Cutting Through the Noise

2015 Re-Cap and Guideposts Heading Into 2016

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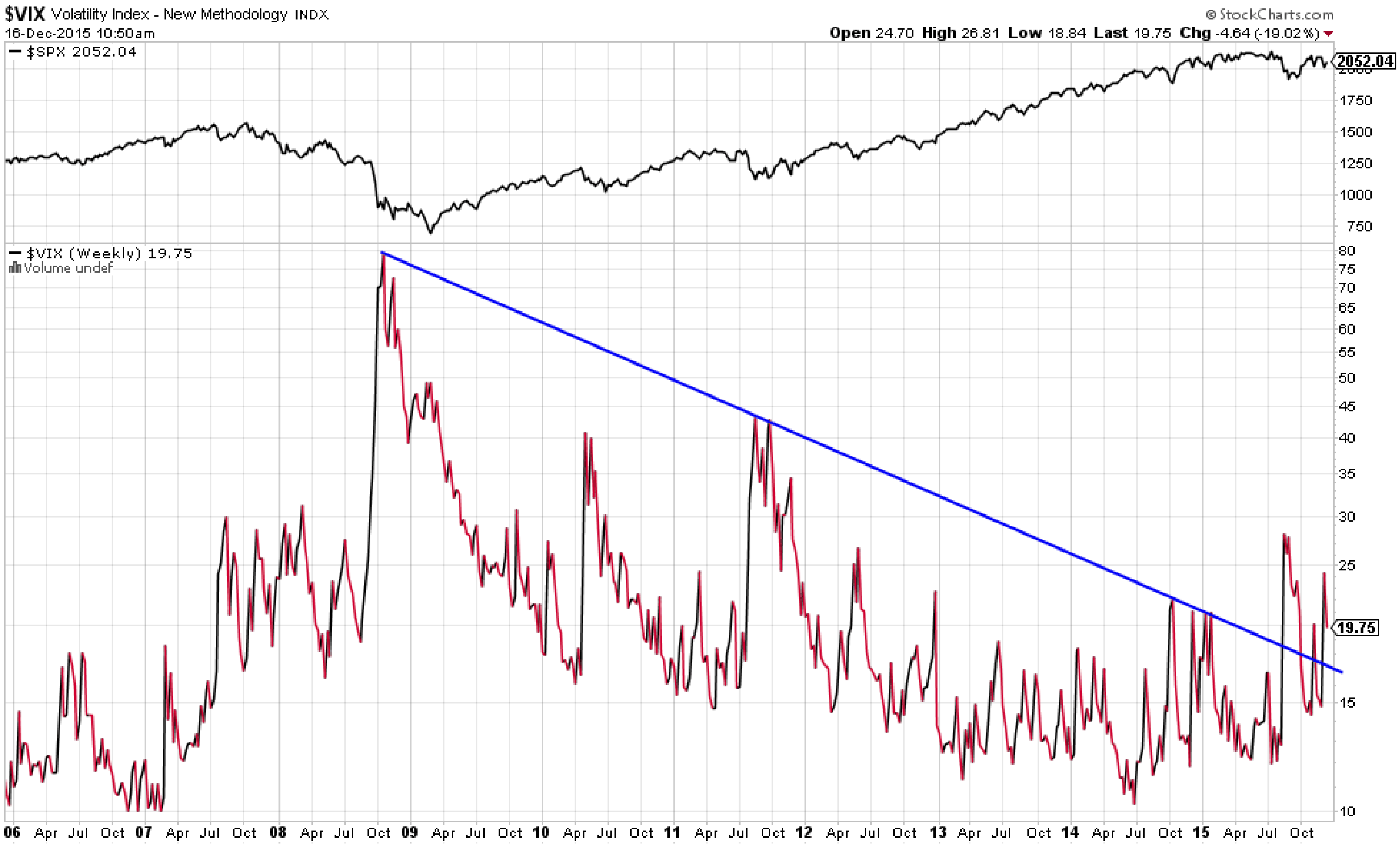
2016 Outlook: Volatility Rising as 2015 Headwinds Linger

For Consideration:

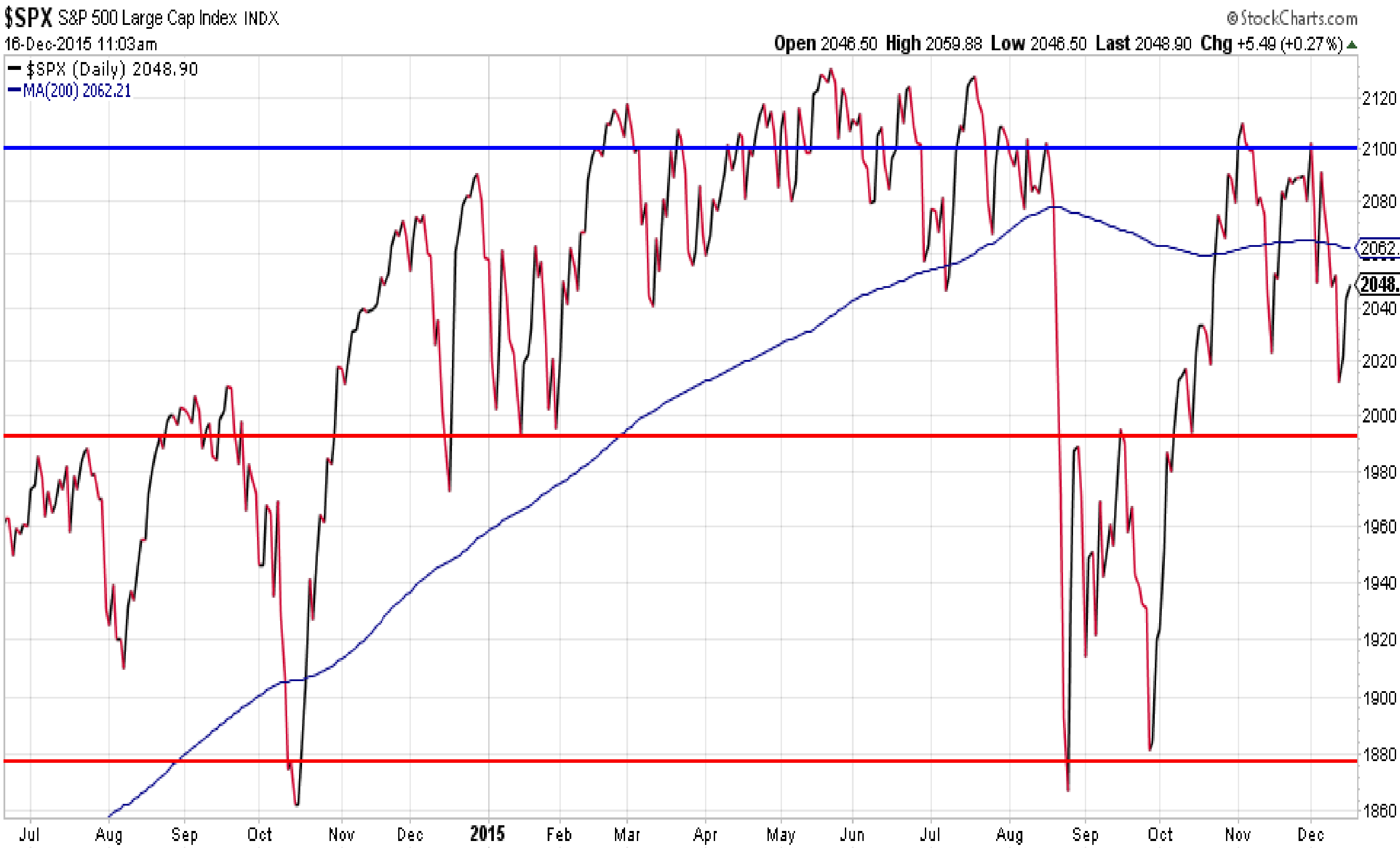
- Three Guideposts
  - Impact of Fed Tightening
  - Economic Resiliency
  - Inflation Surprises
- Two Headwinds (left over from 2015)
  - Excessive Valuations
  - Investor Illiquidity
- One Piece of Advice
  - Tune out the Noise (and there could be a lot of it)

