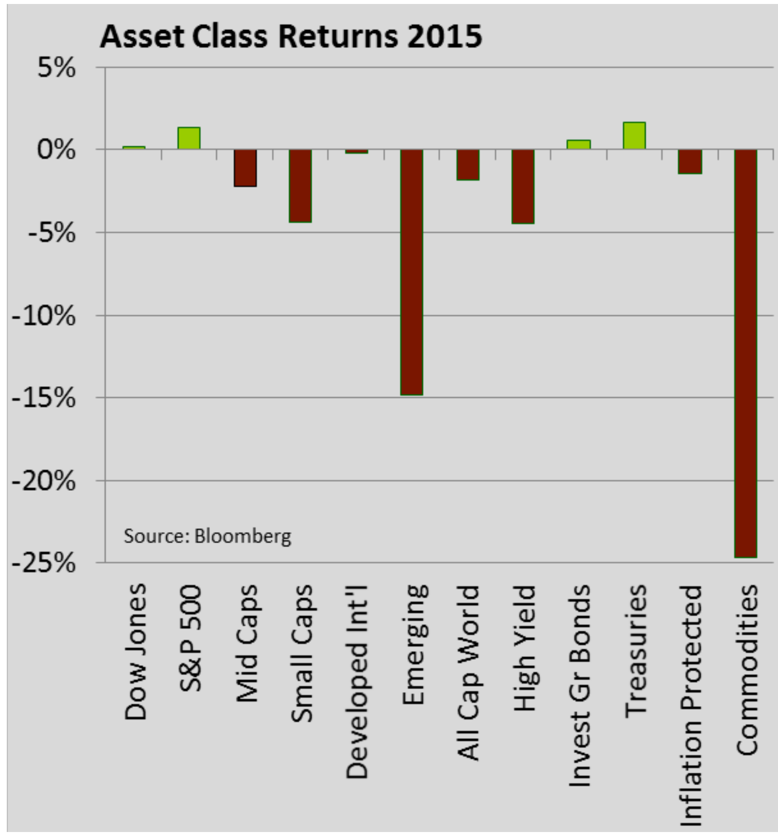
After seven years pegged at zero, the Federal Reserve raised rates by 0.25% in December. Although the increase in the Fed Funds rate was quite small, Fed officials clearly want to move rates away from zero but not tighten conditions too much given global economic uncertainty.



Even in a challenging global environment, loan delinquencies in the U.S. are still improving. Loans supported by commercial real estate and residential mortgages continue to become healthier. General business loans are stable at low delinquency levels. There is little evidence of the unhealthy credit and loan defaults present during the real estate bubble in the 2000s. There is some increase in defaults in the high yield (riskier) bond space, but most of that is driven by weakness in the energy space.

Financial Markets

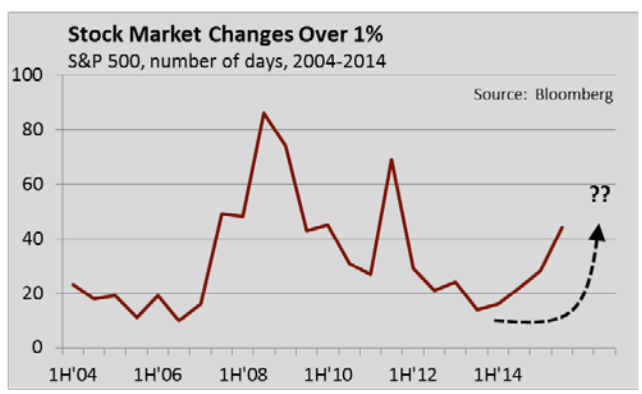
Asset Class Returns



Stock markets around the world were somewhat negative in 2015, with the All Cap World Index down -1.8% for the year. Large cap U.S. stocks were barely positive, while mid cap and small cap stocks lost -2.2% and -4.4%, respectively. Due to commodity and China exposure, emerging markets suffered the largest losses of -14.8%. Developed international stocks were down 1% for the year, but in local currency returns were a positive 5%; the positive stock returns were more than fully offset by the appreciation of the U.S. dollar.

