Retirement Income Solutions

*Helping to grow and preserve your wealth*

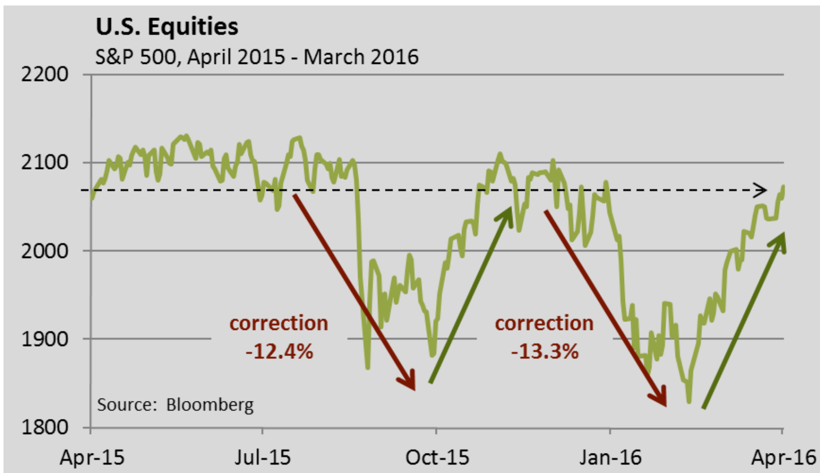
# Assessing Risk & Reward

**April 2016**


## Summary

The first quarter of 2016 followed a familiar script from last summer. August and September of 2015 saw a 12% stock market decline that was reversed by a sharp rally in October. In 2016, investors were greeted with the worst start to a year in the history of the U.S. stock market. The market slid by 13%, reaching a bottom on February 12th. The subsequent rally through March erased the decline, and U.S. stocks ended the first quarter with a small positive return.


This has been a challenging environment for investors. After the 2008 financial crisis, stocks rallied for six years. The last 18 months have been different, as the S&P 500 has been stuck in a range between roughly 2100 and 1800.




Looking forward, stocks can continue to advance, but they will likely do so at a slower rate than to which investors are accustomed. Maybe more importantly, the rough ride is likely to continue. An assessment of the investment environment calls for a more balanced approach between risk and reward:

- ✧ **Stocks are still expensive.** A historical perspective shows that when long-term price-to-earnings multiples are high, future stock returns are lower than average.
- ✧ **Brace for more market volatility.** The start to 2016 was very bumpy with almost two-thirds of trading days moving by at least one percent. Markets were abnormally calm from 2011 until last summer, but the recent big swings in financial markets are likely to continue.
- ✧ **The U.S. economy seems to be avoiding a recession.** Slow and steady economic growth is helping to fuel the longevity of the advance. Of the ten expansions since 1950, only three have lasted longer.
- ✧ **Markets are hyper-sensitive to the Federal Reserve.** The Fed flustered markets in August when it announced plans to raise rates; markets were rattled again after the Fed actually raised rates in December. Wage pressures are building, and it will be difficult for the Fed to avoid future rate hikes.
- ✧ **Central banks continue to create a friendly environment.** Policy makers in Europe, Japan, and many other regions continue to provide meaningful monetary stimulus.
- ✧ **The weak start to the year is a concern.** When the market does not rally during the typically strong winter months, future returns have a greater tendency to be negative. In the 18 cases when January and February were negative, 10 saw losses for the remainder of the year.
- ✧ **Many wildcards exist**… U.S. elections, oil, China growth, dollar strength, U.K. exit, acts of terror…

## Position Change: Reduction in Equity Allocations

We recently made investment changes in client accounts. Although a recession seems unlikely, the ongoing market weakness is concerning, and upside stock market potential may be limited given pending interest rate increases. Stocks are expensive, and volatility is expected to remain. At this point, market risk seems to be markedly higher than late last fall. Stocks can continue to appreciate, but the path may be bumpy. If the script continues with more declines and recoveries, investors may be better served with less risk in portfolios. Accordingly, on April 6, we took steps to reduce risk in client accounts, moving from a "Maximum" to a "Neutral" equity position.