The VIX moved higher in 2015, providing the illusion of volatility



Source: StockCharts

Stocks spent most of the year trading in a narrow range



Source: StockCharts

Actual trading range fell for the second year in a row and was half the long-term average

Year	Max Gain	Max Loss	Range	Year	Max Gain	Max Loss	Range
2015	3.5%	-9.3%	12.8%	1992	5.8%	-5.5%	11.2%
2014	13.1%	-5.8%	18.9%	1991	26.2%	-6.0%	32.1%
2013	29.6%	2.2%	27.4%	1990	4.1%	-16.5%	20.7%
2012	16.6%	1.5%	15.0%	1989	29.6%	-0.9%	30.4%
2011	8.4%	-12.6%	21.0%	1988	14.8%	-1.8%	16.6%
2010	13.0%	-8.3%	21.3%	1987	39.1%	-7.5%	46.6%
2009	24.9%	-25.1%	50.0%	1986	20.2%	-3.7%	23.9%
2008	-1.4%	-48.8%	47.3%	1985	26.8%	-2.1%	28.9%
2007	10.4%	-3.1%	13.5%	1984	3.3%	-10.4%	13.7%
2006	14.3%	-2.0%	16.3%	1983	22.8%	-1.6%	24.4%
2005	5.0%	-6.1%	11.2%	1982	16.7%	-16.4%	33.1%
2004	9.1%	-4.4%	13.5%	1981	1.7%	-16.9%	18.7%
2003	26.4%	-9.0%	35.4%	1980	30.2%	-8.6%	38.8%
2002	2.1%	-32.3%	34.5%	1979	15.8%	0.0%	15.8%
2001	4.0%	-26.8%	30.9%	1978	12.5%	-8.6%	21.1%
2000	4.0%	-13.9%	17.9%	1977	-0.4%	-15.6%	15.2%
1999	19.5%	-1.4%	20.9%	1976	19.6%	0.8%	18.8%
1998	28.0%	-4.4%	32.4%	1975	39%	2%	37.3%
1997	32.8%	-0.5%	33.3%	1974	2.3%	-36.2%	38.5%
1996	22.9%	-2.8%	25.7%	1973	1.9%	-21.9%	23.8%
1995	37.0%	-1.8%	38.8%	1972	16.7%	-0.4%	17.1%
1994	3.3%	-5.9%	9.2%	1971	13.7%	-2.2%	15.9%
1993	8.1%	-1.5%	9.6%	**Average**	**14.5%**	**-9.7%**	**24.2%**

2015's narrow trading range had a downside bias, giving the perception of more volatility than was actually seen on the S&P 500

Our approach balances ***what could be*** versus ***what is***.
It is more about managing risk than making forecasts.
Forget about the headlines and tune out the noise

Fundamental Factors

• Federal Reserve Policy	Neutral	0
• Economic Fundamentals	Bullish	+1
• Valuations	Bearish	-1

