

Capital Market Review and Outlook

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Executive Summary

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Capital Market Returns

- For U.S. investors, 2015 capital market returns were disappointing. Domestic stocks and bonds returned 0.5% and 0.6%, respectively.
- However, the rather boring market return masks significant volatility in various stock / bond market segments. For example, large stocks significantly outperformed mid- and small-company stocks, growth outperformed value, and there was wide discrepancy within sector returns.
- Commodities (not just energy) had a terrible year (again) with a return of -24.7%.

Economic Conditions

- Most indications are that the economy will continue to grow slowly. Consumers appear to be in pretty good shape, but businesses may have hit a slower-growth period.
- The unemployment rate is near a ten-year low. Demand for workers appears strong yet hiring could be stronger. Wages appear to be growing at a modest level.
- Real estate conditions appear good (sales, prices, construction have been increasing in combination with low interest rates).
- Inflation remains below the FED's target. Future interest rate increases appear to be "data dependent" but the market expects four increases during 2016. We do not expect that many.

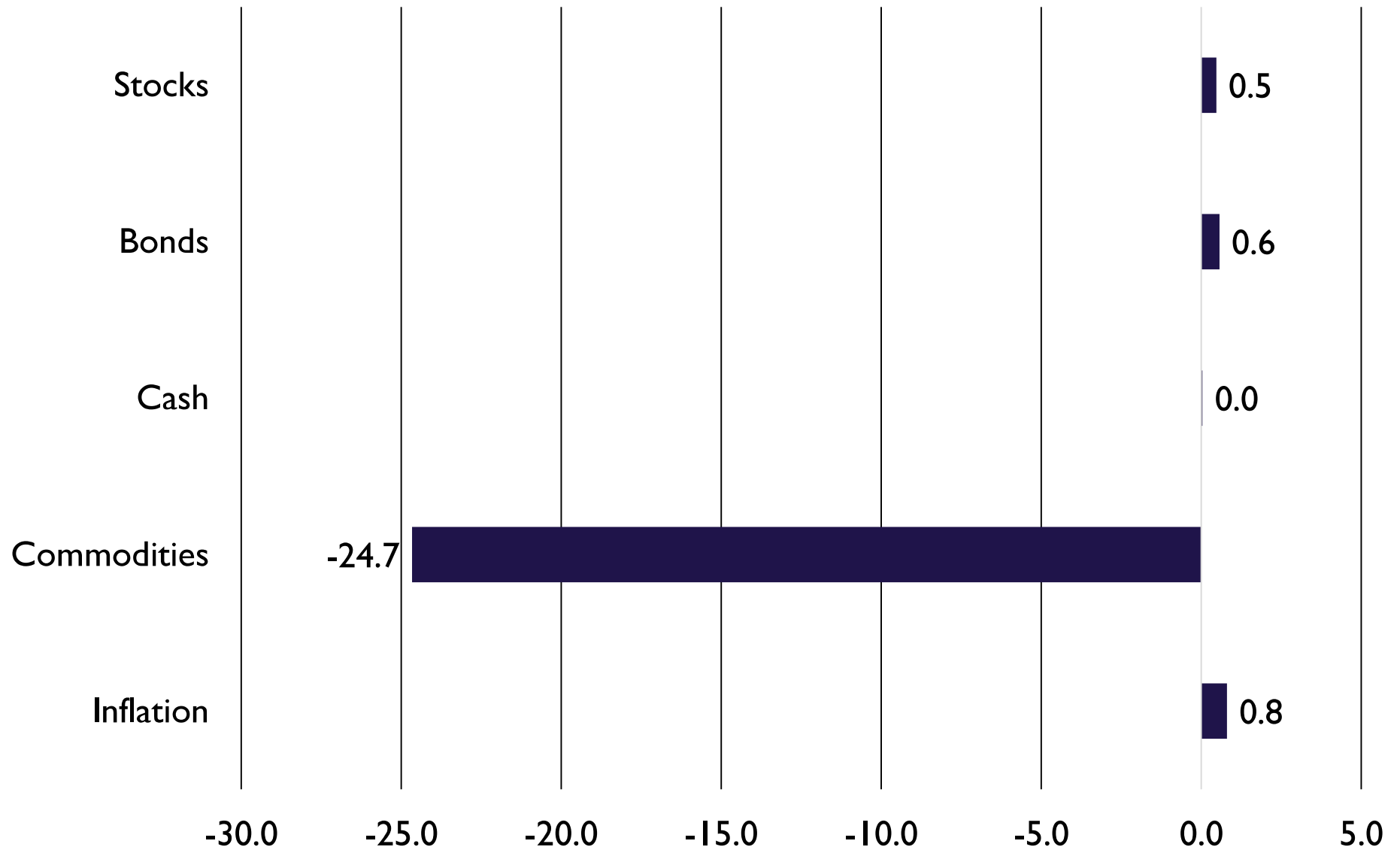
Stock Market

- During 2015, returns were concentrated in a few large-company stocks that did very well. For the broad market (including small company stocks), the average stock lost -3.5% and eight of the 12 sectors had negative returns. Within the S&P 500, five of ten sector returns were negative.
- Large U.S. stocks performed the best. Mid- and small-company stocks, developed international, and emerging market stocks all had negative returns. Emerging market stocks were particularly poor performers.
- Valuations remain elevated. For the past several years stock market volatility has been modest. We expect a higher level of volatility during 2016.
- While valuation is a poor short-term predictor, it does seem to provide insights on longer-term expectations. Current valuation levels suggest more modest future stock returns.

