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2015 YEAR-END REVIEW AND OUTLOOK FOR 2016

2015 began with a minor stock market decline, but stocks stabilized in February and traded in a very narrow range with little volatility throughout the spring and early summer. Then in August, a sharp correction began and the S&P 500 Index declined approximately 12%, while the Dow Jones Industrial Average fell 15% in a very short period of time. Stocks generally recovered most of their losses in October, but another abrupt sell-off occurred in mid-December after the Fed announced the first interest rate increase in over nine years. Although many market analysts attribute this additional late-year volatility to the Fed's interest rate hike, it is also likely that many hedge funds and money managers were liquidating stocks near year-end to meet redemption requests from disgruntled shareholders. Oftentimes, at the end of a difficult year for stocks, investors redeem their funds from managers and mutual funds that have underperformed significantly. Additionally, in a tumultuous year for stocks, many investors liquidate underperforming investments near year-end to lock in capital losses for tax purposes. Although it could have been worse, last year U.S. stocks had their worst annual performance since 2008, with the Dow Jones Industrial Average finishing the year down 2.20% and the S&P 500 Index losing .73%. The Barclays Intermediate U.S. Government/Credit Index gained 1.07% in 2015 as bond market returns were generally flat during 2015.

While the major U.S. stocks market indices, such as the S&P 500 Index and the Dow Jones Industrial Average, ended the year with losses that seem relatively minor, the broader U.S. and global stock markets performed worse than these popular market indices indicate. For example, many small company, mid-size company, and foreign company stocks were down sharply in 2015. In addition, stocks in many industries such as energy, utilities, transportation, and commodities saw significant declines. The main reason for the discrepancy between the performance of popular indices like the S&P 500 Index and the broader stock market is that not only does the S&P 500 represent mainly large company U.S. stocks, but it is also a market-weighted index. This means that the performance of the index is influenced more heavily by the largest companies in that index. In 2015, a handful of the largest stocks in the index such as Facebook, Amazon, Netflix, and Alphabet (formerly Google), performed extremely well, which masked weakness in many other stocks.

Much of the reason for the poor performance of many stocks during 2015 was due to anxiety and uncertainty regarding the Federal Reserve Board's first interest rate increase in over nine years. The Fed stopped printing money in late 2014 and began discussing the possibility of raising interest rates throughout 2015 before actually raising interest rates by 0.25% on December 16. Low interest rates have been one of the primary reasons that the stock market had performed well from 2009 through 2013. By keeping interest rates extraordinarily low, investors had no choice but to allocate more money to stocks in search of higher returns. Similar low interest rate policies led to bubbles in technology company stocks in the late 1990s and in real estate just prior to the financial crisis in 2007-2008. These bubbles burst when interest rates began to rise, leading to significant declines in asset prices and economic problems. Traders now fear that raising interest rates could lead to another major decline in asset prices, especially if the Fed raises interest rates too quickly and too often. This is because when interest rates rise, investors will be able to obtain better returns in alternatives to stocks such as bonds, CDs, and money market accounts and they may transfer funds out of the stock market in order to do so.

An additional problem with the Fed raising interest rates too rapidly is that many foreign central banks are still in the process of lowering interest rates and printing money. This divergence between tightening U.S. monetary policy and loosening foreign monetary policies can create uncertainty, dislocations, and volatility in the financial markets. Also, raising interest rates could further strengthen the U.S. dollar, which would likely harm U.S. corporate earnings. Finally, higher interest rates could also damage the economy by making it less affordable for consumers to borrow money to buy homes and cars.

Another concern that led to market volatility in 2015 was the major decline in the price of oil. Investors have been concerned that oil prices have been declining due to a lack of global demand for energy by consumers and corporations. If this lack of demand is due to rapidly declining global economic growth, this could lead to lower corporate profits on which stock prices are based. Energy stocks were hit particularly hard in 2015 as their revenues declined due to the drop in oil prices, which harmed their profits.

This decline in oil prices negatively impacted the corporate bond market during 2015 as well. Due to the rapid growth of the energy industry in the U.S., many energy companies borrowed a lot of money by issuing bonds to grow their businesses. When oil prices declined and profits of energy companies declined as well, investors became concerned that these companies may no longer be able to make the interest payments on their bonds and they could potentially default. This fear of reduced income and potential defaults led investors to sell bonds issued by companies in the energy industry. It also led to concerns that the same problems could occur with other risky bonds issued by companies in other industries.

Our outlook for 2016 is that the Fed is going to be very sensitive to these concerns regarding global economic growth and the potential for significant declines in stock, bond, and real estate prices if they raise rates too rapidly. Therefore, it is not likely that the Fed will raise interest rates dramatically this year. Furthermore, the Fed does not want to be blamed for harming the economy by raising interest rates too aggressively during an election year. Even if the Fed raises interest rates several times in 2016, interest rates should still remain near historic lows. This would not yet provide significant competition for stocks from fixed income investments like bonds, CDs, money market funds, etc.

Typically, major market declines occur when the U.S. economy is heading into recession and a recession is not expected this year due to an improving labor market, low gas and energy prices, and continued relatively low interest rates. We will be more concerned about a significant, long-term bear market developing in the future if a recession develops in the U.S. or if the Fed is forced to raise rates aggressively to ward off inflation. However, inflation is not a concern at this time and is not likely to become a concern this year. Finally, it is also likely that global economic conditions will improve in 2016 as concerns about the economic problems in Greece, China, Japan, and other countries subside. Consumers are likely going to spend more this year than last year as low oil prices provide families with more capacity to spend money on other items.

If the broader stock market gains momentum in 2016, we may want to allocate more of our clients' equity portfolios to small company, mid-size company, and foreign company stocks. We also recommend continuing to invest the fixed income portion of portfolios primarily in short-term bonds to reduce interest rate risk. In the meantime, please call us if you have any questions or concerns regarding your investments or the financial markets in general.

** Index returns were obtained from the Wall St. Journal and Barclays on January 2, 2016.*

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