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FIRST QUARTER 2016 ECONOMIC AND FINANCIAL MARKETS REVIEW

The stock market volatility that began last summer intensified at the beginning of this year. The major causes of this volatility were fears regarding a potential global economic recession, plunging oil prices, and concerns that the Federal Reserve Board will raise interest rates more aggressively than previously indicated. Some analysts also attributed this volatility to worries about global currency divergences, concerns regarding the stability of major U.S. and foreign banks, and an uncertainty surrounding the contentious election season. Despite these fears and the early-year stock market plunge, the stock market rallied in late February and March as investors became confident that none of these issues would lead to an imminent dire economic situation. As a result, the S&P 500 Index ended the quarter up 0.8%, while the Dow Jones Industrial Average finished up 1.5%. The Barclays Intermediate U.S. Government/Credit Bond Index gained 2.45% during the first quarter of this year.*

After raising interest rates last December for the first time in nine years, an influential Federal Reserve Board member indicated in early January that the Fed's intent was to raise interest rates four times this year. These comments spooked stock market investors who were not expecting the Fed to raise rates this aggressively. They feared that the economy was not strong enough to withstand several interest rate increases in a short period of time. Raising interest rates too rapidly could harm the U.S. economy by increasing the cost of borrowing for consumers and businesses. It would also encourage investors to consider investing in higher-yielding fixed-income investments rather than stocks.

At the same time the Fed was contemplating multiple interest rate hikes in the U.S., the global economy was showing signs of deteriorating. This led many foreign countries' central banks to lower interest rates, with some countries even adopting negative interest rate policies. The disparity between tighter monetary policy in the U.S. and easier monetary policy by foreign central banks had led to fears that the U.S. dollar would strengthen further against foreign currencies, thereby creating headwinds for U.S. corporate profits. Luckily, the Fed backed away from its comments about raising interest rates at the speed that they initially telegraphed earlier this year and the U.S. dollar has stabilized versus foreign currencies.

One country that has been lowering interest rates and devaluing their currency in an attempt to stimulate their slowing economy is China. Investors have been worried that the Chinese economy has been slowing much more rapidly than the Chinese government has been indicating. This has led to fears that Chinese economic problems could begin to negatively impact U.S. economic growth. Fortunately, the Chinese government seems to have calmed economic fears by implementing new stimulus plans to stabilize their economy without devaluing their currency as they did last fall.

An additional concern for the global economy had been the sharp decline in oil and other commodity prices. Investors had been partially blaming the decline in oil prices on reduced global demand as a result of slowing global economic growth. Lately, however, investors are beginning to realize that oil prices had been plunging not due to a lack of demand, but rather due to excessive supply. Also, as a result of extremely low oil prices, investors feared that large U.S. banks could become insolvent due to significant defaults on loans that they made to energy companies that are now suffering losses. Fortunately, it appears that major global banks do

not have as much exposure to oil company losses as was originally thought. Ironically, despite all of the recent concerns regarding economic growth, interest rates, currency fluctuations, oil prices, and the banking system, the global economy could actually benefit greatly in the coming months as additional monetary stimuli and low energy prices provide additional funds for consumers and corporations to spend.

Despite the recent stock market rally, the major market indices are still below where they were last May, and the trend for many stocks has been down over the last eleven months. Furthermore, while the S&P 500 Index and the Dow Jones Industrial Average were only down approximately 15% at their worst levels, many stocks and stock indices declined even further. For example, at its worst level, the Russell 2000 Index of small company stocks was down approximately 25% and the MSCI ACWI Index, which represents global stocks, was down approximately 20%.** The extreme volatility and lack of positive market breadth during rallies have been characteristic of what is known as a bear market.

The good news is that it appears that the worst of this bear market could be behind us. Historically speaking, this bear market has been milder than the most severe bear markets because it has not been accompanied by a recession or financial crisis. The stock market was vulnerable to a decline for quite some time because it became overvalued due to the extremely accommodative monetary policies implemented by the Fed in 2008. Stocks are now more reasonably valued than they have been in a long time. While the stock market may remain volatile during this controversial election year, particularly if oil prices remain unstable, a new bull market will eventually begin. Therefore, we are currently looking for new investment opportunities for growth-oriented investors and we may want to allocate more money to more aggressive parts of the stock market, such as small company stocks, if we see further confirmation that the bear market has ended.

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 April 1, 2016.*

*** Information was obtained from Ned Davis Research and Russell Investments.*

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