Newman Dignan & Sheerar
INVESTMENT ADVISORS

ECONOMIC & CAPITAL
MARKETS REVIEW
NEWMAN DIGNAN & SHEERAR, INC.

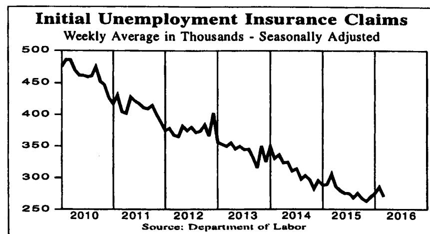
Fed Trumps Market Anxiety

1st Quarter 2016

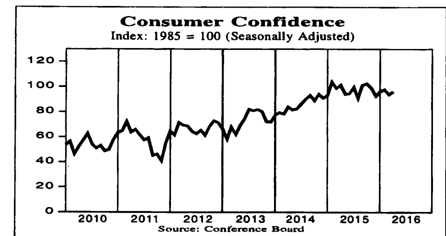
ECONOMY & MARKETS

Markets in the first quarter were about as wild as Donald Trump's hair on a windy day. The first six weeks of the year set records for being one of the worst starts to any year for the S&P 500. Naturally, and right on cue, investor anxiety rocketed higher with calls for the end of the world. But alas, the Fed came to the rescue, and the final six weeks of the quarter erased all of the earlier losses for the year. Since its low of 1810 in early February, the S&P 500 rallied 13.7% to close the quarter with a slight gain. Perhaps the quarter's depressive-manic behavior was simply an overreaction and follow-on to last summer's market correction. Once again, market corrections are always temporary and the long-term advance of the market is permanent.

In the first quarter of 2016, the **DJIA** moved ahead by 1.5% while the **S&P** inched higher by 0.8%. The **NASDAQ** lost 2.7% for the quarter due to a sell-off in tech shares. International markets lost ground as the **EAFE** Index gave back 3.7% during the quarter. Bond returns were good as the Barclay's Aggregate **Bond Index** gained 3.0% for the quarter on a flight-to-safety into U.S. bonds. It continues to amaze us how willing investors are to purchase treasuries at today's low rates.



Domestic economic news continues to gradually improve. Low oil and gasoline prices, tame inflation, **lower jobless claims** *(see chart above)*, higher average hourly earnings, strong auto sales, improving manufacturing, and rising home prices are all contributing to encouraging **consumer confidence** *(see chart below)*. Increased consumer confidence, however, has not been able to jump start consumer spending despite slightly higher personal income. We are, however, beginning to signs of improvement in building materials, healthcare, technology, clothing and sporting goods.

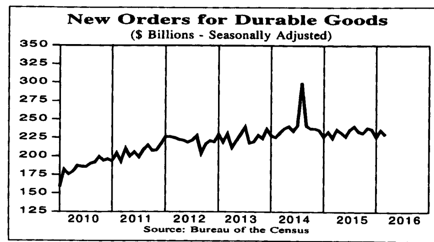


The March **ISM Manufacturing Index** number was better-than-expected at 51.8 (up from 49.5 in February). A number above 50 indicates growth. It appears that manufacturing is finally showing some signs of life. Also encouraging was the March **ISM Services Index** as it beat expectations and came in at 54.5. Comments from the Institute of Supply Management were generally positive – *"The majority of respondents' comments indicate that business conditions are mostly positive and that the economy is stable and will continue on a course of slow, steady growth."*

February **New Home Sales** *(see chart above)* totaled 512,000 – slightly ahead of estimates of 510,000. The median price rose 2.6% year-over-year to $301,400. A robust housing market is a good indicator of an improving economy.

Durable Goods Orders *(see next page)* are a bit troublesome. February's 1.8% month-over-month drop was disappointing - especially compared to an expected 0.5% drop. This poor showing will, no doubt, lead to downward

revisions in first quarter GDP. An improvement in durable goods orders is necessary for an improvement in the economy's overall final demand. We'll be watching this.



OUTLOOK

... expect continued volatility

Bottom Line – We have repeatedly cautioned investors to expect continued volatility in the markets. Nothing has changed … stay buckled-up and ignore the headline news.

