ROOF ADVISORY GROUP, INC.®
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

INVESTMENT INSIGHT
4th Quarter Review

Divergence

Market Update

While we did not end the year with a “Santa Claus Rally”, equity markets did post solid gains in the fourth quarter and largely recovered from the declines experienced in the previous quarter. The S&P 500 Index posted a fourth quarter advance of 6.5% while developed international markets were higher by 4.4%. Despite the first interest rate hike in nine years, interest rates moved only marginally higher during the quarter. Given the slight uptick in interest rates, the U.S. Barclays Aggregate Bond Index declined by 0.6% in the fourth quarter.

Bonds outperformed stocks in 2015 with the U.S. Barclays Aggregate Bond Index posting a 0.6% gain while the S&P 500 Index registered a decline of 0.7%. International and global stocks lagged domestic equity markets in 2015 with the MSCI EAFE Index (developed international stocks) declining by 3.3% and the MSCI All Country World Index (global stocks) falling by 2.1%.

While these are obviously not results to get excited about, the resilience of the stock market has been impressive. A quick review of some of the 2015 challenges/issues/concerns is warranted and includes – a collapse in energy and commodity prices, fears of a “hard landing” in China, a narrowly averted debt default in Greece, multiple terrorist attacks, a 10% rise in the value of the U.S. Dollar currency which negatively impacted corporate profit growth, concerns over the implications of interest rate hikes, a decline in corporate earnings growth, optimistic equity valuations, the first 10%+ equity market correction in four years, and a “flash-crash” in August where the DOW Index plunged by 1,100 points. This list could be expanded upon but given all of the hurdles the market faced in 2015, flat was certainly not the worst possible outcome.

Divergence Detailed

What was remarkable about 2015 is how quickly equity markets bounced back and forth between enthusiasm and panic. In fact, records were broken for the number of times the S&P 500 oscillated above and below the unchanged line for the year. The explanation for investors’ lack of conviction and the stock market’s lack of direction could be summed up by one word – “divergence”. Below we outline a number of examples of divergence in economic data, market returns, and monetary policy that kept investors guessing in 2015.

Global Central Bank Policies

- In a vote of confidence for the strength of the U.S. economy, our central bank raised interest rates in December for the first time in nine years.
- However, many central banks outside of the U.S. are continuing and/or increasing stimulus efforts in order to boost flagging economic growth.

U.S. Economic Data

- The services side of our economy (which represents 88% of activity) remains in good shape, evidenced by solid consumer spending, auto sales, and new homes sales.
- However, U.S. manufacturing (only 12% of activity) has weakened in the second half of the year and has recently moved into contraction territory. Exports have also been trending downward as the strength in the U.S. Dollar has made our goods more expensive to foreign consumers.

Corporate Profits

- While the final tally of 2015 corporate profit growth has not been calculated, the end result will not be very impressive. Corporate profits for companies included in the S&P 500 Index are expected to have contracted by roughly 0.5% compared to 2014. But the results have been extremely bifurcated. Some sectors such as healthcare, financials and consumer discretionary have registered solid double-digit earnings growth.

- However, with the collapse in commodity prices, the energy and materials sectors are expected to post significant declines in earnings of -60% and -8% respectively.

Individual Stock Performance

- While the overall return of the S&P 500 Index was generally flat, there was also a dramatic division of returns among the stocks that constitute the index. There were some star performers, mainly “high-flying” technology stocks that helped to lift the overall index return.
- However, a significant portion of the S&P 500 stocks ended the year with returns firmly in negative territory. Roughly 21% of the stocks in the index declined by more than 20% and approximately 35% of the index components dropped by more than 10%. Many once considered “blue chip” stocks were (to use a technical term) “taken out behind the woodshed” in 2015. To give a few examples, here are the 2015 returns for a number of well-known components of the S&P 500 Index – Alcoa -37%, Macy’s -45%, Michael Kors -47%, Staples -45%, Wynn Resorts -51%, Kinder Morgan -60%, Chesapeake Energy -76%.

Employment

- The unemployment rate has continued to decline and now stands at only 5%. Monthly additions to the payrolls averaged a very healthy 210,000 for the first 11 months of the year and were even slightly stronger in the first two months of the fourth quarter. The amount of job openings stands at 5.4 million, the highest level in 15 years. In addition workers are finally seeing some growth in wages. These are all very positive signs for a strong consumer going forward.
- However, the labor force participation rate is trending downwards and stands at a 38-year low as unemployed people who couldn’t find work have become even more discouraged, lost their skills and dropped out of the labor force indefinitely.