Bond returns were lackluster in 2015. Investment grade bonds returned 0.6%, and U.S. Treasury bonds topped the list of asset classes with a 1.6% return. Lower quality bonds (high yield) lost -4.5%, and inflation protected bonds lost -1.4%. Commodities struggled broadly (oil was negative and many other commodities saw price declines) with a total loss of -24.7%.

A Return to Volatility



In our January 2015 commentary, the case was made that the environment was ripe for increasing volatility in equity markets. We recommended that investors "prepare for a rougher ride in the stock market… [and] given the environment, the market may be less stable and more prone to big swings on a day-to-day basis."

Unfortunately, that expectation became reality, and the number of days with large swings in the market has increased steadily since the second half of 2013. Increasing instability is consistent with an environment where economic growth around the world is either low or slowing, monetary conditions are moving from extreme easing back towards normal conditions, and stock valuations are higher and therefore less attractive than several years ago. Although big market swings can be uncomfortable, they are not uncommon historically and are likely to continue into 2016.

Weak Years are Good

2015 might be best described as "violently flat." Stock returns were weak, but the increasing volatility and a 12% correction were the biggest challenge investors have seen since 2011. Such weak (flat) returns are often a pause inside of a longer-term advance. Markets do not move forward in a straight line, and often a period of consolidation is necessary for positive returns to continue.

Weak Year	Weak Year Returns	% Gain Next Year
2015	1.4%	???
2011	2.1%	15.9%
2005	4.8%	15.6%
1994	1.3%	37.1%
1990	-3.2%	29.9%
1981	-4.8%	20.4%
1970	3.5%	14.1%
1960	0.3%	26.6%
1953	-1.2%	51.2%
Median		23.5%

Source: Bloomberg

Fortunately, another weak year is unlikely to occur again in 2016. After weak years in equity markets (defined as years with returns between positive 5% and negative -5%), equity returns typically strengthen in subsequent years. Since 1950, weak stock market years have been typically followed by double-digit stock market returns and a median gain of 23.5%. Although even achieving the median gain seems unlikely in 2016, the key is that while pauses in the market are uncomfortable, they are typically worth enduring some discomfort for the future potential returns. Given the historical context, 2016 may deliver better returns than expected.

A similar environment last occurred in 2011, as worries of a double-dip recession, European debt crisis, and fiscal cliff negotiations in the U.S. caused a mid-year correction. After a 19.4% drawdown in 2011, volatility was high throughout 2012, but stocks ended with a 15.9% return.

Non-Recessionary Corrections

It is difficult to tell in advance if an economy is entering a recession; however, most indications are that the U.S. economy should be able to avoid a recession in the near term. This is important since stock market corrections tend to be shallower when the economy is not in a recession. Since 1950, only 3 of 23 corrections not associated with a recession exceeded a 20% drawdown. The median correction was a loss of -13.6%.

In recessionary environments, the markets tend to swing more significantly. The average loss is greater, and the frequency of large losses is also greater. Almost 40% of corrections in a recession exceed a 20% loss (versus only 13% in non-recessionary periods), and 8 of the 10 corrections exceeding a 25% drawdown in stocks occurred during a recession.

Statistics on Non-Recessionary Corrections

1950-2015

Number of corrections exceeding 20%	3
Number of corrections less than 20%	20
Percentage corrections over 20%	13%
Median correction losses	-13.6%

Source: Ned Davis Research

Presidential Election Influences – The Lame Duck

Historically, the stock market has posted solid returns during election years. Since 1950, election years have generated stock market gains of 6.6%; however, stock returns in the last year of a two-term presidency have not been positive.

Obama is only the fifth president to achieve a second term since the passage of the 22nd amendment (effective in 1953), which limits presidents to two terms in office. The eighth year of such two-term presidencies has not generated strong stock returns and is the weakest of the 8-year cycle. The median return for the S&P 500 in year 8 is a -6.6% loss, and only 25% of the years have generated positive returns.

This tendency could occur because two-term presidents are "lame ducks" and may have less influence over policy and spending. This could also occur because, without the potential for re-election, a two-term president has less incentive to stimulate the economy and that influences stock market returns.

