Global Events Drive Volatility: The Economic Outlook and Fundamentals Still Look Solid.

2015 was a challenging year, with increased market volatility brought on by concerns about China's economic growth, rising geo-political tensions, deflationary pressures from commodity price declines and uncertainty created by the Federal Reserve. All of these things tended to offset the positive news on U.S. and global economic growth. Financial markets seemed to trade more on emotion than on fundamentals throughout the year. Market returns were low to negative across nearly every asset class. The S&P 500 index was up 1.4% for the year and the Dow Jones Industrial Average was up 0.2%, but these returns really do not reflect the underlying market returns for the year. Top-line index returns were driven by a narrow group of companies, many with little to no earnings and lofty valuations. If you exclude the impact of those companies, the index returns would have been negative for the year. Beyond this narrow group of stocks, the average company saw its equity price decline for the year. While we can and do see periods where momentum overrides fundamental value, over the longer-term fundamentals matter and good companies with underlying value and growth prospects should do well.

The U.S. economy continued on its path of modestly positive economic growth led by a healthy consumer, and we believe that the consumer can continue to be a positive driver of economic growth in 2016. Last year, we saw an average of 221,000 new jobs added each month for a total of 2.65M for the year. This is the second best year of job growth since 1999. The unemployment rate, which began the year at 5.7 %, ended the year at 5.0%. The rate of under-employed, which includes part-time workers who would prefer to be full- time, fell from 11.2% to 9.9% over the course of the year. This is well below the longer-term average of 11.2%. While wage gains remain modest, rising 2.5% year-over-year, the consumer is benefitting from the dramatic decline in energy prices. The average driver will save in excess of $800 a year from gasoline savings alone. There is generally a lag of many months between when gas prices fall meaningfully and when consumers begin to alter their spending habits. That has certainly been the case this time, as so far consumers have chosen to pay down debt and boost savings before increasing spending.

We are starting to see the signs of increased spending in certain areas and expect that will continue. While it appears that holiday traffic was slower at more traditional outlets, on-line sales were up 20% year-over-year. The consumer is spending more on experiences, such as dining out, versus spending on goods, but large ticket items are doing well. Auto sales ended the year just below a record pace of 18 million cars sold, nearly double the low seen in 2009. With the average age of cars in the U.S. at 10-years, there is still room for auto sales to remain strong going forward. In addition, the housing sector continues to show modest, if somewhat uneven, improvement. Home prices are increasing at a 4-5% pace and both new and existing home sales are trending higher. Along with home sales, we continue to see expanding household formation, which takes into account people that are renting rather than buying. Household formation is a good indicator of future spending on items such as furniture, appliances or other household items.

Political uncertainty has been a factor in rising market volatility for the last several years, as disagreements about the debt-ceiling and budget have raised the specter of government shut downs. But, given the recently passed longer-term deal on both the debt ceiling and the federal budget, some of the uncertainty in Washington should ease. The new budget does provide for higher levels of spending that should benefit some sectors of the economy, such as defense. Higher tax receipts have also led to increased spending at the state and local level recently. Government spending, which has been a drag on GDP for the last several years, should be a positive contributor in 2016. However, while one source of political uncertainty has receded, it is not unusual to see increase market volatility in Presidential election years and this year is not expected to be different.

After providing months of uncertainty and confusion, the Federal Reserve's Open Market Committee (FOMC) finally took its first step towards normalizing interest rates. At the December FOMC meeting, the committee voted to increase its target range for the short term rate by 0.25%. While the vote was unanimous, the recently released minutes from the meeting show that it was a highly debated decision. Several members expressed concerns about the potential for continued deflationary pressures from slowing growth in China and the broad-based commodity sell-off. While the FOMC has indicated they could raise rates around 4 times this year, the market is expecting a much slower path, especially if inflation remains below the Fed's 2% target. Currently, consumer prices are rising at a 0.5% annual pace as the significant decline in energy prices more than offsets gains in other places. The so-called "core inflation rate", which excludes the more volatile food and energy segments, is right at the 2% target level. No matter how you measure it, it is clear that inflation has not become a problem and that it will allow the FOMC to normalize rates at a slow pace. Shorter-term interest rates have begun to move higher in response to expected normalization, while longer-term interest rates have seen more modest moves.

Commodity markets, including energy, have always tended to be more volatile than other financial markets and that was certainly the case in 2015. There were 74 days last year that the price of oil moved more than 5% during the course of the trading day. This is nearly three times the level seen in a more normal year. While the market is likely to remain under pressure, we believe that over time global supply will come in line with increasing demand and eventually prices will move towards equilibrium. Over the short-run it is difficult to predict the direction of oil prices, but over the longer-term prices should be driven by market fundamentals. We are focused on owning high quality, well-managed companies with solid balance sheets that are well-positioned to wait out this volatile period in the commodity cycle. Through innovation and efficiency gains, these companies will be able to generate greater profits at lower oil prices than they could have even 2 years ago. Finally, it is important to remember that while low energy prices are a challenge for the energy sector and for countries dependant on energy production, they are a significant tailwind to economic growth for the vast majority of the world.

While in the short-run, markets can trade on emotion, over longer time periods returns are driven by fundamentals. We still believe the U.S. economy has the potential to continue to grow at a moderate pace, which will support sales and earnings growth for U.S. companies. We believe that going forward the market will again begin to place value on well- managed companies that are delivering solid top and bottom line growth. We continue to expect that companies with strong fundamentals that can successfully manage through the economic cycle will provide the best returns over time. Interest rates should move higher throughout the year and we will continue to maintain fixed income exposures that can provide incremental income while protecting against interest rate risk. We continue to monitor events as they unfold and seek to separate the short-term events from the longer-term fundamentals; and we expect to remain fully invested as long as the fundamental outlook is attractive.