# Investment Briefing

Fourth Quarter 2015

# Introduction

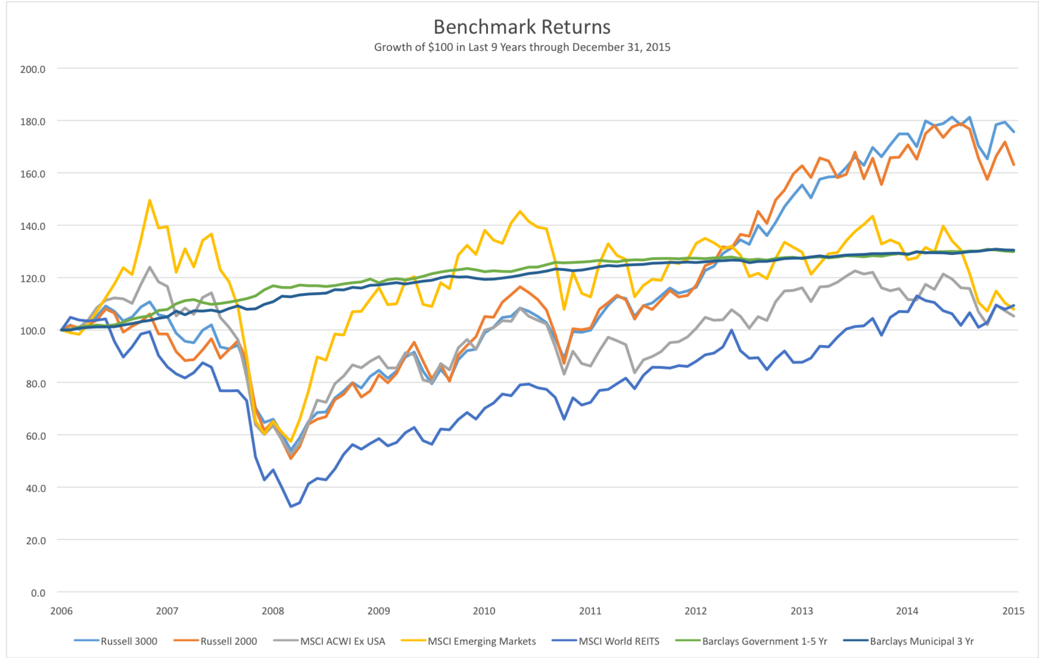
Every year, the Wall Street Journal polls prominent economists and market masters, asking where they predict the S&P 500 will be at the end of the next year.

The 22 respondents for 2015 predicted, on average, an 8.2% return for the year. As the table below shows, the actual return was 1.38%. By the way, the individuals predicted returns ranging from a high of 14.1% to a low of 2.0%. Such precision, with inspiring assurance of intelligence and foresight. If only one of them had been right.

As shown below, although the fourth quarter had the best performance, the full year of 2015 was mostly flat. The quarter's best performer was Real Estate Investment Trusts, while the worst was bonds because of the rise in interest rates. Looking out to 10 years, the U.S. stock market holds the prize for the best, with international developed stocks now being the laggards.

| Asset Class * | 4th Quarter | 12 Months | 5 Years (annualized) | 10 Years (annualized) |
|---|---|---|---|---|
| U.S. Stocks (Russell 3000) | 6.27% | 0.48% | 12.18% | 7.36% |
| International Developed (MSCI All Country World ex U.S.) | 3.24% | -5.66% | 1.06% | 2.92% |
| Emerging Markets (MSCI EM) | 0.66% | -14.92% | -4.81% | 3.61% |
| Real Estate Investment Trusts (MSCI World | 6.30% | 2.24% | 9.30% | 3.45% |

| Asset Class * | 4th Quarter | 12 Months | 5 Years (annualized) | 10 Years (annualized) |
|---|---|---|---|---|
| REITs) | | | | |
| Taxable Bonds (Barclays 1-5 Yr Gov) | -0.65% | 0.93% | 1.23% | 3.06% |
| Municipal Bonds (Barclays Muni 3 Yr) | -0.01% | 1.18% | 1.81% | 3.01% |




* Return data and charts are from Morningstar Direct and BCA Research.

# U.S. Markets: We're Good, Let's Raise Rates!

The markets seem to be like an old car that makes a trip from San Francisco to Reno.