## Asset Class Returns

Over the last 12 months, many asset class returns look lackluster, but underlying the modest 1.8% return for U.S. stocks were big moves up and down. Markets endured two corrections with losses (and recoveries) of 12% and 13%.

Globally, stocks squeaked out a positive first quarter but are still down by 4.4% since a year ago. The slight positive in U.S. stocks was more than offset by weakness abroad in both developed countries (down 8.3%) and emerging markets (down 12.0%).

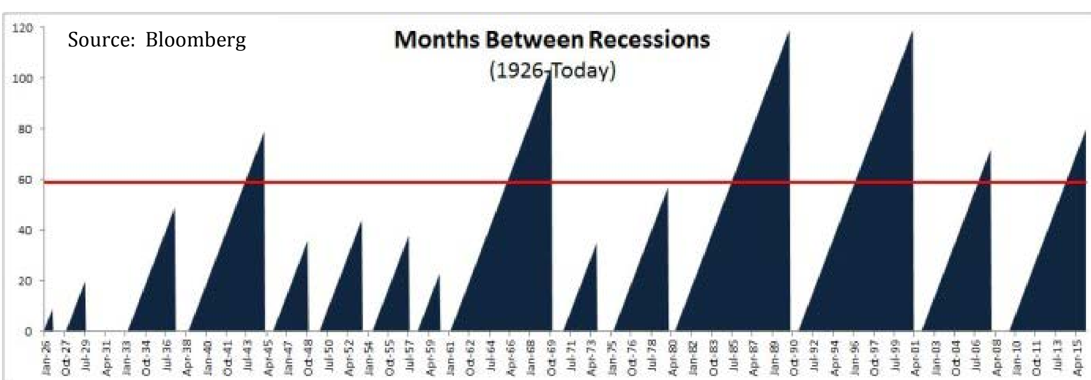
Higher-quality bonds such as investment-grade, treasuries and inflation-protected gained 1.5% to 2.4% over the past year; most of those gains occurred during the volatility of the first quarter of 2016. High yield bonds and commodities continue to struggle, posting negative returns over the past year.

| | First Quarter | Last 12 months |
|---|---|---|
| All Country World | 0.3% | -4.4% |
| S&P 500 | 1.4% | 1.8% |
| Dow Jones IA | 2.2% | 2.1% |
| Mid caps | 3.8% | -3.6% |
| Small caps | -1.5% | -9.8% |
| International | -3.0% | -8.3% |
| Emerging | 5.7% | -12.0% |
| High Yield | 3.3% | -4.1% |
| Invest Grade Bds | 3.0% | 2.0% |
| Inflation | 4.5% | 1.5% |
| Treasuries | 3.2% | 2.4% |
| Commodities | -2.5% | -28.7% |

Source: Bloomberg

## Chances of a Recession

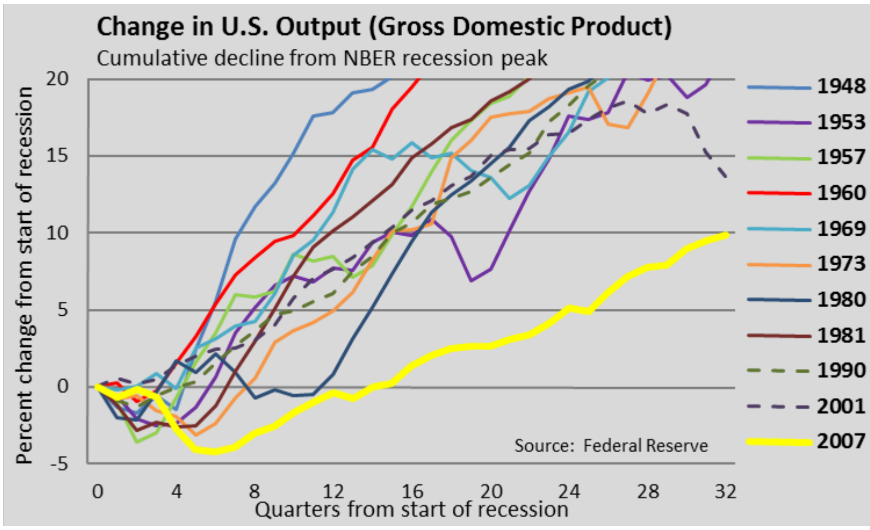
During the first few months of 2016, the risk of recession was a frequent topic in financial news. This distinction is important since stock market drawdowns are typically far worse in a recession than outside of one. Although many commentators were quick to try to identify the "canary in the coal mine," most of the reliable indicators have not yet signaled a problem.