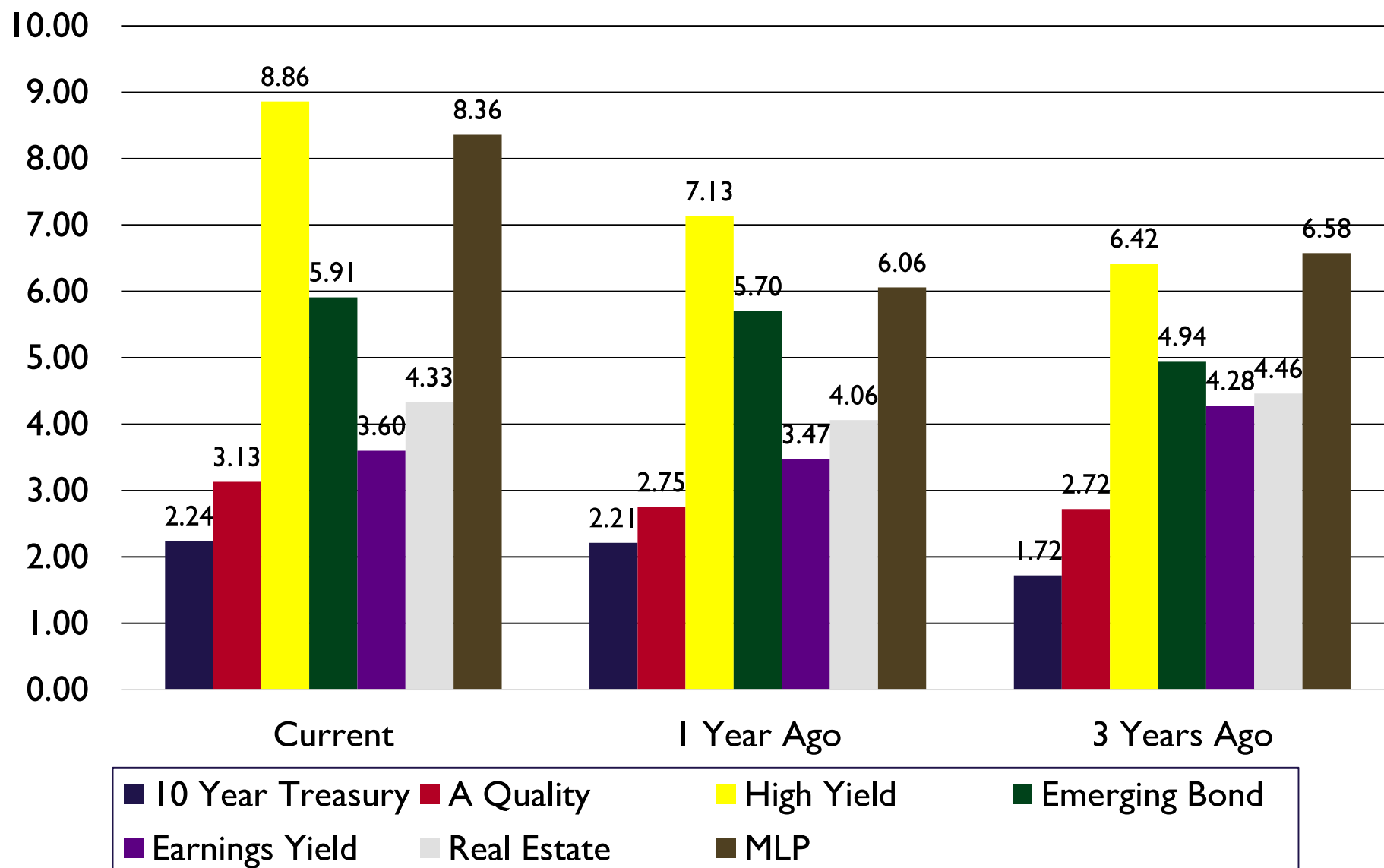
Bond Market

- The Federal Reserve increased short-term interest rates for the first time in nearly a decade. The market currently expects four interest rate increases during 2016. We are skeptical there will be this many interest rate increases.
- Tax-free bonds outperformed taxable bonds. Mortgage bonds were the best performing sector. High yield bonds performed poorly.
- Expect low bond returns (similar to their yields). Investment grade corporate and high yield bonds are more interesting now.

