# Investment Commentary

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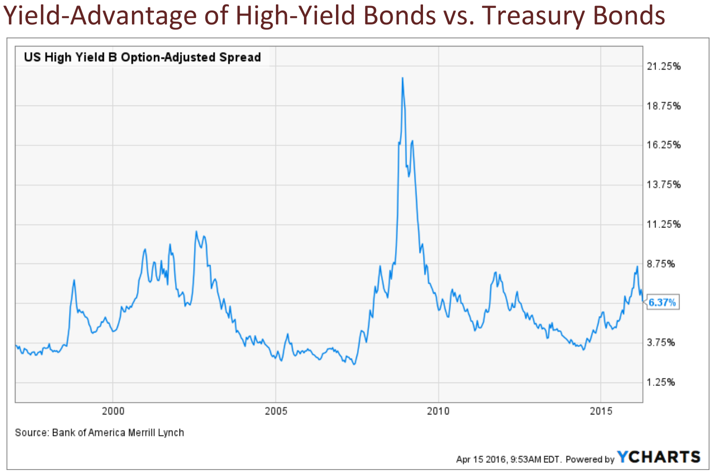
2016 started out as one of the worst years in history for stock prices. However, prices have firmed up considerably and seem to carry with them the momentum to finish the year positively. The future is unknowable, however, a review of the market's strengths and weaknesses has led us to a moderately favorable view for the balance of 2016.

## What happened in January and February?

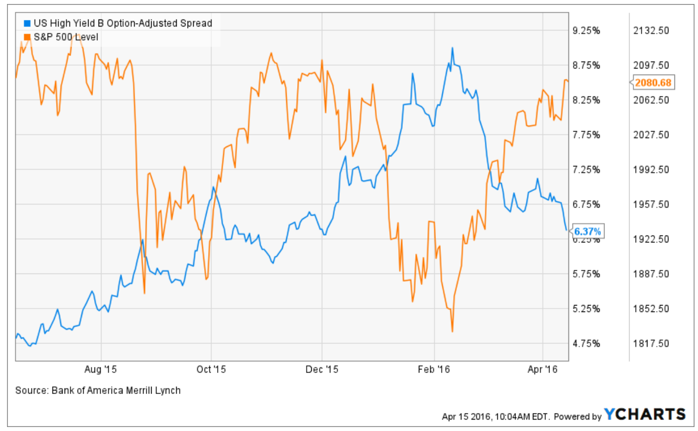
One of the primary risk factors that caused weakness in asset prices earlier this year has diminished somewhat but remains on our radar. Specifically, the credit markets staged a minor rebellion as a result of fear from energy company defaults. This led to a broader corporate bond sell-off which spread like wildfire to stock prices. As yields of many corporate bonds spiked to unjustifiably high levels, money flowed back into bonds - leading to a recovery in stock prices.

The following chart demonstrates the yield-advantage of high-yield bonds versus treasury bonds. When that differential widens, corporate bonds prices fall relative to Treasury bonds indicating investors fear a pickup in corporate defaults. As you can see, 2008 fears reached incredibly high levels. On the right side of the chart, from the end of 2015 through mid-February 2016, default fears reached levels higher than a large majority of the time.

Yield-Advantage of High-Yield Bonds vs. Treasury Bonds




Stock Prices and Yield-Advantage of High-Yield Bonds




Despite a significant decline in this measure coupled with a rise in stock prices (see above: March 2016 through today), default fears remain higher than normal. As a result, the risk that caused indigestion earlier this year remains somewhat elevated.

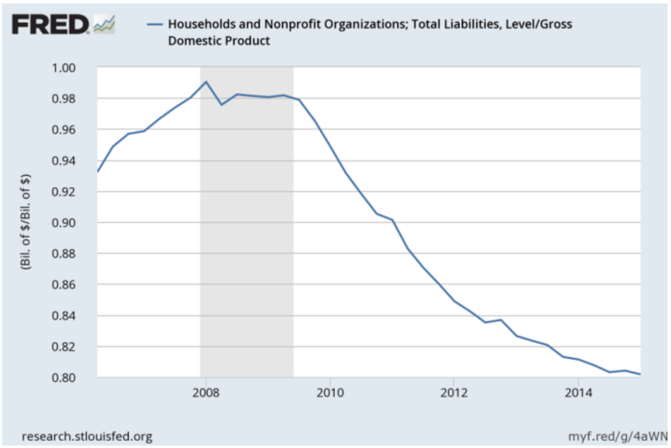
Specifically, if the rate of U.S. corporate defaults actually does pick-up – which is quite possible – corporate bond and equity markets may experience more turbulence. Most defaults would likely come from the energy and commodity sectors which represent less than 10% of the stock and bond markets, based on market size. As the broad market tends to overreact, as it did earlier this year, we believe smart uses of cash will be possible.

## So, how do we get to a moderately favorable view on the stock market for the remainder of 2016?

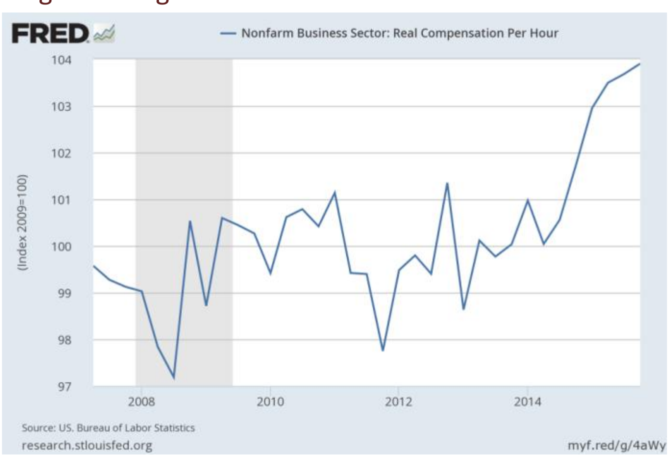
Market risks outlined above represent a potential over-reaction to a pick-up in corporate defaults of companies that represent less than 10% of the market. In other words, the actual damage (corporate defaults) will likely be smaller than the market's reaction (or fear) to it.