S&P 500 Index Percent Change By Presidential Term

Two-Term Presidents, 1950-2015

President	Term	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8
Eisenhower	1953-1960	-6.6	45.0	26.4	2.6	-14.3	38.1	8.5	-3.0
Reagan	1981-1988	-9.7	14.8	17.3	1.4	26.3	14.6	2.0	12.4
Clinton	1993-2000	7.1	-1.5	34.1	20.3	31.0	26.7	19.5	-10.1
Bush II	2001-2008	-13.0	-23.4	26.4	9.0	3.0	13.6	3.5	-38.5
Obama	2009-2016	23.5	12.8	0.0	13.4	29.6	11.4	-0.7	???
Median		0.3	-1.5	20.1	13.0	14.7	14.6	3.5	-6.6
Percent positive		50	45	91	100	67	100	80	25

Source: Bloomberg

There are a few other interesting statistics regarding the market and elections. The stock market has tended to struggle in years when the incumbent party loses the election (see year 8 for Eisenhower, Clinton and Bush II above). According to Ned Davis Research, "Holding on to the presidency is not easy: the last time the Democrats won a third consecutive term was 1940, when FDR ran for a third time. The last non-sitting Democrat to win the presidency after the party had held the office for two terms was Martin Van Buren in 1836." The tie to markets is clear: the S&P 500 has risen by 2.2% during election years when the incumbent party has lost while it has gained 9.7% in years when the incumbent party wins.

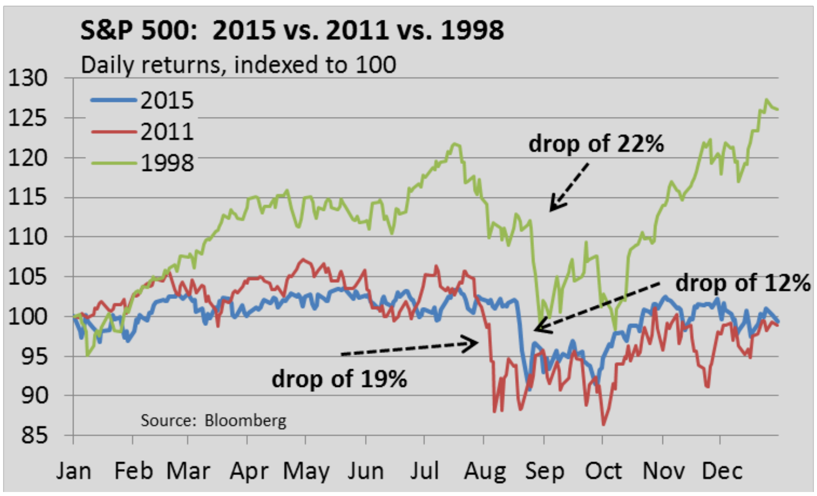
In addition, January returns tend to be a leading indicator in election years. According to the Stock Trader's Almanac, "In presidential election years, [January] has a solid record. In the last 16 presidential election years, 14 full years followed the direction of the first five days [of January]… 12 of the last 16 full years followed January's direction." So far this January, the start to 2016 is sobering.

Part of the volatility in election years is driven by uncertainty over the outcome. While the outcome of the election is unknown, all voters are nervous about the potential for the wrong person to get elected. As the expected election result becomes clearer, markets tend to have positive results. In fact, the last seven months of an election year have realized gains in 14 of 16 presidential election years since 1950. One of the two missed years was 2000, when the election's outcome was delayed for 36 days during the Florida voting discrepancies and Supreme Court challenge.

Analogies with 2011 and 1998

There are several similarities between the current environment and those of 2011 and 1998. In all three periods, solid economic growth in the U.S. was overshadowed by global financial stresses, resulting in negative stock market returns and increasing uncertainty.

In 1998, world markets were struggling to recover from the prior year crisis in Asian currencies when dramatically lower oil prices triggered a similar currency crisis in Russia. The stock market flattened in the middle of the year before falling 22% in the late summer. The Fed had tightened monetary policy in the prior year, but worries over global financial markets outweighed solid GDP growth in the U.S. The Fed reversed course and cut interest rates three times in the fall. It took the stock market six weeks to confirm the worst was over, and it rallied to new highs by the end of the year.