It starts out fast and strong, but later slows down to a crawl as it reaches the mountains, which eventually feel unconquerable. The dashboard begins to light up with unintelligible symbols flashing in orange while the car continues to lose momentum. Eventually the car's electronics push it into “limp mode." Is this where our economy is today? When we look at the U.S. markets, it may seem so. However, the Federal Reserve raised rates in December, a move typically used to slow down an economy. Isn't this the same as if we applied the brakes to our struggling car in the Sierras? Why slow down a struggling economy?

To understand, we'd better back up and explore the story in more

detail. The financial crisis, which began more than seven years ago, was what many refer to as a “balance sheet recession" meaning that our economy's debts had become unsustainably high. Once debt hits a certain level, it becomes a very slow and difficult task to pay down. Some are forced to give up and declare bankruptcy. While our economy didn't go bankrupt, it was so overburdened that it has struggled to recover. This recovery, although essentially long and steady, has been weak. It has taken a long time for unemployment to drop and there are still more long-term unemployed people than there should be. While consumers have done a nice job of paying down debt, government debt has remained high.

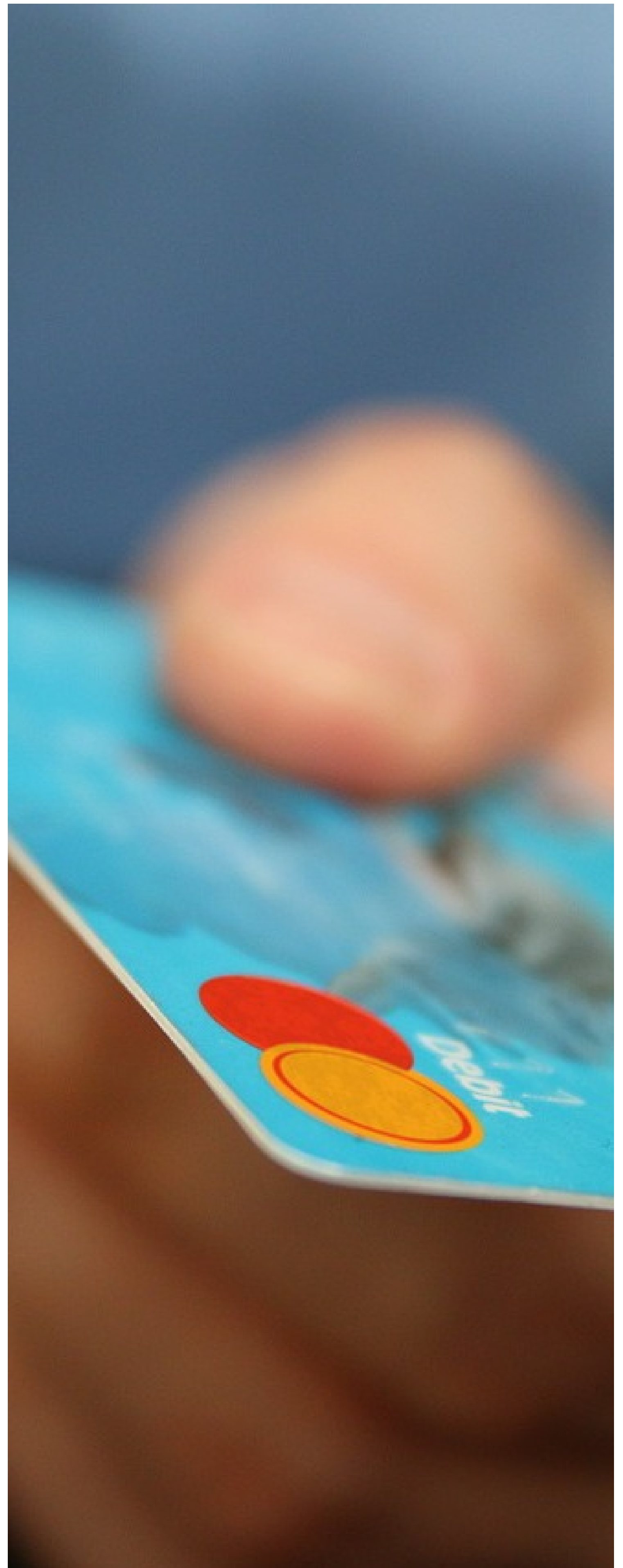
We don't really consider the Fed's rate rise from 0% to 0.25% as hitting the brakes in our uphill ride, but more like just taking the foot off the gas pedal and letting the car idle on its own. At 0.25%, the Fed is still considered to be accommodative to a struggling economy. Keep in mind, however, that every time the Fed has become less accommodative, the stock market has shuddered (e.g. the “taper tantrum" in August 2013). With the Fed talking of more rises in 2016, stocks could have a rocky ride.