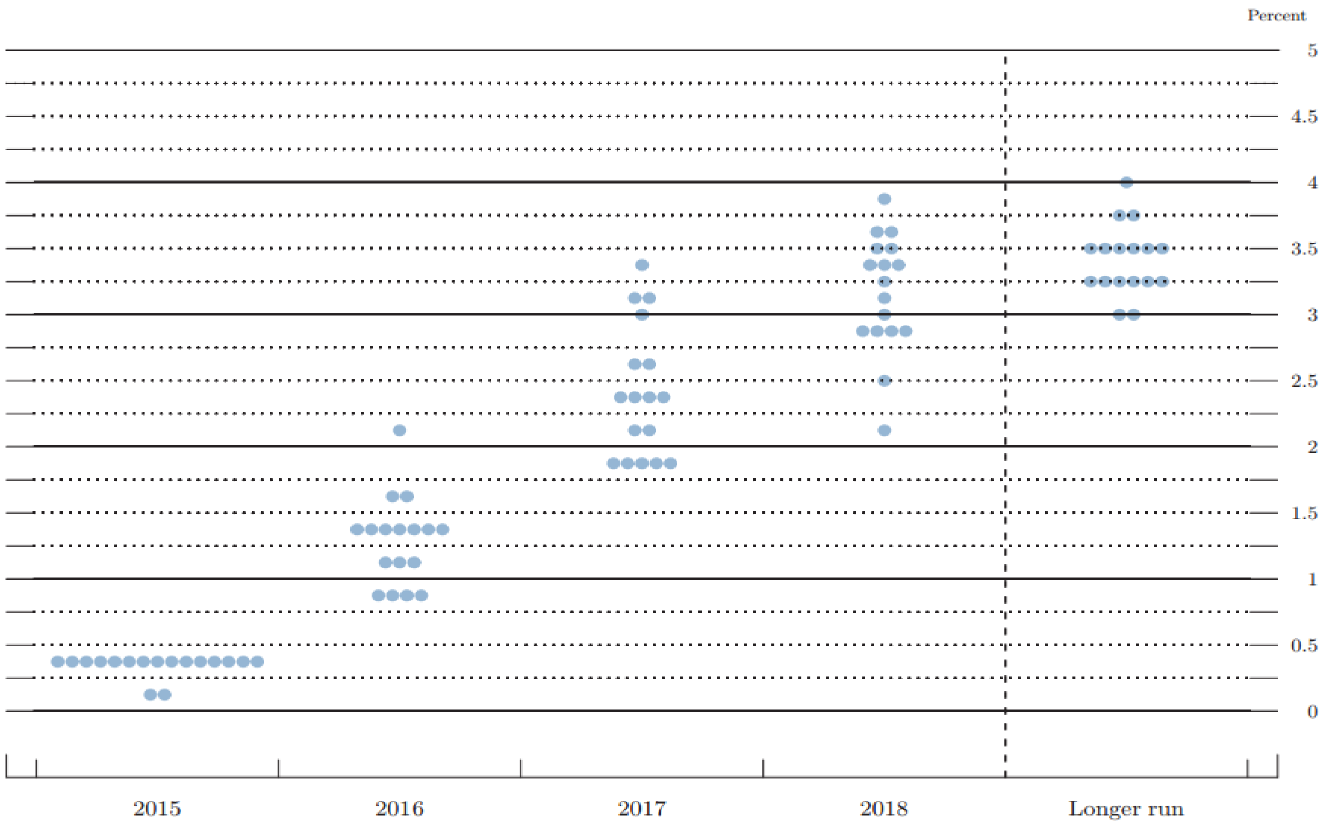
Technical Factors

• Investor Sentiment	Neutral	0
• Seasonal Influences	Bullish	+1
• Tape	Neutral	0

Weight of the Evidence =	Mildly Bullish	+1

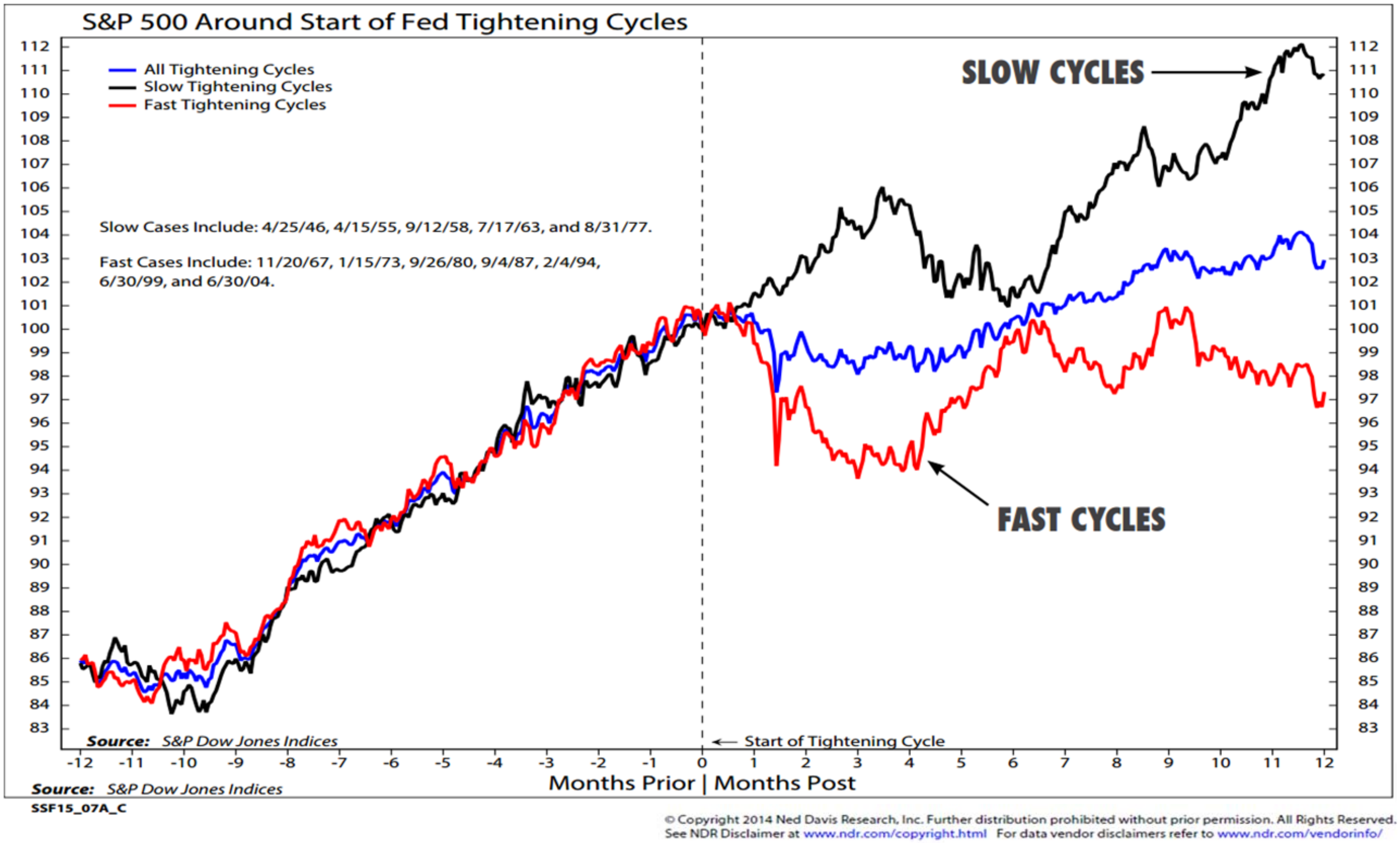
Lift-off has been achieved, but path ahead for rates will be critical