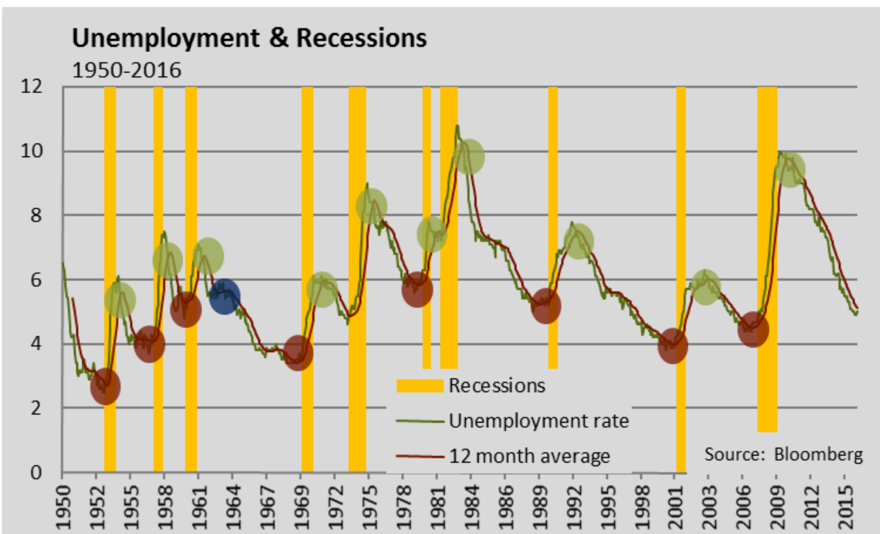

The current expansion is well-aged, but there is no time clock to predict recessions. While the current period is the fourth longest expansion since 1926 (see chart, above), three others lasted years longer. The age of the expansion should tell investors to watch other indicators carefully but necessarily not run for the exit.

There are a few recessionary indicators worth noting at this point in the cycle.

The economic recovery since the 2008 financial crisis has been long in duration but small in magnitude. The result is that the cumulative recovery is still modest compared to prior periods. The cumulative GDP recovery since the financial crisis is only 10% (see chart, below). Comparatively, 9 of the 10 prior recessions resulted in cumulative GDP growth reaching 15-30% before falling back into recession. The measured pace of the current recovery should help mitigate recessionary forces.