As regular readers of this missive know, we don't attempt to contribute to the dim idea of predicting markets. We would rather keep our portfolios' tilts toward value stocks and stocks of smaller companies, where research reveals better performance than the overall market over time. We should still keep in mind, however, that since the U.S. market has been fairly valued for awhile and earnings growth has been weakening, price growth at this time may be a tall order. Historically, it is at times like these that the value style of investing tends to perform comparatively well.

Growth stocks have tended to be the star performers since the financial crisis. Some of the factors contributing to their comparative success have likely been sales and earnings growth which was a result of very accommodative Fed policies. As the Fed's policies continue to shift and earnings weaken, it is likely that at some point value will once again assume its winning role.

# International Developed Markets: We’re Slow, Let’s Pump More Money!

This quarter certainly wasn't wanting for news events outside the U.S.




There were both negative and positive items:

- China revealed that growth dropped below 7% (to 6.9%) in the third quarter. Some experts, who don't believe the Chinese government's figures, have estimated real growth was closer to 3%.
- Standard & Poor's warned that China's large state-owned firms' creditworthiness worsened over the last few months.
- Consumer prices in the

Eurozone declined (by 0.1%), bringing deflation back to the headlines.

- Germany's exports declined by approximately 5%, probably due to the slowdown in China.

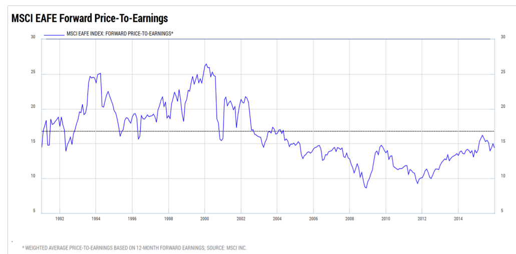
- Greece's parliament approved a bill to recapitalize her banks using private funds, instead of the euro zone's rescue fund.

- The Japanese government sold Japan Post (its post office/savings bank) in the largest initial public offering ever, raising over $12 billion dollars (yen equivalent).

Yet, despite all of this, international stock markets were usually the quarter's best performers, in local currency terms. To give you an idea of what the approximate numbers were, while U.S. stock returns ranged from 3% to 7%, international stocks were up from 4% to 8% in local currency terms.

The big news came in December, when the European Central Bank pledged that it would continue its efforts to pump money into the economy (via quantitative easing) through March of 2017. While this move helped their stock prices, it harmed their currency when compared to our dollar. The net effect on returns was still positive, but not as robust as in the U.S.

Valuations of international stocks are still below their averages, as shown in the chart below.