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate

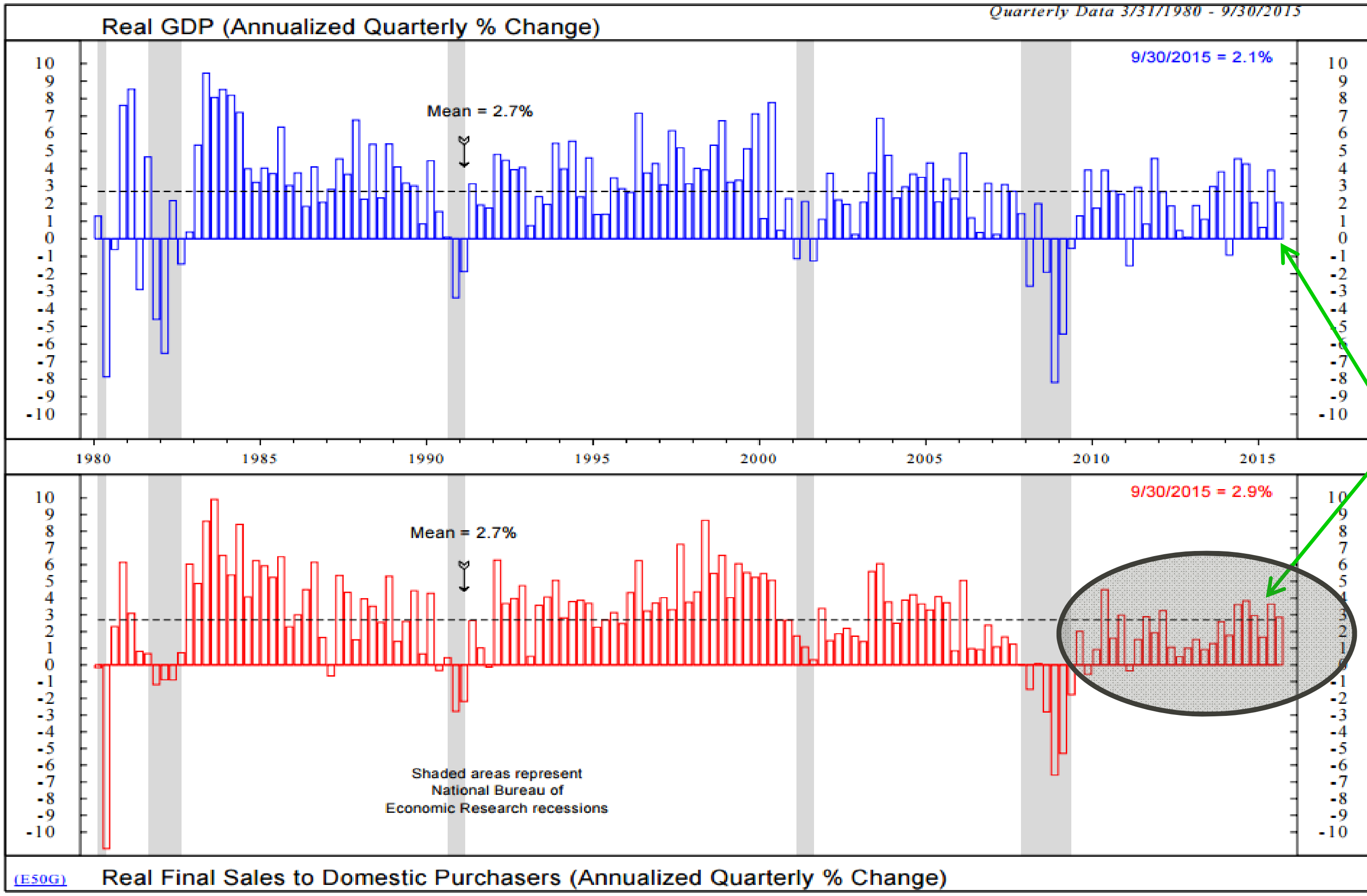


FOMC members expect another 100 basis points of tightening in 2016 (a quarter point every other meeting). That is a faster pace than has been priced into the market

A gradual path of tightening unlikely to be disruptive for stocks



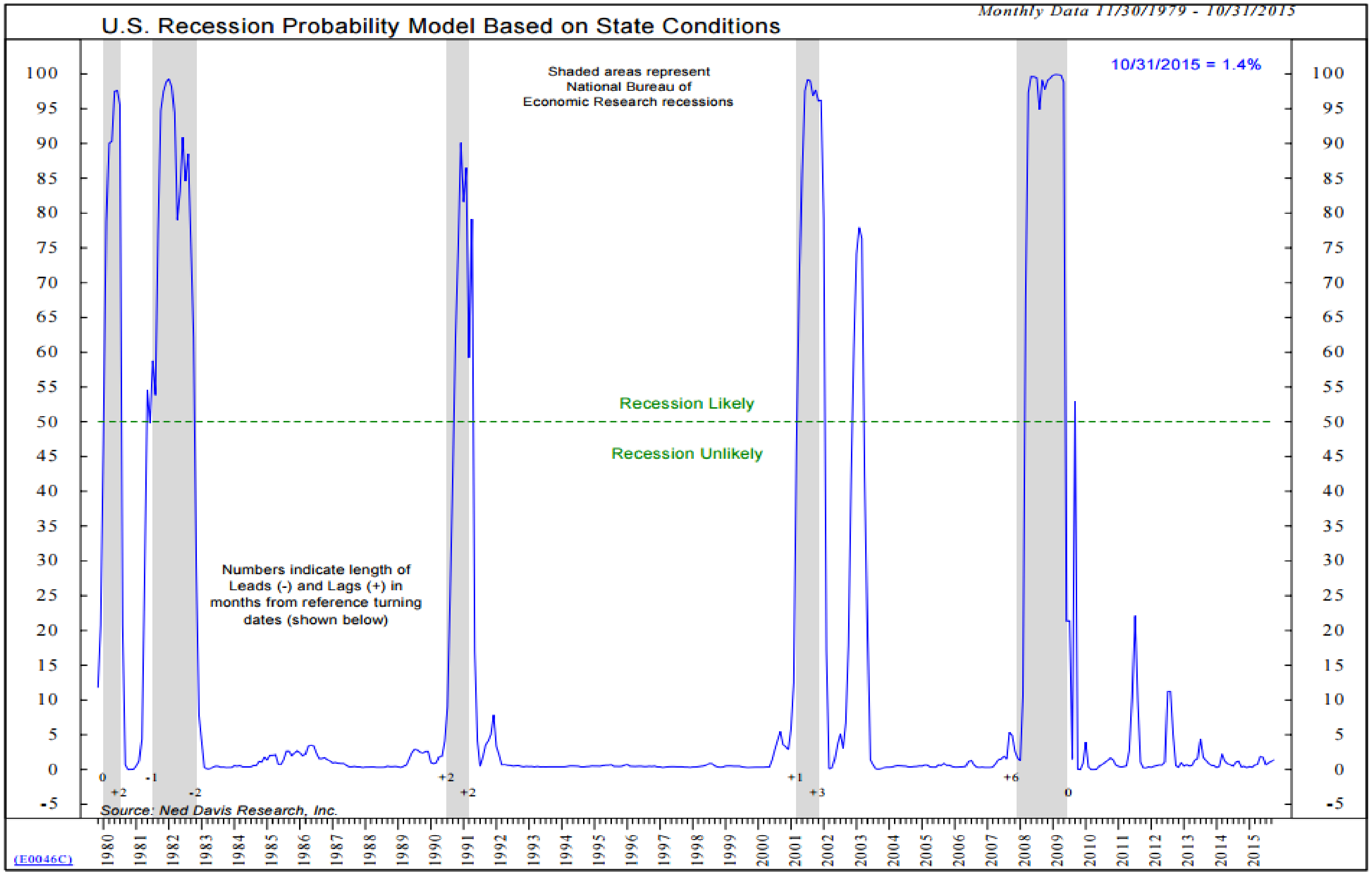
Beyond the headlines, economic growth still steady, if unspectacular



Headline growth has been choppy, but growth in domestic demand has been greater than its long-term average in 5 of 6 quarters

