Market View

April 2016

In the first quarter US stocks went on a wild ride, dropping 10% by mid-February then recovering to end the quarter just barely in positive territory. The stock market turmoil was one reason the Federal Reserve slowed its plan to raise short term interest rates. Most global economies are still growing slowly. US payrolls continue to expand at a healthy pace, and the consumer appears to be in good shape. The aging of the baby boomers is a secular trend that may reduce long term economic growth.

Financial Markets

US stock indices eked out a small gain in the first quarter. The S&P 500 Index of large capitalization US stocks produced a total return of +1.3% and the Dow Jones Industrial Average of blue chip companies returned +2.2%. Developed international markets trailed the US, down -2.7%, while emerging markets reversed a multiple year trend, up +6.4%. By quarter end oil recovered to close at $38 per barrel after tumbling into the mid $20 range. Stocks of energy and export-focused companies rebounded accordingly, reversing last year's performance. Profits of companies in the S&P 500 Index did not grow at all in 2015 and are expected to increase only 4% in 2016. A large part of the 2015 earnings weakness was attributable to energy companies.

Interest rates moved lower in the first quarter. The 5 year US Treasury yield dropped from 1.76% at year end to 1.21%. The 10 year followed a similar pattern, falling from 2.27% to 1.77%. The Federal Reserve held off on any further short term interest rate rises, and policy officials now expect only two rate hikes over the course of 2016.

The Economy

The US economy continues to expand at a slow, uneven pace, buffeted primarily by international pressures. US Gross Domestic Product grew 2.4% in 2015, the same as the year before, with the 4th quarter growing only 1.4%. While this was the tenth consecutive year of less than 3% growth, it was still better than most international developed economies.

Market Indicators 3/31/2016

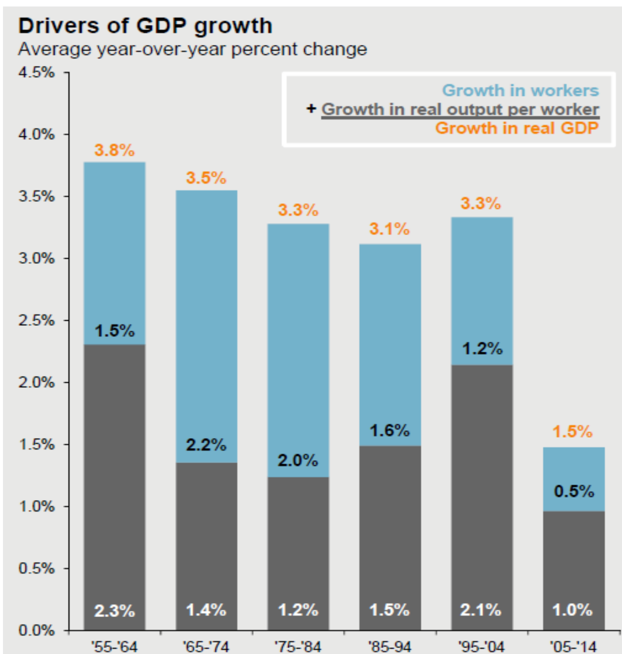
	Total Return	
US Stock Markets	**12 Mos**	**1st Qtr 2016**
S&P 500 Index	1.8%	1.3%
S&P 400 Mid Cap	-3.6%	3.8%
Russell 2000 Small Cap	-9.8%	-1.5%
International Stock Markets *ETF Returns in US$*		
EAFE Index *(Europe, Australasia, Far East)*	-8.6%	-2.7%
Japan *(MSCI Index)*	-7.8%	-5.9%
China *(Xinhua 25)*	-21.9%	-4.3%
Emerging Mkts Index	-12.7%	6.4%
US Fixed Income Yields	**12/31/15**	**3/31/15**
6 Mo US T-Bill	0.48%	0.38%
2 Yr US T-Note	1.05%	0.72%
10 Yr US T-Note	2.27%	1.77%

Payrolls have been growing at a strong, steady pace, adding more than 200,000 jobs monthly over the past year. The disappointment has been that average hourly earnings have risen slowly. Consumer spending increased 3.1% in 2015, a healthy figure. Lower prices at the gas pump appear to have resulted in a higher savings rate, as opposed to more robust spending. Early signs of compensation levels rising at a higher rate may cause a change in this dynamic.

The strong US dollar, weakness in China and other foreign economies, and reduced activity in the oil patch combined to hurt the US industrial economy, causing business investment (non-residential fixed investment) to fall by 2.1% in the fourth quarter of 2015.

Question: What is the stock market worried about?

The China slowdown, Europe's struggles, rising US short term rates, and a strong US Dollar have all caused investors to fear another recession in the US. With growth close to stall speed, a slight wobble could cause the economy to contract. Since the end of the 2008/9 recession, GDP growth has been just 2.1%, while it was 4% or more for various periods after the 1980-1982 double dip recession and the 1990/1991 recession.



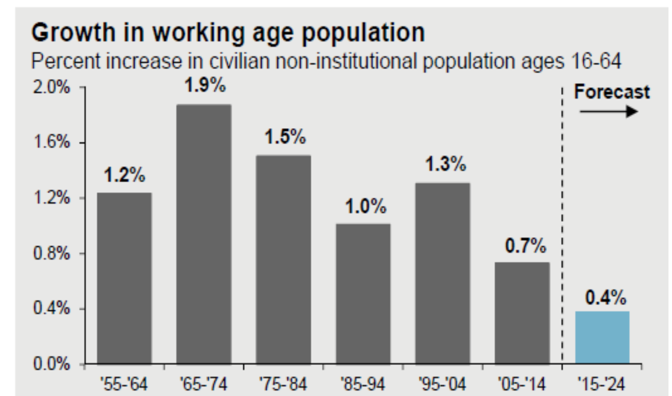
Source: JPMorgan Guide to Markets 1Q 2016

Q: Why has economic growth been so slow?

Growth of workers and productivity are drivers of economic growth. As shown on the left, the post war baby boom caused large increases in the working age population and GDP growth in excess of 3%. The maturing of that cohort is having a secular effect and may retard economic growth for quite some time. A higher birth rate to reverse this trend is not likely, and immigration, a source of worker growth in the past, is controversial in today's political climate. The chart also shows productivity growth has slowed, except for the technology driven rise in the 1990's. Most economic forecasters think the type of productivity improvement seen in the west in the early 20th Century, or in China over the last 25 years, is unlikely to re-appear any time soon in the mature US economy.

Question: How would policymakers respond to a recession today?

The world today is in uncharted territory should it face an economic contraction. With governments reluctant to provide fiscal stimulus, central banks, acting alone, have used new and novel monetary tools to jump start economies. With short term rates zero bound, the European Central Bank has introduced negative rates on bank reserves, hoping to prompt banks to lend money more aggressively. The jury is still out on this strategy. Central banks are accustomed to dealing with inflation, and the tools to tame it, but chronic slow growth and fear of deflation present new challenges.



Source: JPMorgan Guide to Markets 1Q 2016

Conclusion

A slowing of the secular growth rate for economies worldwide, driven by maturing populations around the globe, will have a significant effect on the financial markets. Lower economic growth will likely mean lower returns from bonds and stocks, and reduced inflation. Companies able to grow their earnings faster may deserve an even larger premium. Investors should own a diversified portfolio of companies positioned to grow through varying economic conditions. While we would not extend bond maturities, lower interest rates and inflation may be with us for longer than most expect.

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