First quarter earnings will likely be a source of volatility for the markets. According to FactSet, first quarter earnings for S&P 500 companies are expected to decline 8.5% year-over-year. This would mark the fourth consecutive quarter of slowing earnings. The good news is that lackluster quarterly earnings are already expected by the markets. Volatility, of course, will result from earnings being better or worse than expected … we'll see. Fortunately, earnings for S&P 500 companies begin to look better as the year advances due to easier year-over-year comparisons.

The ongoing drama in our polity will no doubt add to market uncertainty, but it should not be market moving. Of course, there will be pundits postulating about who is better for the markets, but there is nothing that anybody can do except to vote.

Gradually improving

Economic conditions are gradually improving, and we expect the markets to wobble along for the next quarter or so. The fact that investor skepticism remains high gives us confidence that a major market correction is unlikely any time soon. An overly exuberant investor climate would give us more cause for concern.

Market valuations are not exactly cheap, but low interest rates and low inflation should allow markets to trade at higher-than-average valuations. According to FactSet, the S&P 500 trailing price-to-earnings ratio is 18.2 versus its 10-year average of 15.8. Against 2016 consensus estimates of $120.64 for the S&P 500, the market is trading at 17X. With the economy, valuations and sentiment in the not-so-bad camp we see the Fed as the likely culprit for any market surprises over the next few quarters (barring a Brexit or any horrible terrorist event like Brussels). Recent dovish comments from the Fed seem to indicate just one or two rate increases this year (as opposed to four that were anticipated at the beginning of the year). A more hawkish tone by the Fed could send markets into a short-term pullback/correction, but remember that they will raise rates only if the underlying economic conditions are improving.

Bond prices should fluctuate widely over the next few quarters as chatter about the next Fed rate hike intensifies. We anticipate keeping average durations in the short-to-intermediate range. Low rates will likely persist for longer than usual given negative rates overseas (yield-starved investors from around the world will purchase U.S. treasuries to grab at least some positive yield). Five central banks around the world already have negative rates – Denmark, Sweden, Switzerland, the Eurozone and Japan. Yield purgatory will be around for a while. Be careful of stretching for yield.

Small and mid-cap equities still add value to an overall asset allocation strategy, but we remain underweight as valuations appear fully priced. We continue to be sanguine on *international equities* – both *developed* and *developing,* given relatively attractive valuations and yields. Again, we believe that *large-cap companies with higher quality attributes* should continue to provide better-than-market returns (valuations are a bit stretched, but they provide predictable growth and dividends). We like companies with excellent dividend growth potential *(not necessarily just high dividend yields)*. *Commodities* offer investors some protection from potential inflation and dollar weakness. *Alternative assets* will continue to provide good risk-management for portfolios ... particularly in an environment of increased volatility.

We suggest that investors maintain a fully diversified portfolio consistent with one's longer-term objectives and risk tolerance. ***Happy Spring!***

Corrections Come and Corrections Go …

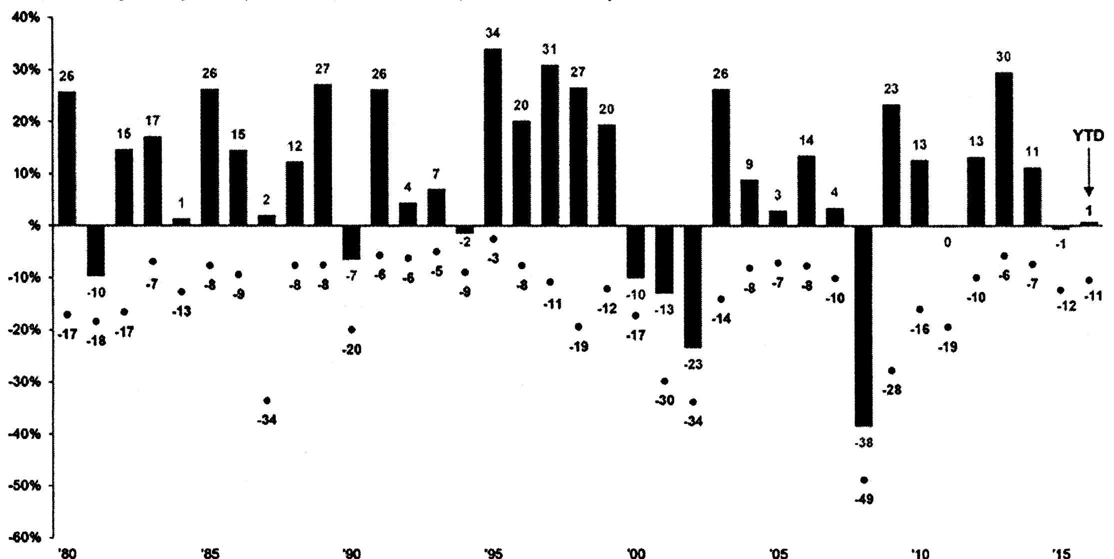
In the last 8 months investors have experienced two “corrections” - defined as a decline in the market of 10% or more. Until last summer, the markets had not experienced a correction since September of 2011 when the US creditworthiness was downgraded from AAA, so it is no wonder that investors feel a bit whip-sawed. As you can see in the chart below, on average, the market has experienced an intra-year decline of 14.2% since 1980. If you were following the markets at all in mid-February, you would have been asking yourself could the market go down even farther and are we headed for a bear market (a closing low 20% or more below the previous market peak). What followed was a 6 week rally where the S&P 500 finished slightly above where it began the year.