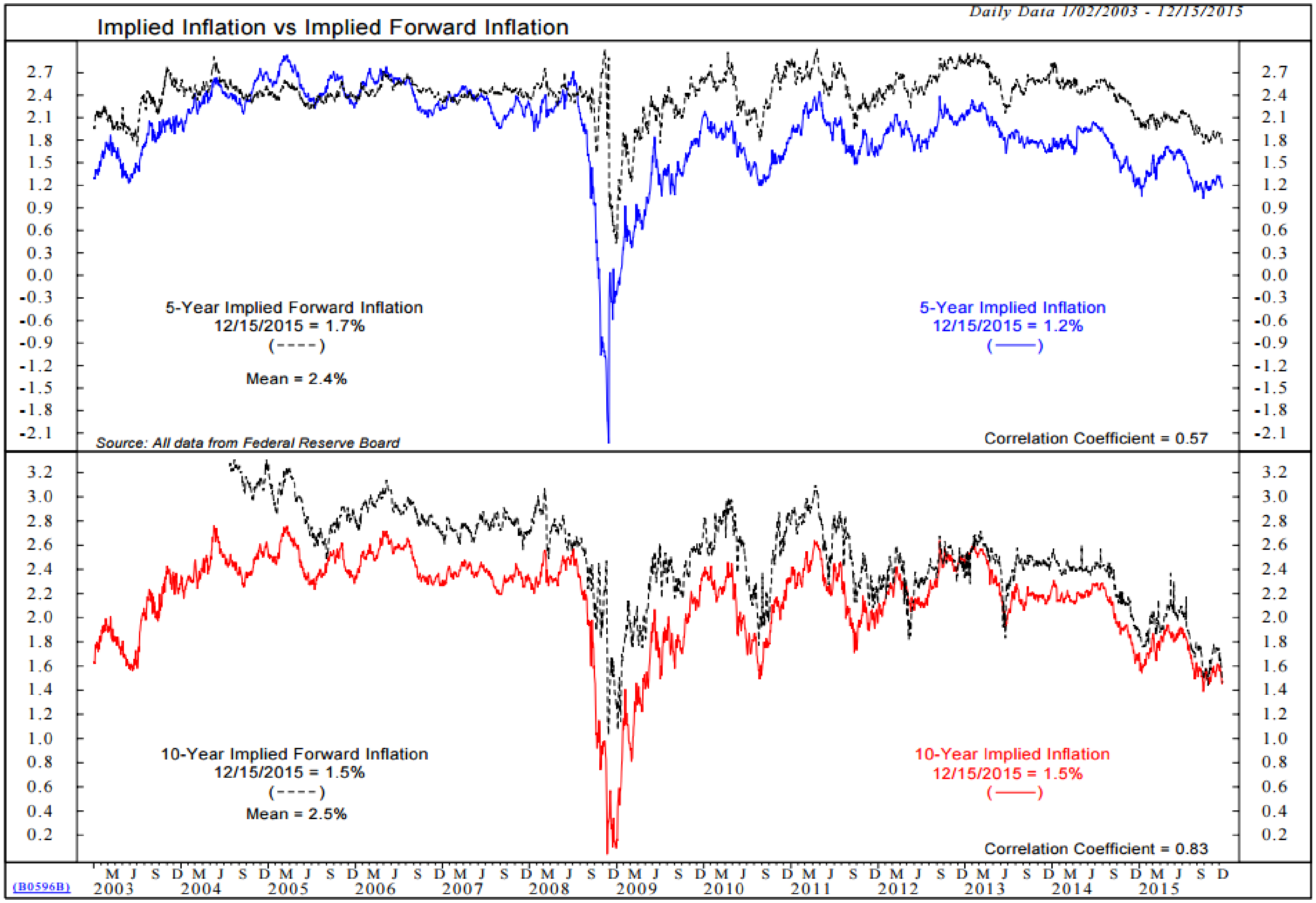
Source: Ned Davis Research

Global economic growth has slowed and manufacturing is weak, but recession risk in the U.S. is minimal



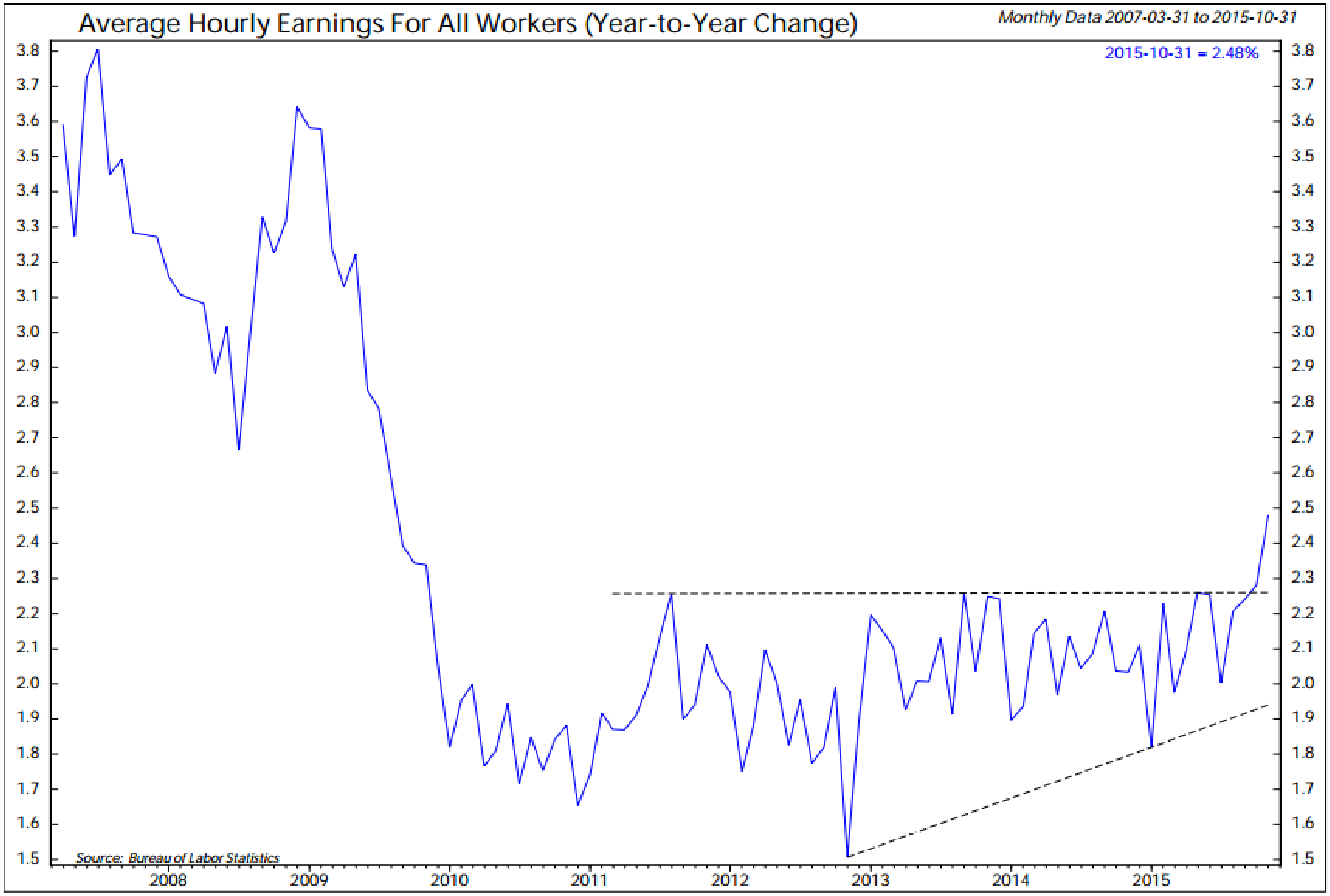
Source: Ned Davis Research

Inflation expectations have steadily retreated and are at their lowest level since 2009



Source: Ned Davis Research

Wage growth has accelerated, joining other indicators that suggest inflation could be set to move higher