In 2011, world markets were impacted by the debt crisis in Europe. Fear of default grew rapidly as several countries with large debt burdens encountered a tough combination of weak economic growth and rising interest rates. Oil prices fell by 30%, and the stock market moved "sideways" until late summer before falling by 19%. The Fed's second quantitative easing program (QE2) ended in the summer, but the Fed was forced to announce another round of monetary easing dubbed "Operation Twist." After two months of volatile markets, the stock market got back on track, rallying in the fourth quarter and reaching recent highs in early 2012.

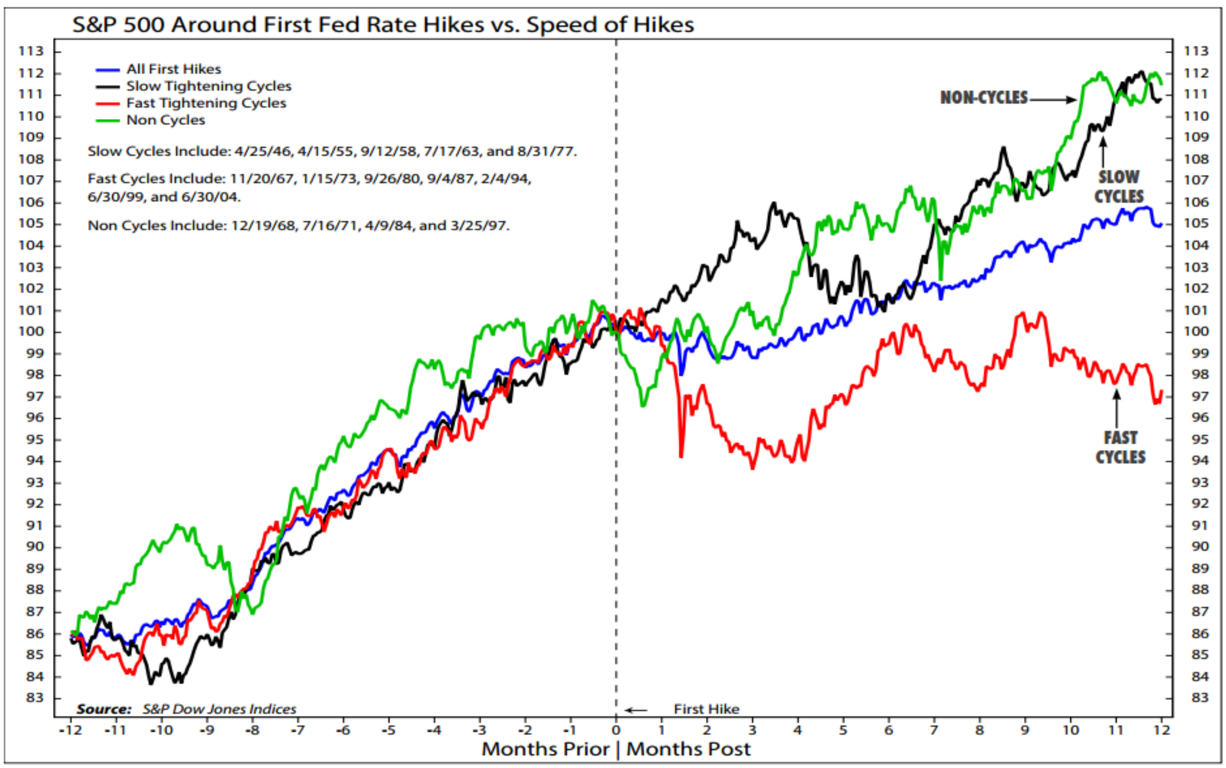
	2015	2011	1998
Global stress	China growth / currency + Greek debt turmoil	European debt crisis	Asian & Russian currency crises
Oil prices	-33% over 2 months	-29% over 5 months	-30% over 2 months
Monetary policy	After concluding QE3, the Fed repeatedly delayed planned interest rate increases.	After concluding QE2, the Fed announced a new monetary easing program.	After a tightening monetary policy, the Fed cut rates three times due to global financial stress.
Correction	-12%	-19%	-21%
Subsequent year returns	??? (2016)	16% (2012)	21% (1999)

Last year, the environment and markets unfolded in a similar fashion. Greek debt problems resurfaced including a potential exit from the euro, and worries about China's growth dominated headlines. The Chinese government controls the yuan currency value and announced significant devaluations over three successive days, destabilizing many stock and bond markets. Oil fell by 40% from a recent high in the spring of 2015, continuing bigger declines from 2014. The stock market traded sideways for the first half of the year, barely squeaking out a positive return over 6 months, before falling 12% in the late summer. The Fed's latest monetary easing policy ended in 2014, and the Fed raised interest rates in December 2015. It has not been an easy decision for the Fed to raise rates since global financial instability continues to be high.