Further, and perhaps more importantly, the economy seems to be on stable footing based on a strong base of consumers - who have lowered their liabilities (paid off debts and mortgages) and increased their income levels (wages are up and unemployment is down).

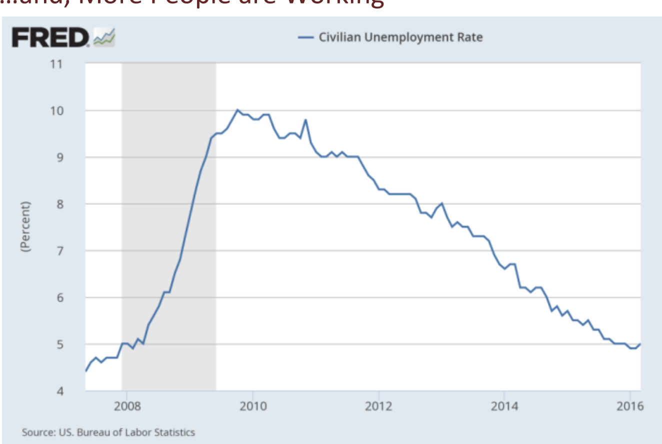
Household Debts are Lower…




Wages are Higher…




…and, More People are Working




## The best predictor of a U.S. recession is positive, but is worth watching.

Despite a strong consumer, we continue to monitor other areas of the economy that highlight risks to it. One such indicator is the "yield curve" which compares the yields of 10-year Treasury bonds versus 2-year Treasury bonds. The measure effectively compares long-term bonds to shorter-term bonds. Long-term bonds generally represent an overall market view of total economic growth including inflation. When this rate is low, like it is now, long-term economic expectations are low. On the other hand, rising short term rates reflect a reaction to more immediate factors like an increasing Federal Funds rate or a surprise pickup in inflation. When both of these happen (short rates higher than long rates), the relationship is inverted. An inverted yield-curve shows up as less than zero in the next chart and represents the risk that the economy is out of balance – often preceding an actual recession.

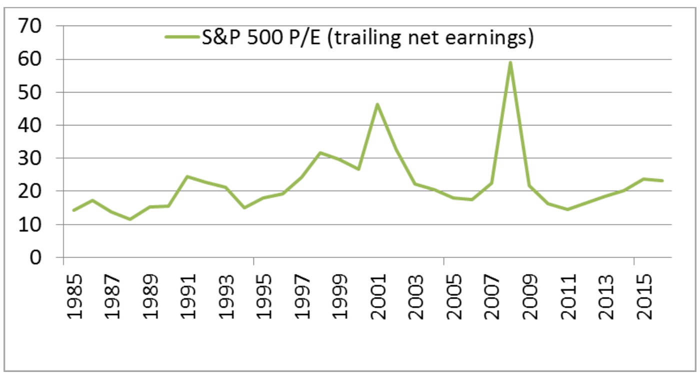
Currently, the yield curve is at normal levels, however, it is declining as long-term rates continue to sink to historically low levels. If for some reason the curve inverts, we would likely take a more cautious view of the markets. We do not believe this will happen in 2016 because: 1) The Fed seems to be very cautious about raising the short-term Federal Funds rates, 2) current inflation is low, and 3) long term economic growth and inflation expectations are low although growth factors are stable-to-improving.

The Yield Curve is Falling, but at Normal Levels

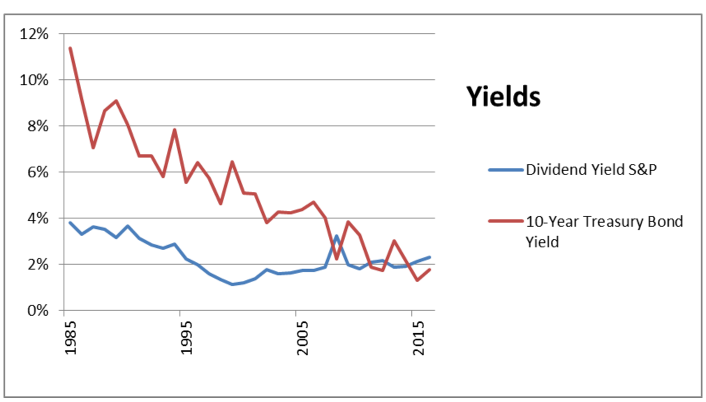
In the end, we believe the economic pros outweigh the cons for 2016 which bodes well for business growth. While solid business growth is generally associated with rising stock prices, another major factor that impacts stock prices is valuations.

Given our relatively positive view of the economy, we look for reasonable (or better yet attractive) valuations on market values to give us comfort that overall market risks are reasonable.

Evaluating price-to-earnings (P/E) levels is one common approach to judging market valuations. The S&P 500 Index shows us valuations are not low but are still somewhere in the normal range.




Another way to measure stock valuations is to compare dividend yields to bond yields. The dividend yield for stocks is currently higher than most treasury bonds, something we haven't seen often over the past three decades, and represents the view that stocks are relatively attractive.




The result of both of these valuation methods is the market appears to be reasonably priced overall from our perspective.

## Conclusion

In the end, we are closely monitoring the warning signs related to corporate defaults, a declining yield curve, and the issues they imply. Despite these risks, we see a vibrant economy supported by a healthy consumer and reasonable market valuations. Although periods of elevated risk may lead to market volatility, we believe the stock market will likely finish the year higher.

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