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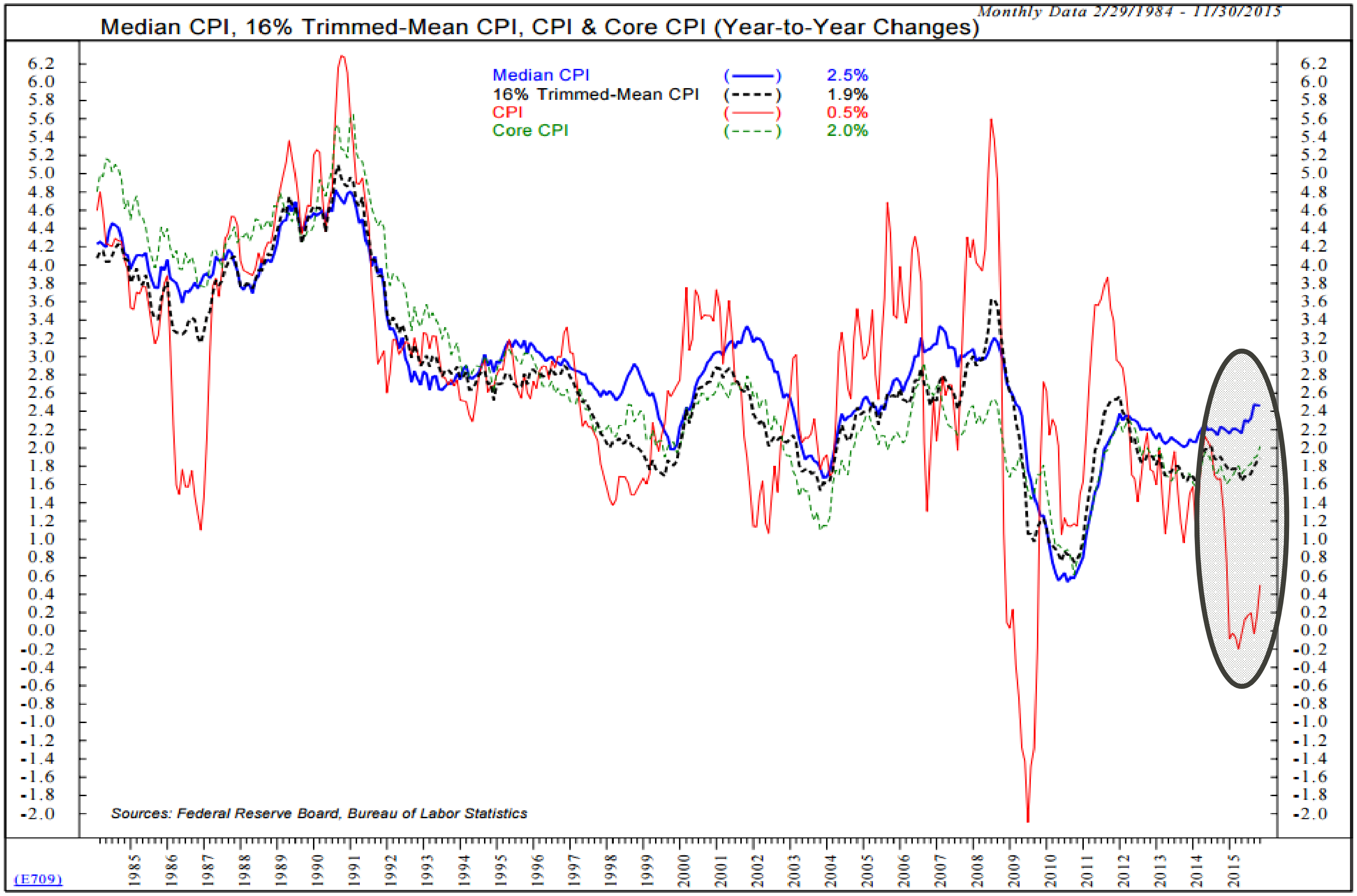
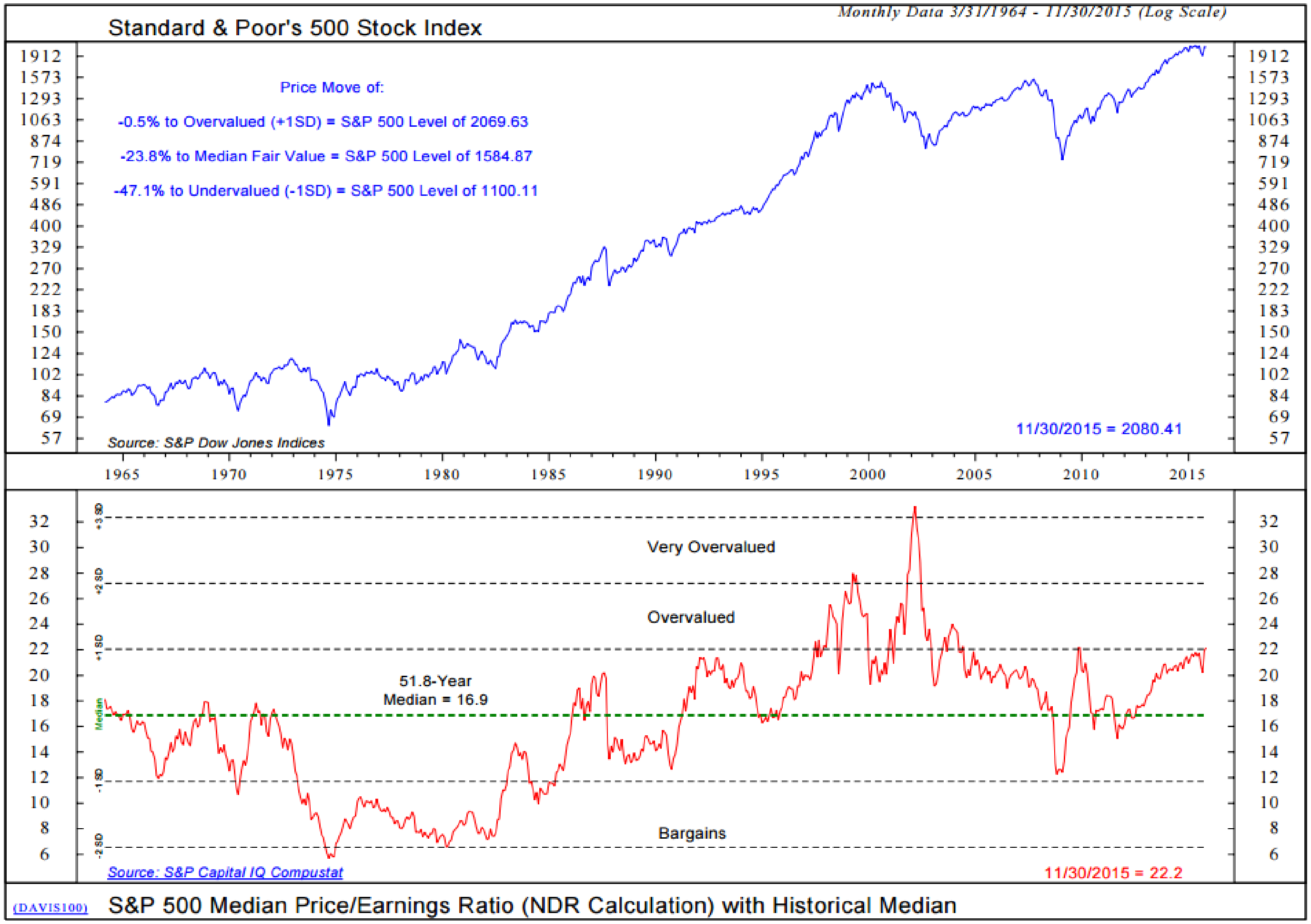
Weakness in energy has depressed the overall CPI but other measures of inflation are rising