2015 Asset Class Returns



Asset Class Yield Comparisons

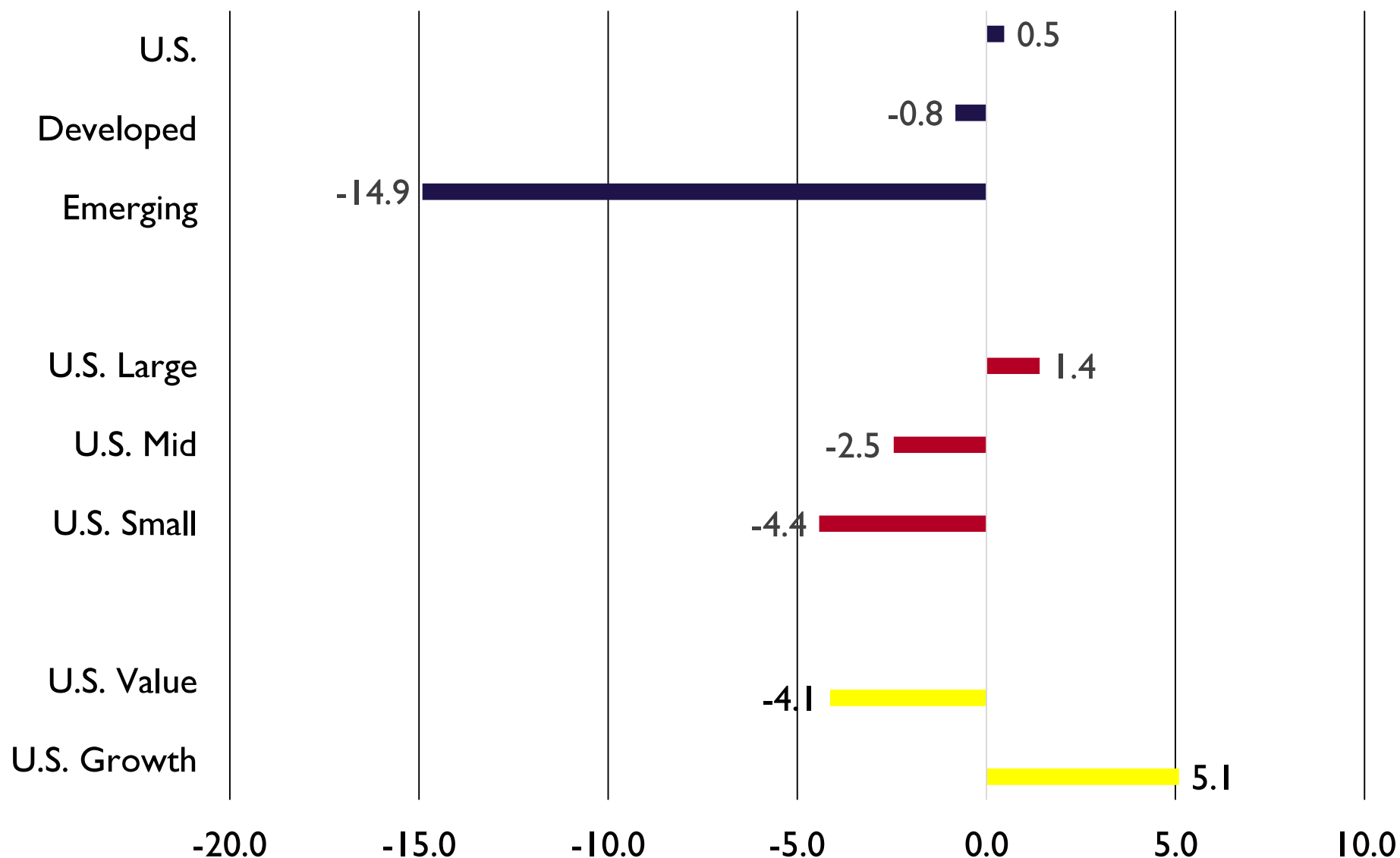


Stock Market

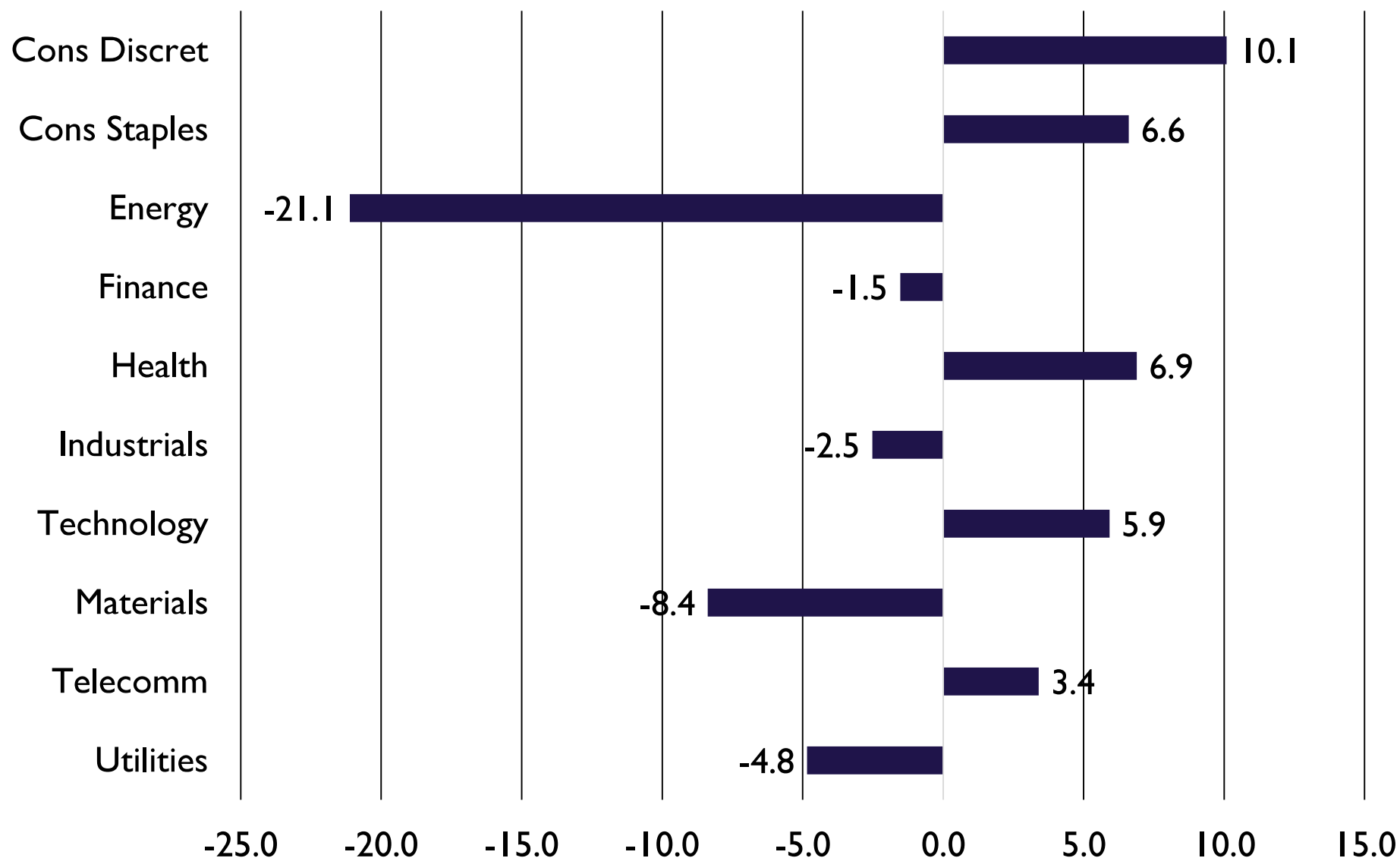
Observations

- During 2015, U.S. stocks were essentially flat with a return of 0.5%. Developed international and emerging market stocks returned -0.8% and -14.9%, respectively. Large company stocks returned 1.4%, outperforming the mid- and small-company stock returns of -2.5% and -4.4%, respectively. By investment approach, growth stocks return of 5.1% was significantly ahead of the value stock return of -4.1%.
- While the U.S. stock market had a positive return, that is really the result of a few very large companies (Facebook, Amazon, Netflix, and Google) doing very well. The broader stock market was much less healthy. Overall, 56% of stocks declined during 2015 with an average decline of -3.5%. Of the 12 economic sectors examined, only Consumer Non-Cyclical, Finance, Healthcare, and Technology had more stocks with a positive return. The other 8 sectors had more stocks with a negative return. For example, the Basic Materials, Energy, and Transportation sectors had 76%, 86%, and 72% of stocks within their respective sectors decline. The average 2015 stock return in those sectors was -18%, -35%, and -18%, respectively.