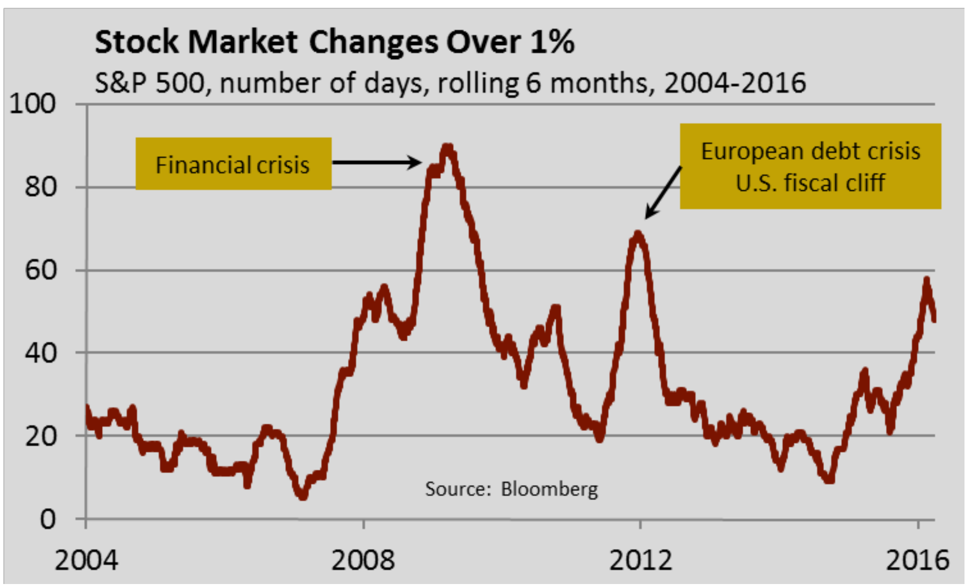

A second indicator of recession is the strong correlation between oil price spikes and recessions. An economist from the University of California San Diego, James Hamilton, noted in a recent study that 10 out of 11 post-World War II recessions were preceded by a sharp increase in the price of oil. The sole exception was a mild recession in 1960-61 where no rise in oil prices occurred. This is not surprising since most recessions occur after a period of robust economic growth and inflationary pressure. Today's oil prices are down 60% (the opposite of the oil spike study) from 2014. While the initial impact of swift oil price declines is destabilizing, it is not typically associated with recessions; a more likely outcome is that lower oil prices reduce costs for producers and consumers which supports the economy.



A third indicator of potential recession is the unemployment rate, which is a lagging indicator that increases substantially after a recession has already begun. A lagging indicator does not help with forward-looking analysis; however, the *change* in employment rate can be a leading indicator (see chart, prior page). Historically, when the unemployment rate crosses its 12-month moving average, a recession has almost always occurred shortly thereafter. The only meaningful exception was in the early 1960s when unemployment ticked up crossing the 12-month moving average but a recession did not occur. At this point, both lines are in a downward trend, and the change in unemployment indicator is not signaling a warning.

## Brace for More Stock Market Volatility

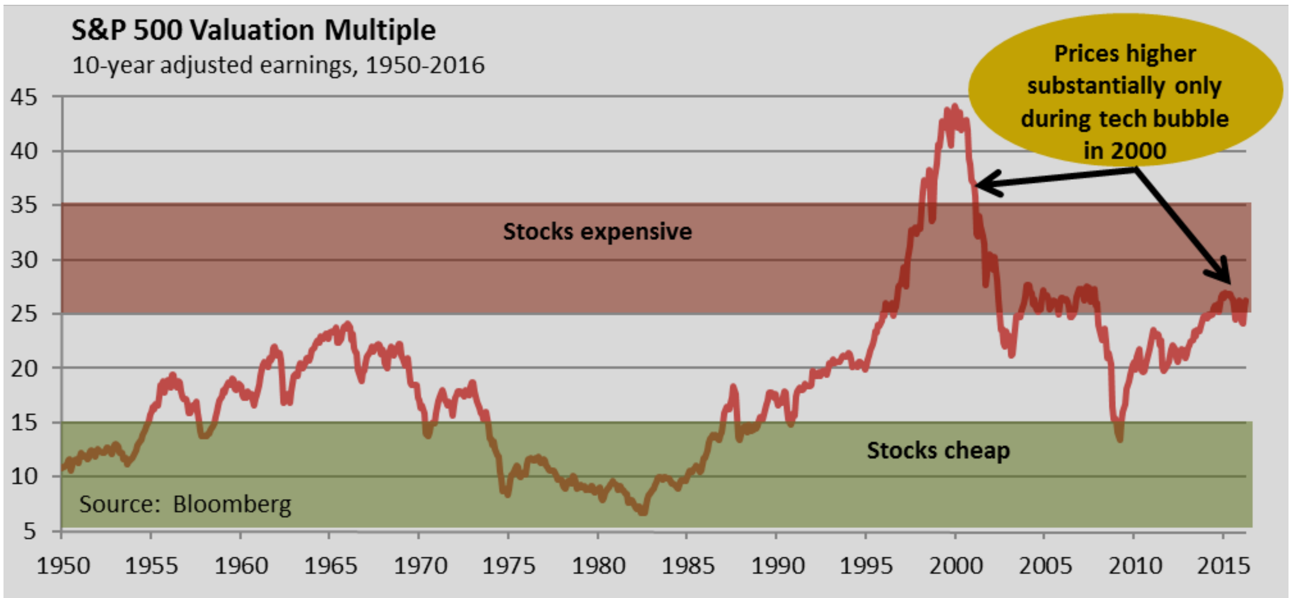
There are a lot of ways to measure stock market volatility, but one of the simplest is the number of days that stocks move by more than 1% (up or down). When markets are chaotic and uncertainty is high, the market anxiety can be seen in the number of days with big market swings. This is evident in 2008 during the financial crisis and in 2011 during the European debt crisis and fiscal cliff in the U.S.