In the two cases prior to 2015, global stresses faded and stocks generated meaningful positive returns in the subsequent year. If those external forces can fade in 2016, the secular bull market advance should continue.

Is the Fed Tightening Monetary Policy… or Returning to Normal?

In December, the Fed raised rates by 0.25%. Although the increase in the Fed Funds rate was quite small, it is the signal sent by the Fed that is most important. Past periods of rate hikes by the Fed provided clear signals that tighter monetary conditions were prudent to combat rising inflationary forces. The most recent rate hike is designed less to combat inflation than to eliminate the "crisis-level" rates that have existed since the financial crisis in 2008-2009. Consequently, the signal and context provided by the Fed is less clear; Fed officials clearly want to move rates away from zero but also not tighten conditions too much given an environment with significant uncertainty about strength of the global economy.



Source: Ned Davis Research

The first rate hike by the Fed is not nearly as important as the signal that it sends about the ongoing pace of rate increases. In a study conducted by Ned Davis Research (see above), stock market returns after the first rate hike are much higher when future increases are slow than those when rates are increased at a fast pace. The current expectation is for a slow pace of rate hikes, and as long as the Fed continues to reinforce that belief, future stock returns should continue to be positive.

Summary of Current Positioning

Over the last month, financial market volatility increased significantly. Despite the lack of swings in recent history, these declines in market returns are not only common but also expected to continue in the future. Ten percent corrections occur every nine months on average; if the past four years saw no ten-percent corrections, then it would not be surprising to see such declines happen more frequently in the future. News on China, oil and the Fed may trigger future downward moves, but we believe this period is more of a shallow correction, which is typical of stock market corrections outside of a recession. We are watching the market and our indicators closely for data that would change that view.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

Brock E. Hastie
Managing Partner

Karen Chapell
Managing Partner

Todd Kephart
Managing Partner

John Goff
Managing Partner

K. Larry Hastie
Managing Director

R. Griffith McDonald
Managing Director

Margaret Kephart
Sr. Vice President

Pamela Loduca-Massa
Sr. Vice President

These data are for illustrative purposes only and is not indicative of any investment or strategy result. The S&P 500 is an index of 500 stocks representing major U.S. industry sectors. The Dow Jones Industrial Average is an index made up of 30 large U.S. company stocks. Small Cap is represented by Russell 2000 Index, which is an index of the 2000 smallest companies in the Russell 3000 Index of 3000 broad-based U.S. companies. Mid Cap is represented by S&P Mid-Cap 400 Index, which tracks medium-sized U.S. firms, which is broadly defined as a company with a market capitalization ranging from about $2 billion to $10 billion. Developed Int'l is represented by MSCI EAFE Index, which is an index of major international equity markets as represented by 21 major MSCI indexes from Europe, Australia and Southeast Asia. Emerging Markets is represented by MSCI Emerging Markets Index, which is an index that is designed to measure equity market performance in global emerging markets (over 20 countries including Brazil, Russia, India, and China). World stocks (the All Cap World index) are represented by the MSCI ACWI index and is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices. High-Yield is represented by the Barclays U.S Corporate High-Yield Index, which measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt. Investment grade and broad market bonds are represented by the Barclays Aggregate Bond Index includes most U.S. traded investment grade bonds, including Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S. Treasuries are represented by the Barclays Capital U.S. 7-10 Year Treasury index, which measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years. TIPS are represented by the Barclays U.S. Government Inflation-linked Bond Index, which includes publicly issued, U.S. Treasury inflation protected securities that have at least 1 year remaining to maturity. Commodities are represented by the S&P GSCI is a world-production weighted index designed to track investable commodities representing the price movements of the world economy.