Market Commentary

First Quarter 2016

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US Equities took investors on a wild ride during the first quarter of 2016. After ending 2015 within 2% of it's all time-high, the S&P 500 began a sharp dive, ultimately declining 10.5% in the six weeks ended February 11. From that point through the end of the quarter, stocks rallied strongly, wiping out the entire decline and posting a modest total return of 1.35% for the 3 month period. The intra-quarter decline was caused by fears over falling growth rates in both the US and international economies, weak earnings results from many companies for the fourth quarter of 2015, and a delayed reaction to the Fed interest rate hike in late 2015. However, as the quarter progressed, most of these fears subsided and US economic reports continued to show better than expected growth, leading to the market rebound. During the quarter, the consensus viewpoint on the number of Fed rate hikes in 2016 gyrated from four down to essentially zero, before snapping back to two. We have been projecting no more than two rate hikes this year for many months now as the economy is not growing fast enough to justify more. The yield on the benchmark 10-year US Treasury Note declined to 1.79% on March 31, 2016, down from 2.27% at year-end 2015. The decline in yields boosted fixed income returns during the quarter. The US dollar moved back and forth during the quarter, but closed little changed versus most major currencies.

Economic and Market Outlook

Since 1973, every recession has been preceded by a spike in oil prices. The higher costs and shock to consumers and businesses from rapidly rising energy prices tend to lead to reduced economic activity. While investors have been focused myopically on the negative effects on energy producers, they are ignoring the 85%+ of companies that are consumers of energy and thus net beneficiaries of lower energy prices. Unless one believes that lower oil prices portend a sharp decline in demand due to an impending economic slowdown, there is no reason for stock prices to trade in lockstep with oil.

Evidence shows that increased unemployment rates consistently lead economic turndowns. Every recession since World War II saw the jobless rate increase at least once on a three-month basis. This is far from the case in the current environment. In fact, it is over three years since the three-month change in the unemployment rate has increased. Since that time it has been flat or lower on every three-month rolling period. Additionally, initial jobless claims have long been considered one of the most reliable leading indicators for economic prospects. With average weekly claims running under 300,000 – near the lowest level in decades - there is no sign of an increase in joblessness in the US economy.

The US economy continues to grow at a sub-par level, slightly below 2% annually on a real GDP basis. While this is below the 3%+ we had become accustomed to in the decades before the 2008-2009 financial crisis, it remains well above the growth rate in most of the developed world. While talk of an imminent recession has been around for most of the past 12 months, we project continued GDP growth in the 1.5-2.0% range with occasional readings of below 1%. One of the primary reasons for the continued lower GDP growth readings is a reduction in productivity from the levels of the past few decades. Productivity growth has averaged just 1.0% since the end of the recession in 2009. This is well below the 2.3% average from 1990-2007. A productive workforce generates more output with fewer

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hours worked, which can boost gross domestic product. The relatively weak GDP growth in recent years - despite strong gains in employment - is a direct result of the rapid slowdown in productivity. Not only would higher productivity boost GDP growth, but it would likely lead to wage growth as well.

While there is talk about the next Federal Reserve interest rate hike occurring at the late April meeting, we believe it will be June or later when the Fed takes the next step towards normalizing interest rates. The Fed continues to say it is "data dependent" without specifying which data it is focusing on. We believe that with the unemployment rate below 5% (admitting the distortions due to the declining participation rate), wage growth beginning to tick higher, and the continued increase in disposable income from low energy prices, household spending should remain strong through 2016. This modest, albeit encouraging part of the economy should restrain the Fed while encouraging investors.

Earnings estimates for the S&P 500 have begun to move modestly higher in the past few weeks due to a combination of rising oil prices, US dollar stability, and better than expected economic data on housing and manufacturing. On a year over year basis, comparisons to 2015 corporate earnings will be relatively easier as the year goes on. This could justify higher prices for equities, all else being equal.

Portfolio Positioning

Portfolios have seen modest changes over the past few months as we position investments for the latter part of an economic cycle. With expectations for modest returns from both equities and fixed income, we believe income (both dividends and interest income) will provide a significant portion of total returns over the next few quarters. This leads us to eschew riskier assets which may provide better returns in the short-term but hold too much inherent risk for this part of the economic cycle. While daily volatility has decreased, we remain vigilant in assessing potential risks to client portfolios. We have always believed in forgoing some potential upside as a trade-off for protecting downside risks.

Conclusion

We believe the most important factors for investors through the balance of 2016 will be US interest rate policy, the political environment, and inflationary expectations in the US. Tandem has long believed the Fed would move interest rates higher at a more gradual pace than most had expected and we continue this belief. One or two more hikes during 2016 are likely which would leave the Fed Funds rate below 1.0% at the end of 2016. We expect fixed income to continue providing modest, albeit positive returns with little change in the term structure of interest rates over the next few months. With the US Dollar showing little year over year change, and oil prices having rebounded from the mid-$20s range, our forecast of high single-digit increases in S&P 500 earnings looks more likely. This scenario could result in total returns on equities approximating the long-term average of about 10% over the next 12 months.

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