

## Fourth Quarter Review: As Go Earnings, So Go Stocks

The quarter began hopefully enough. The S&P 500 recovered most of what it had lost in the August-September pullback over the course of a month-long rally. Most, but not all. The index set an all-time high in late May and fell a bit short of that high in a July rally. October's rally failed to top either the July or the May peak. As the year headed to a close it appeared the much-loved "Santa Claus rally" would not be making an appearance this year. In fact, the S&P 500 failed to register any price appreciation at all, closing slightly below where it opened 2015. The index was positive on a total return basis, with all the gains coming from dividends. US mid cap and small cap did worse still, and non-US emerging markets continued their losing ways.

Opinions abound on what was behind the negative sentiment. The Fed's decision to raise rates may have sparked discontent. Having wound down its quantitative easing programs in 2014, December's rate hike, however gentle, signified that the policy training wheels were now fully off. That, in turn, meant a return to focusing on fundamental performance measures like earnings and sales. US businesses faced stiff headwinds in 2015 from a strong US dollar and weak global demand. S&P 500 earnings per share are expected to be slightly negative for the full year, once the fourth quarter results have been tallied. In other words, earnings and share prices ended the year more or less in tandem. That's less fun than a holiday rally, but it is a perfectly rational outcome.

A spectacular collapse in energy-related and industrial commodities was the other bookend event for the year. Crude oil prices fell to their lowest levels in more than a decade, while key industrial metals like copper, nickel and aluminum also experienced double-digit losses. Supply-demand imbalances and generally lackluster growth around the world are behind the commodities weakness. With about \$400 billion in new energy projects likely to be delayed or cancelled there should be some re-alignment of supply and demand, but it will probably take more than a year to fully work itself out.

## First Quarter Outlook: Winter of Discontent

Weather on the US East Coast has been much warmer than usual for much of the winter thus far, but conditions for asset markets have been brutal for the first two weeks of the new year. Stocks plunged on the first day back from the holiday and have mostly continued to fall since then. As we write this, the S&P 500 is more than twelve percent below its May 2015 high. It is still slightly above the trough level reached last August, but support levels look very tenuous for the near future. The main narrative accompanying the weakness is China. The world's second largest economy is having a difficult period as it tries to engineer an economic rebalancing away from public and private investment and export dependence, towards more consumer-led growth. China is more dependent on the US than the US is on China. But fears of a sharp slowdown, along with the attendant anxiety over the commodities collapse, are setting a very negative tone.

Pullbacks should always be looked at in context. This one comes after an extended secular bull market that began in 2009, and the pullback's magnitude is modest compared to the cumulative gains made over the period. It is too early to call an end to the bull, but we do see a bias to downside risk as an emergent theme this year. Before last August the market had not experienced a technical correction – a reversal of ten percent or more – since 2011. We have now experienced two in the space of just four months. The economic headwinds of a strong dollar and weak demand are still in place, geopolitical X-factors from the Middle East to US elections are clear and present, and asset valuations are not cheap.

In light of all this, we believe the prudent course of action for portfolios under our management is to take a more defensive position than we had last year, and we have acted accordingly. This means a higher proportion of cash, a focus on safer and higher quality fixed income assets, and more weight for investment strategies with low correlation to both equities and fixed income. Conditions in the market today appear oversold, but we see potential for further volatility. It is not a time to panic, but it is a good time for caution and careful risk management.