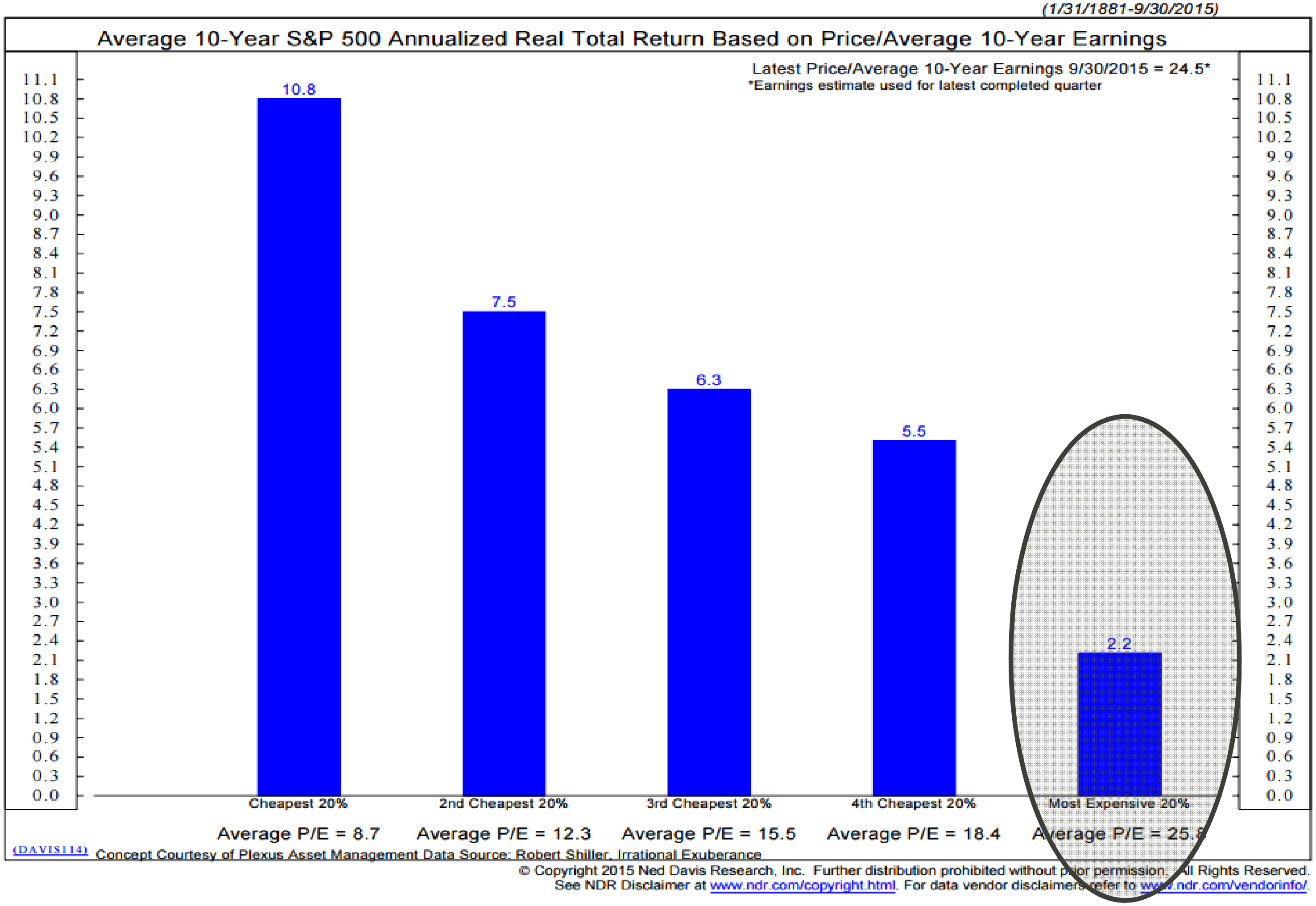
Alternative measures of consumer prices show inflation starting to tick higher – an inflation "scare" in 2016 is not out of the question

Source: Ned Davis Research

Stocks were expensive at the start of 2015, and remain so at the end of the year

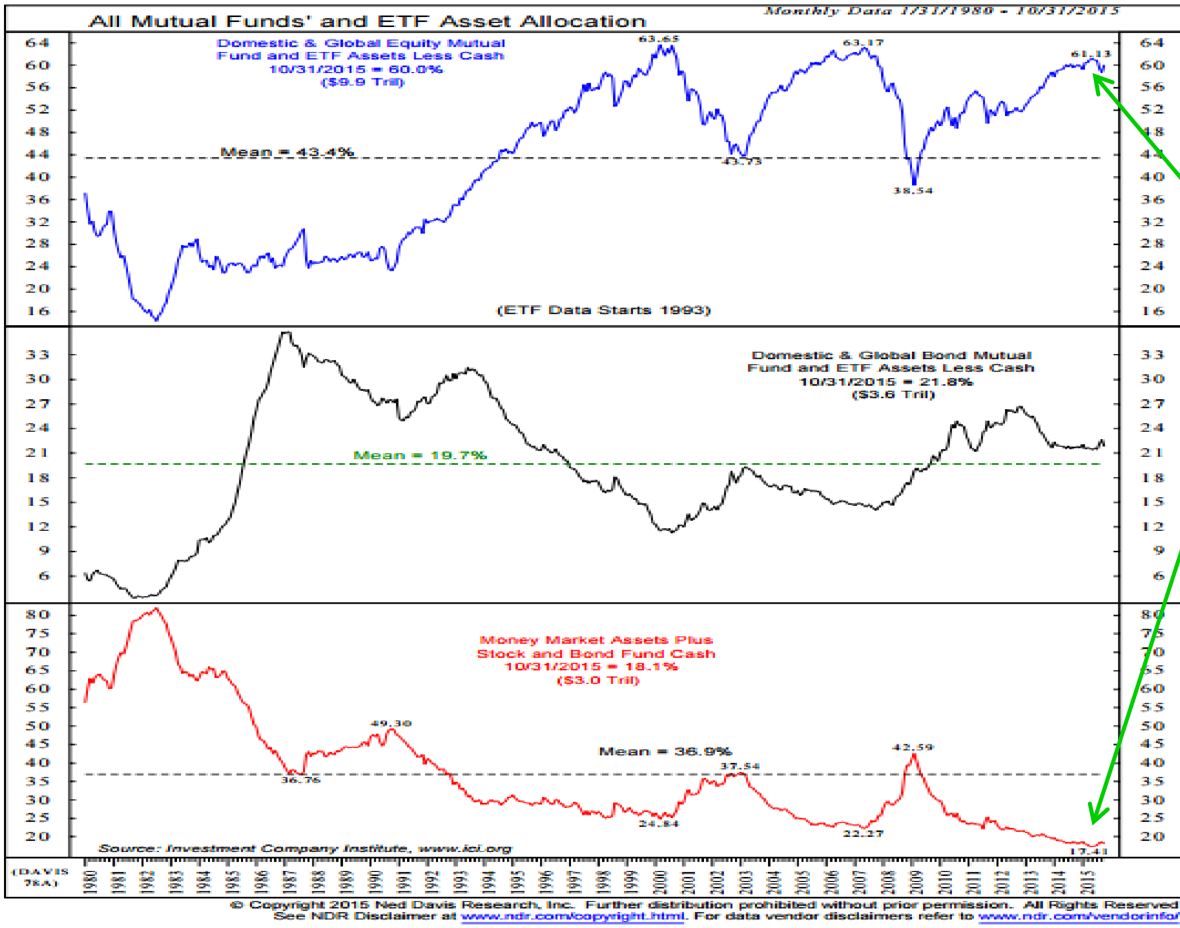


High valuations do not always immediately impact prices, but over time they depress returns