After a four-year lull (from fall of 2011 to fall of 2015), stock market volatility has been increasing over the past six to nine months as worries about recession, oil prices and monetary policy influence stock prices. Current volatility is high compared to recent history, only exceeded by crises in 2008 and 2011. The start to 2016 was rough with almost two-thirds of trading days moving by at least one percent. Although this increased volatility was expected, it does not make it easier to stomach.

## Stocks are Expensive

There are many factors involved with valuing a stock or the stock market. The most basic method is based on a formula of **Price = Earnings x Earnings Multiple** (or P/E multiple). The earnings multiple, in this case the "P/E" or price-to-earnings multiple, represents how much an investor is willing to pay for earnings (profits). If investor expectations are relatively low, they might only pay 10 times profits, implying that the profits may not grow much or they have a low confidence since future profits are very risky. If investor expectations are relatively high, they might pay 30 times profits, implying they expect the company to increase profits substantially in the future and have a high confidence in that belief.




Viewed historically, stocks are somewhat expensive when the P/E multiple exceeds roughly 25, and stocks are somewhat cheap when the P/E multiple falls to below 15. The P/E in the chart above is based on a Robert Shiller calculation using ten years of adjusted earnings. The current measure of the Shiller P/E is over 26. Such a reading does not mean that stock prices cannot go higher, but it does imply that future stock market appreciation will need to be driven by the other part of the price formula above, i.e. earnings. If corporate profits do not improve meaningfully in the next year, it will be difficult for the stock market to generate positive results.

