Market Review and Outlook—April 6, 2016

All revved up and no where to go. The stock markets tumbled, 10% or so, in January, and yet the chart below shows mostly gains for the past quarter. While oil prices plunged, the chart shows natural resource funds up over 5%. The best summary for the quarter is "Disregard January Headlines." The doomsayers were so clear in their projections that when their predictions failed to come to pass, investors wised up and focused on actual economics, and this enabled the stock and bond markets to end the quarter with modest, positive results.

Oil and US Dollar Sanity While oil prices fell in January, and remain 65% below where they were two years ago, they have begun to recover. Similarly, the US dollar had risen over 35% from August 2011 lows, but has reversed recently. Extremes are bad, so recoveries/reversals are positive signs.

Interest Rates and the Fed We had been expecting four to six interest rate increases by the Fed in 2016. Due to the jumpy markets, and the desperate action by foreign central banks, the Fed is currently expected to raise rates onto twice this year. This slower rate of increase encouraged bond investors, who bid up prices and returns. The (continued) strengthening US economy helped returns for high yield bonds, both taxable and municipal. Taxable high yield bonds were aided by the (limited) stability that energy companies achieved by late in the quarter.

Taking Stock While China was a great area of concern in January, by late March the worst of the worries had subsided in China, as there was recognition that the Chinese central bank and government have substantial tools at their disposal to prevent any 'hard landing.' With Chinese worries dissipating, emerging market stocks jumped 11% in March, more than making up for January and February losses. Foreign stocks similarly rose nicely in March, but were unable to fully recover from losses earlier in the year. US stocks generally managed very modest gains for the quarter.

The table below looked MUCH worse a month ago, but the strong March results did wonders in eliminating red figures. While it was quite volatile, the overall quarter was largely sideways, and thus many investors are as well diversified now as they were in early January. We still recommend that investors regularly measure their asset allocation, and rebalance when the deviations are large enough. We made it through a difficult storm earlier this year. Keep your portfolio on course, ready for both fair weather and foul.

Category	**3 Months**	**12 Months**	**3-Yr Avg**	**5-Yr Avg**	**10-Yr Avg**
Fidelity Cash Reserves	+0.01%	+0.01%	+0.01%	+0.01%	+1.22%
Intermediate Term Bond	+2.50%	+0.65%	+1.88%	+3.53%	+4.50%
Intermediate Muni Bond	+1.42%	+3.15%	+2.72%	+4.73%	+3.98%
Large-Cap Stock	+0.30%	-1.96%	+9.62%	+9.61%	+5.98%
Mid-Cap Stock	+1.28%	-6.61%	+7.78%	+7.75%	+5.92%
Small-Cap Stock	+0.56%	-8.14%	+6.41%	+6.74%	+5.15%
Foreign Large-Cap Stock	-1.98%	-7.99%	+1.72%	+1.61%	+1.57%
Real Estate	+4.68%	+2.66%	+9.43%	+10.78%	+5.73%
Natural Resources	+5.33%	-17.35%	-8.07%	-7.21%	-0.84%
Technology	-2.25%	-0.32%	+13.70%	+8.88%	+7.26%
Moderate Allocation (60% stocks)	+0.88%	-2.85%	+5.22%	+5.88%	+4.95%

The data in this table comes from Morningstar and is as of March 31, 2016.

Interest Rates This week JP Morgan's chief global strategist, Dr. David Kelly, noted that "never in the course of human history have so many invested so much for so little for so long." Money market investors must decide whether receiving close to zero interest, while core inflation is now running over 2%, is worth keeping cash levels high. Quality bond investors must decide whether low bond yields and high bond prices, in a normalizing inflation environment, are worth keeping bond balances high.

Perhaps surprisingly, there are reasons to embrace some bonds today. The developing theme for interest rates is "Lower for Longer." While bond prices are unlikely to fall sharply in a lower/longer environment, stable bond prices are welcome. In fact we maintain a small level of long-term bonds, to help client portfolios should bond prices remain stable for quite awhile. We also find attractive opportunities in opportunity bonds, bonds which trade more on their credit quality than on their term. The 'growing slowly' US economy continues to help companies improve their credit quality, and this helps the returns from opportunity bonds. In the past five years high-yield bonds have returned 7½% annually, while intermediate-term quality bonds have returned only 3½% annually. We expect this to continue while rates are low and US economic growth continues at a steady Eddie pace.

Taking Stock The US economy continues to move forward, the European economy is recovering, but from a lower level, and China and the Pacific region are growing at rates that are low for them, but attractive for most other regions. With this backdrop, the US stock market is pretty fairly priced, the European market is fairly priced and provides significant upside as the markets recover (think about the US markets' gains in 2009-2014). Emerging markets, which have been a significant disappointment to investors for many years, offer two big factors going for them. First, they are cheap, about 25% cheaper than they are historically. Second, like European markets, emerging market stocks are depressed and have substantial upside (as did the US in 2009). We therefore see a heads we win, tails we don't lose outlook for stock investors. The US offers fair prices and a pretty solid economy. Europe looks better, and emerging markets better still.

In the US, we are encouraged by the diminishment of two headwinds that stocks faced in 2015. The freefall in the price of oil, and the resulting large losses suffered by energy stocks, helped produce very weak stock results in 2015. Oil prices appear to be stabilizing, and this can remove a downward pressure on S&P 500 earnings. Secondly, the US dollar had surged in 2015, and US companies which sell globally lost market share to foreign stocks with less expensive goods and services. The dollar has reversed its climb, and it, too, may be stabilizing. Even without a return to its earlier, lower, level, a stable US dollar in 2016 will be neutral, and a welcome absence of a negative suffered throughout 2015.

We continue to emphasize financial stocks, health care stocks, and technology stocks. All three appear to be inexpensively priced, and there is a good story supporting optimism on the direction of each sector. Unfortunately the first two sectors suffered losses of 5% or more in the past quarter, however we currently view this as merely providing a greater 'bargain element' to these sectors.

We are eliminating Japanese stocks from our mix, although Japanese stocks will remain in our more general category foreign stock funds (Pacific region, foreign large caps, and global stock funds). A year ago we saw a likelihood that the Japanese economy was emerging from its decades-long funk. Japan stocks have fared better than foreign large-caps in the past year (by losing less). We no longer see sufficient promise to warrant a specific Japan-stock sleeve in client portfolios.

Emerging market stocks have been very difficult to continue to trust. They are down over 3¾% annually over the past five years, while foreign large-caps are up over 1½% annually. Nonetheless, we like the higher economic growth rate, and cheaper valuations that are regularly found in emerging markets at this time.

Our broken record keeps spinning, **"Diversify and rebalance. Rinse and repeat."**