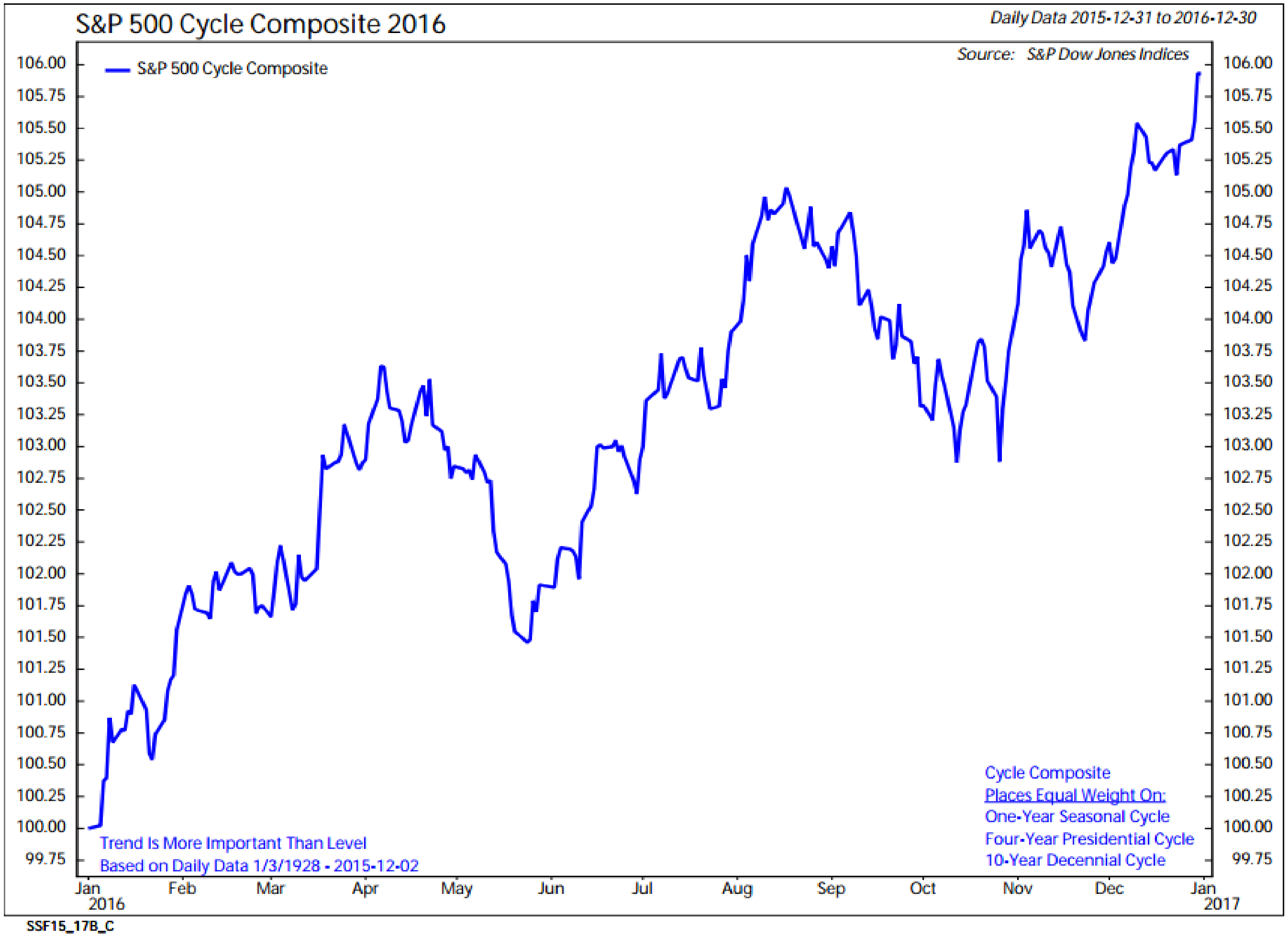
Source: Ned Davis Research

Short-term sentiment surveys show more caution, but the overall allocation to equities is elevated



Household exposure to equities is near its all-time high, while cash has moved below the 2000 and 2007 lows. This is not totally surprising at this point in the cycle, but could serve to exacerbate periods of volatility in 2016

The cycle composite has an upside tilt for 2016, but the Presidential election could add to the chop in Q2 and Q3



Stocks look poised to start the year with a modest tailwind, but the best opportunity for a rally could come after the outcome of the presidential election is more certain, regardless of which party is poised to control the White House

Source: Ned Davis Research

Bottom line (and what to do about it):

- *Feeling of volatility in 2015 could be followed by actual volatility in 2016*
- *Fed tightening is not an impediment, but inflation could be wildcard. Economic growth gaining traction*
- *Excessive valuations and elevated equity exposure remain key headwinds*
- *Presidential election years tend to be noisy and 2016 looks to be no different. Ear plugs may be useful*

What to do about it:

- *Trends continue to favor U.S. leadership, but prospects in Europe improving*
- *Small-caps enjoy tailwind into Q1*
- *Sector leadership remains with Technology, Consumer Discretionary. Industrials could offer upside surprise in 2016*
- *In periods of volatility and illiquidity, cash is a scarce resource*

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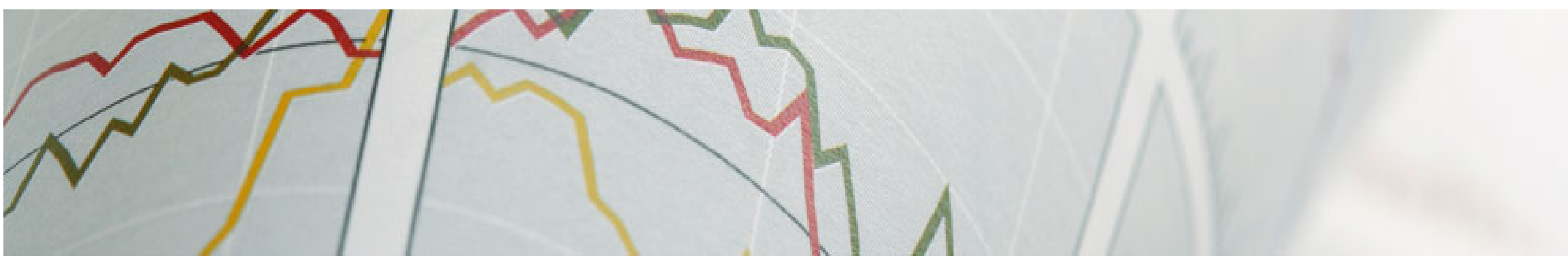

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