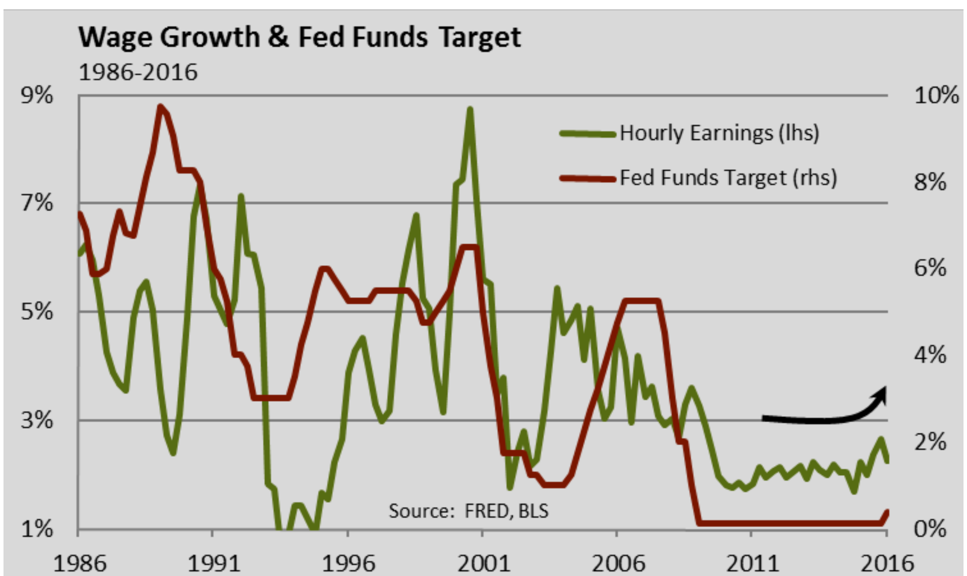
To be clear, this indicator is very poor at assessing the short-term direction of the stock market. It has no tactical value. However, this P/E multiple has a very strong negative correlation with returns over the next 10 years. When the Shiller P/E is high, long-run returns are low (and vice versa). This is perhaps another (more complicated) way of communicating that the "easy" stock market returns from 2009 to 2014 have already been realized. Future stock returns can be positive but not at the same pace we have seen since the financial crisis.

## Markets are Hyper-Sensitive to Central Bank Actions

For six years, monetary policy was very friendly to financial markets. The Fed kept interest rates low and pursued a new policy of "quantitative easing." That friendly environment changed recently, and markets have been hyper-sensitive to policy adjustments ever since.

Last summer, the Fed indicated that it would begin raising rates "soon," and markets revolted in August with a 12% stock market correction. The Fed eased off that path, allowing markets to recover. In December 2015, markets appeared braced for a rate hike, and the Fed finally pulled the trigger raising short-term interest rates by 0.25% and projecting four more rate increases for 2016. However, markets revolted again with another 13% stock market correction in January and February of this year. The Fed loosened its stance for more rate increases this year, and markets rallied back into positive territory for the year.

This environment puts the Fed in a tough spot. Many of the traditional central bank indicators are far from crisis levels, but Fed policy remains positioned for a crisis. The Fed has a dual mandate targeting both unemployment and inflation. The unemployment rate remains low at 5% while inflation (core PCE) is rising, at its highest level in three years, and approaching the Fed's target of 2%. Viewing traditional measures in isolation would clearly indicate rate hikes could come quickly. However, most other central banks continue to move in the opposite direction, creating a stronger monetary stimulus. Compounding the difficulty is global uncertainty ranging from China growth to oil prices to U.S. dollar strength. These global systemic risks seem to be more prominent in Fed policy statements over the past year.




So, what will the Fed do next? Looking beyond the headline indicators, wages have been strongly correlated with Fed controlled interest rates (see chart, above). This makes intuitive sense because wages represent a combination of both the health of the economy and future inflation expectations. Over the past year, wages increased at a pace higher than any time since the financial crisis. Unless other economic conditions deteriorate rapidly, it will be difficult for the Fed to avoid raising rates later this year (even as early as the June meeting). Regardless, whenever the next rate increase occurs, it may be destabilizing for financial markets.

## Weak Start to Year Leans to Caution

After last year's stock market correction in August and September, the market rallied significantly, almost reaching new all-time highs. This market strength seemed to fit with the tendency for markets to rally in the fourth quarter of the year. Stocks then slipped a bit in December, and the slide continued through January. Uncertainty was high in that period, driven by the Fed raising interest rates for the first time since 2006 and chaos in oil markets. The stock market finally bottoming on February 11th after a 13% decline.

This rough start to the year is not uncommon, but it does increase concerns about stock market performance during the remainder of the year. February is often a slow month during market advances, but market weakness this year was more widespread than expected, and winter weakness can be a cautionary signal. In the words of Edson Gould, "If the market does not rally, as it should during bullish seasonal periods, it is a sign that other forces are stronger and that when the seasonal period ends those forces will really have their say."

