MV | CAPITAL MANAGEMENT

2016 Investment Thesis: Executive Summary

January 15, 2016

Our Annual Outlook will be published next week. Below is the executive summary.

- 2015 was a key transitional year in capital markets. In the US the year signified the end of an era. From 2009 through 2014 US equity markets grew at an average annual rate of 12.6 percent largely due to the efforts of the US central bank – the Federal Reserve – to stimulate markets through a combination of zero-level interest rates and outright open market purchases of fixed income securities. The Fed wound down QE (quantitative easing, the term for its bond-buying programs) in 2014. At the end of 2015 it raised interest rates for the first time since 2006, albeit very gently. With the training wheels of monetary policy stimulus coming off, US stock markets returned last year to a focus on fundamentals. For better or for worse, we expect that trend to continue in 2016.

- The economic backdrop in which US equities will perform this year is little different from the trend of the past couple years. The economy is growing, albeit modestly in comparison to historical norms. We are close to what economists would consider to be "full employment", with the strongest consecutive periods of job creation since the late 1990s. Upward movement in wages is still elusive, though it bears mentioning that wage growth did slightly outpace inflation in 2015. Consumer spending, which makes up the lion's share of US GDP, continues to grow although there was a general sense of disappointment with the 2015 holiday season. We see little reason to believe that GDP will grow by more than three percent this year or by less than one percent. Overall, US economic fundamentals should remain favorable this year.

- Elsewhere in the world the story is quite different. The European Central Bank launched an expanded monetary stimulus program early last year, extended the terms of the program yet again towards year-end, and is expected to do more again this year to lift Europe out of its economic funk. China is also contending with the realities of slowing growth and looking for ways to manage a very tricky economic rebalancing away from investment towards consumer activity. In essence, the global economy's path is diverging, with the US on one track and the rest of the world on another. The related uncertainty suggests the potential for more volatility than we have seen in recent years.

- The aforementioned China rebalancing looms large as the year gets under way. The world's second largest economy continues to grow, if not at the double-digit levels to which it was accustomed in the previous decade. Retail sales and other measures of activity are healthy. But slowing growth is a concern for a variety of reasons. China's non-financial debt-to-GDP ratio is approximately 250 percent. A sharp growth contraction could have a negative knock-on effect among other Asian economies. And China has the potential to roil international credit markets if it feels compelled to sell off large amounts of FX reserves (mostly US Treasuries and other sovereign debt) to prevent a currency rout.

- At the same time, China's shift away from the massive public and private investment programs which drove its earlier phase of growth has major implications that reach far beyond its own borders. In particular, the growth boom of 2000-14 drove a massive commodities supercycle. It will likely take a very long time for the energy and industrial commodities which rode the boom to approach anything close to their peak prices. In the meantime, stabilization at lower trading ranges is the most optimistic case for a wide range of commodities in 2016. Resource exporters from Brazil to Australia and Russia will feel the pain. And companies in the energy and mining sectors will

continue to deal with downsizing, project cancellations and, in some cases, potential for debt defaults.

- As headline-grabbing as China's predicament is, the situation is more dire still in other emerging markets. Brazil and Russia, which alongside China and India make up the once-dynamic BRICs, are both in protracted economic and (in Brazil's case) political crises. Other erstwhile engines of growth from Turkey to South Africa, Malaysia to Indonesia, have seen their currencies collapse by the largest amount since the 1997 Asian currency crisis. Dollar-denominated debt obligations remain a potent overhang. And with weak demand seemingly a chronic feature just about everywhere, opportunities to export one's way out of trouble seem limited. Emerging markets as an asset class has disappointed for several years; we do not see that changing significantly this year.

- How will the monetary policy divergence noted above affect interest rates in 2016? The short end of the yield curve is probably more predictable. The spread between US and Eurozone yields, with the latter firmly ensconced in negative territory, could widen further still if the Fed sticks to its plan of gradual rate hikes. The intermediate/long term is subject to other variables, not the least of which is the potential for foreign central bank sales of US Treasuries to support their beleaguered currencies. Finally, expect credit quality spreads to be a continuing story in 2016. The sorry state of resource sectors like exploration & production and mining has taken a toll on the high yield market. But spreads continue to widen as well between higher-and lower-rated investment grade securities. Tightening credit conditions could also have an effect on corporate decision-making. Stock buybacks and M&A, both of which rely heavily on debt financing, could feel the impact of more stringent credit conditions.

- X-factors – our shorthand for latent risks that could turn into live threats – abound in 2016. The Middle East, never the world's most calmest region, looks less stable than ever. Europe faces a potential humanitarian crisis as refugees continue to arrive in droves. In the US, the Presidential election reflects a sharply divided and dissatisfied populace, with the potential to throw out the playbook on the usual rules of the game. Russia's foreign policy adventurism continues apace. These are just a few of the prominent potential threats we know; there very probably are others. Always remember, though, that X-factors can be both positive and negative. Market sentiment can change very quickly as the landscape changes.

- In summary, we believe 2016 will likely be a year of trend continuation rather than mean reversion, with dominant trends like monetary policy divergence, a strong dollar, commodities prices and uncertainty about China shaping the sentiment. We expect US equity markets to be strongly influenced by earnings. Rationally, that would imply the potential for price gains in the low single digits. However, as bull markets get old – the current one is in its seventh year – rationality often gives way to volatility. Volatility can work on both the upside and the downside – melt-ups are as common as melt-downs. We believe the right response to the uncertainty of this environment is to remain diversified across a spectrum of low-correlated asset exposures, and to avoid large concentrations in any given area.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research

Investment Advisory Services offered through MV Capital Management, Inc., a Registered Investment Advisor. MV Financial Group, Inc. and MV Capital Management, Inc. are independently owned and operated.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by MV Capital Management, Inc.), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from MV Capital Management, Inc. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. MV Capital Management, Inc. is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the MV Capital Management, Inc.'s current written disclosure statement discussing our advisory services and fees is available for review upon request.