Source: BCA Analytics

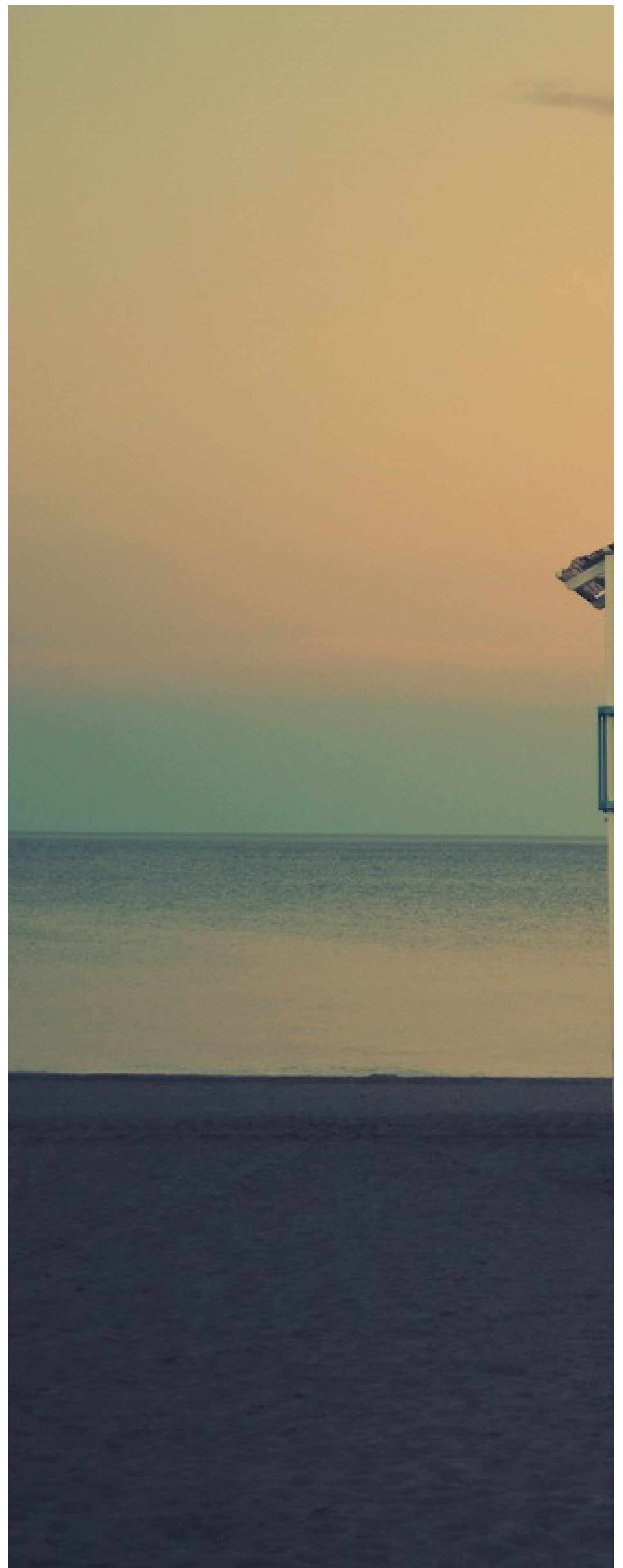
Looking forward, and as we have written in the past, currency returns tend to even out over time. We suspect this time will be no different. Keeping our long-term perspective is just as important for this purpose as well. And beyond currencies, encouraging indicators show that the European economy continues to improve. France, Spain and Germany all had bullish supply manager surveys, which are good indicators for the outlook of manufacturing. Continued stimulus from the European Central Bank should also help.

# Emerging Markets: Help! Buy Our Stuff!

Emerging Markets (EM) continued to face the unfortunate storm of higher U.S. interest rates and weak commodity prices.

When U.S. interest rates were low, investors were willing to take the risk of investing in EM bonds with their higher interest rates. Since interest rates in the U.S. have risen, capital has flowed away from EM bonds back into the U.S.

Price drops in oil and other commodities produced in emerging markets have also weakened their economies. Between America's increased production and less dependence on foreign oil, and China's slowdown, commodity prices have plummeted. The outlook, in the short term, does not look good for EM. However, they remain important growth engines in the global economy, especially those countries, as in Eastern Europe and Asia, that aren't



dependent on commodity exports. They also remain an important part of your stock portfolio because their stock markets, despite the recent poor performance, continue to comprise approximately 10% of the world's stock markets.

# Bonds: Hello? Anybody home?

Along with the release of Star Wars, we have seen other acts of force.

The Federal Reserve hiked their target rate by 0.25%, the first rate hike since 2006. Most banks also raised their prime lending rates by 0.25% to 3.50%. The bond market's reaction? They obviously saw it coming, because there was very little change.

Currently, there are mixed opinions on the speed of future rate hikes. The Fed has indicated raising rates about 0.25% per quarter through 2016, while the market (based on various indicators) expects about half that. It will be interesting to see if the Fed follows the market, or if the market follows the Fed (or something in between). At any rate, there is some uncertainty here, which the markets are unlikely to take easily unless the Fed continues to be transparent and methodical.

After a banner year in 2014, corporate bonds posted negative returns for 2015, with losses for both investment-grade and high-yield bond varieties. Speculators attribute this pessimistic behavior to oil and commodities resuming their downward trend. U.S. Treasuries performed a little better and generated positive returns, but due to the aforementioned slight rise in interest rates and consistently low yields throughout all fixed-income vehicles, returns were crestfallen.

Throughout the last quarter of the year municipal bonds remained true to their high-quality nature, offering tax-free income and strong risk-adjusted returns. Municipal bonds generally continued to offer less volatility than other fixed income assets.

# Thanks

We hope this briefing brings a little more light to the numbers you see in your reports. As always, we look forward to any questions you may have. Thank you for your trust in Vista.

## Your Vista Wealth Management Team

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