… proven to be temporary

Looking back through history, market “corrections” happen on average once a year. Bear markets are not so frequent (fortunately!), but they do happen on average about once every five years. According to BTN Research, the S&P 500 has experienced 11 bear markets since the end of WWII. Bear markets are exceedingly difficult to predict/time with any consistency, but what we can tell you is that every “bear market” or “correction” has proven to be temporary. Every correction/bear market has not only found a bottom, but they have also gone on to new highs at some point in the future. We have no reason to believe these recent corrections will be any different.

Every investor in the stock market must understand and be willing to accept the inherent volatility in the markets. As the chart below shows, one year returns have been positive 75% of the time, with dividends adding 2% more. History has shown that the patient investor is usually rewarded.

In other words … *Stay the Course*



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2015, except for 2016, which is year to date.
Guide to the Markets – U.S. Data are as of March 31, 2016.

Mixed results ↪

1st QUARTER 2016 SCOREBOARD

Index	Close	1st Quarter % Change	Year-to-Date % Change
DJIA	17685.1	1.5	1.5
S&P 500	2059.7	0.8	0.8
NASDAQ	4869.8	-2.7	-2.7
Russell 2000	1114.0	-1.9	-1.9
MSCI EAFE	1652.0	-3.7	-3.7

3 Month T-Bill	0.21%	Fed Funds Rate	0.25% - 0.50%
5 Year T-Note	1.21%	Prime Rate	3.50%
10 Year T-Note	1.77%	Gold	$1234.20
30 Year T-Note	2.61%	Oil	$38.34

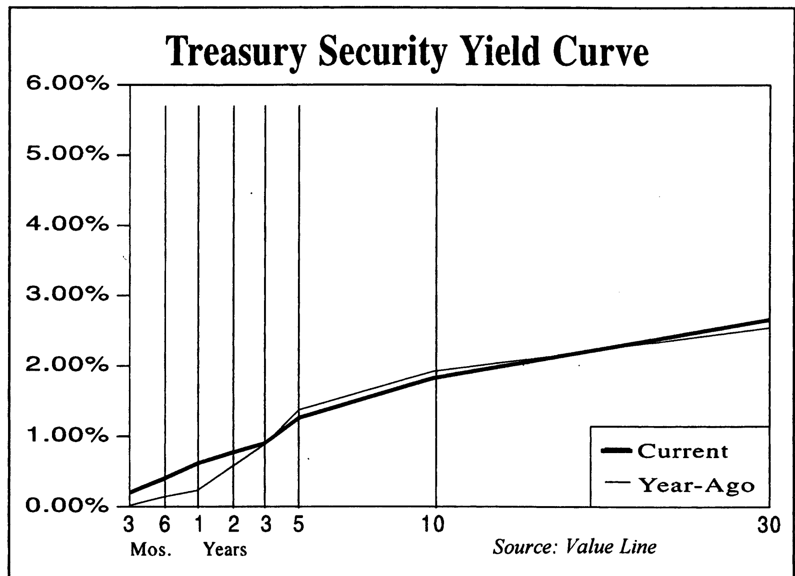
Index returns are price only

Oil up 3.5% in 1st qtr

Gold surges 16% YTD

Still time to re-fi

Lower for longer ↪



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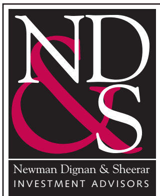

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