This tendency is evident in historical data. Stock market weakness in January and February often leads to choppy market conditions. Ned Davis Research performed a study of "weak starts" to the year (see table, right), defined as negative returns in the months of January and February. In the 18 cases of weak starts, 10 of the cases were negative (56%) and 5 of the 10 negatives were double digits.

Additionally, several of the largest positive "rest of year" returns were recoveries after bear market, recessionary declines (those periods were 1935, 1982, 2003 and 2009). Excluding those four years, the median "rest of year" return falls to -5.5% loss and 10 of 14 cases were negative (71%).

In our January commentary, it was noted that weak stock market years (those between positive 5% and negative 5%) are typically followed by strong gains in the following year. In the eight occurrences since 1950, each flat year was followed by a strong double-digit year.

There is potential that the "pause" of a weak year (2015) follows the historical pattern of positive results by year end. However, the poor start to 2016 calls into question how large of a gain can follow a weak 2015. A weak winter happens only one in five years, and indicates that lackluster (or negative) results may continue.

**Weak Starts**

S&P 500, 1926-2016

| Year | Jan & Feb Return | Rest of Year Return |
|---|---|---|
| 1935 | -8.0 | 53.7 |
| 1941 | -6.2 | -12.4 |
| 1948 | -8.5 | 8.6 |
| 1953 | -2.5 | -4.2 |
| 1957 | -7.3 | -7.6 |
| 1968 | -7.4 | 16.2 |
| 1969 | -5.5 | -6.2 |
| 1973 | -5.4 | -12.7 |
| 1974 | -1.4 | -28.7 |
| 1977 | -7.1 | -4.7 |
| 1978 | -8.5 | 10.4 |
| 1982 | -7.7 | 24.3 |
| 1984 | -4.8 | 6.5 |
| 2000 | -7.0 | -3.4 |
| 2002 | -3.6 | -20.5 |
| 2003 | -4.4 | 32.2 |
| 2008 | -9.4 | -32.1 |
| 2009 | -18.6 | 51.7 |
| 2016 | -5.5 | ?? |
| **Median** | **-7.4** | **-3.8** |

Source: Bloomberg

Interestingly, over the 15-year period from 1985 to 1999 (the strongest stock market in history), there were zero weak starts to the year. Over the next 16-year period from 2000 to 2015, there were five weak starts, roughly one in every three years. That secular change reiterates how volatility is different than the past and how important active management of portfolios can be.

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](http://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


IMPORTANT DISCLAIMERS

This letter represents a general economic outlook of this firm and does not constitute specific investment advice, nor should it be considered assurance of any future market performance. Our views on markets, investments, and portfolios change as new information is available. Past performance is not indicative of future results. The discussion above reflects the changes in investments made for most but not all of our managed accounts at the time(s) shown above. The Seasonal Strategy used by RIS cannot in and of itself be used to determine which securities to buy and sell, the amount to buy and sell, or when to buy and sell them for an individual account because client objectives differ. Losses can occur by using any investment strategy, including RIS's Seasonal Strategy.

**The discussion above and elsewhere in the commentary reflects the changes in investments made for most but not all of our managed accounts at the time(s) shown above. The strategies used by RIS cannot in and of themselves be used to determine which securities to buy and sell, the amount to buy and sell, or when to buy and sell them for an individual account because client objectives differ. During this period, some clients lost money and others gained. Factors such as specific securities price movements, timing of investments, the amounts invested and withdrawn, cyclical and market trends, client growth or conservative objectives, economic conditions, interest rates and other factors all influence performance materially. For these reasons, the charts and commentary should not be considered the performance results of RIS or any RIS account. Losses can occur by using any investment strategy, including RIS's strategies. Past performance is not indicative of future results.

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.