Global Growth

- The U.S. economy continues to expand moderately. The recovery in the Eurozone seems to be gaining some traction and the Japanese economy has returned to growth after multiple quarters of contraction. While below trend, growth in the developed world is positive.
- However, emerging market economies are slowing. China’s GDP growth rate has declined from an average of over 10% during the past 25 years to more like 6%-7%. Energy exporting nations such as Brazil, Russia and Venezuela are experiencing measurable GDP declines and significant economic stress.

We could go into more detail in regards to the divergence theme but these examples help to explain the volatility and lack of a clear trend in many asset classes in 2015.

Portfolio Positioning

We ended the year with our equity allocation slightly above the mid-point level across Investment Policies. This represents a modest increase in equity exposure compared to the end of September as we did some selective buying in the quarter. Our current stance still reflects some conservatism but is also slightly biased towards equities which we view as more attractive than fixed income as we enter 2016 as well as for the long term.

Our fixed income allocation remains diversified across strategies, some higher yielding and more economically sensitive strategies, balanced by more conservative approaches with the objective of capital preservation. Short duration or limited sensitivity to interest rate movements remains a key theme in our fixed income allocation. We view this positioning as appropriate in an environment where the Federal Reserve has started to and will likely continue to hike interest rates.

Performance Attribution

With the majority of equity indices finishing 2015 flat or in negative territory and bonds providing only fractionally positive returns, the environment left little room for victory laps or pats on the back. We are encouraged that the majority of our individual stocks and the majority of our mutual funds and ETFs outperformed the broad equity market. In addition, several of our fixed income strategies, especially preferred stocks, significantly outpaced broad bond market returns. Even more important were the asset classes and pitfalls that we avoided in 2015. Many asset classes that are generally accepted to be components of well diversified portfolios experienced significant declines. Emerging market stocks declined 14.6%, commodities as a group declined 24.7%, gold declined 10.44%, the broadest hedge fund index declined 3.5%, and even the long maturity investment grade corporate bond index declined 4.61%. While positive returns were difficult to come by in 2015, opportunities for significant erosion of investors' capital were plentiful. Sidestepping any meaningful exposure to these areas of measurable stress was a positive outcome.

Closing Thoughts

When looking forward to 2016, a scene from one of our favorite movies seems to sum up our thoughts fairly well. In the 1989 film "Field of Dreams" a small town doctor in the twilight of his career is cosmically granted a lifelong wish and travels back in time where he is in his prime and gets the opportunity to square off against a big league pitcher. As the grizzled veteran pitcher winds up for the first pitch, the cocky young slugger gives him a wink. The wink does not go over well and after receiving two fastballs aimed squarely at his head, the rookie is visibly shaken up. His coach calls a time out to settle his nerves and to help him focus on the next pitch. The coach calmly attempts to prepare the hitter by asking him what type of pitch he anticipates next. The anxious young batter cautiously responded that after the two previous "high and tight" fastballs that brushed him back from the plate, his base case assumption was that he expected the next pitch to be "low and away" but he also recognized there was a possibility that it could end up "in his ear".

Our base case for 2016 includes expectations for moderate global growth, a return to corporate earnings growth, low inflation and for a slow and gradual rise in interest rates. These constructive views seem to be fairly congruent with the consensus thinking of Wall Street strategists who are forecasting equity market returns in the 7% range for 2016. Of course only time will tell but we view these return forecasts as reasonable. It is difficult to get excited about the fixed income markets with bond yields at historically low levels and the process of normalizing interest rates now underway. While we still view fixed income as an essential component of well diversified portfolios, expectations for returns in excess of the bond yields are probably too optimistic.

Similar to the batter in "Field of Dreams" we are also aware of and focused on the possibility of an outcome different than our base case assumption. Geopolitical events, negative effects from the commodity collapse, a further contraction in emerging market economies, as well as the myriad of divergence themes we outlined are risks that we will monitor closely in the New Year. While it is easy to become frustrated in the wake of a year where performance was largely driven by macroeconomic headwinds and uncertainty, it is important for investors to remember to stay invested for the long run and that these storms are best weathered with a diversified portfolio.