- Emerging market stocks were negatively impacted by the collapse in commodity prices as well as more sluggish growth in China. For countries that are highly dependent on oil revenue (Brazil, Russia), the fall in oil prices will likely lead to additional budget / debt / currency issues. This has the potential to be a significant economic event.
- The dramatic decline in Energy prices has negatively impacted some of the fundamental characteristics of the S&P 500. For example, for the one-year period ending September, sales and operating growth has been negative. However, the median economic sector operating income growth was 3.2% -- so fundamental characteristics may not be as bad as the "headline" number (when energy is excluded).
- Valuations remain on the high side. At the end of the year, the Price / Operating Earnings ratio was 18.1x (compared to 16.9x a year ago and 14.4 five years ago). Price to book value is also significantly higher than five years ago.
- Using normalized earnings (averaged over a 10-year period), valuation is near a 10-year high. However, when comparing the stock earnings yield to that of a 10-year Treasury, stocks look somewhat more attractive.
- Analysts expect bottom-up earnings growth for large-company stocks to be 16.6% in 2016 and 13.7% in 2017. Given the broad macro-economic environment, we find these estimates essentially meaningless. Mid- and small-company expected earnings growth are even higher (and more meaningless). JIC believes large-company stocks will continue to outperform mid- and small company stocks.
- For the past few years, volatility has generally been low. But, we are seeing more frequent spikes -- in October and now in January. In addition, we are seeing certain stock market sentiment indicators flash some warning signs. We believe 2016 will be a much more volatile year for the stock market compared to the past few years.
- Future stock returns are comprised of essentially three things: dividend yields, future earnings growth, and changes in valuation multiples. Given relatively high valuation levels and lower expected earnings growth, we believe investors should moderate their stock market return expectations.

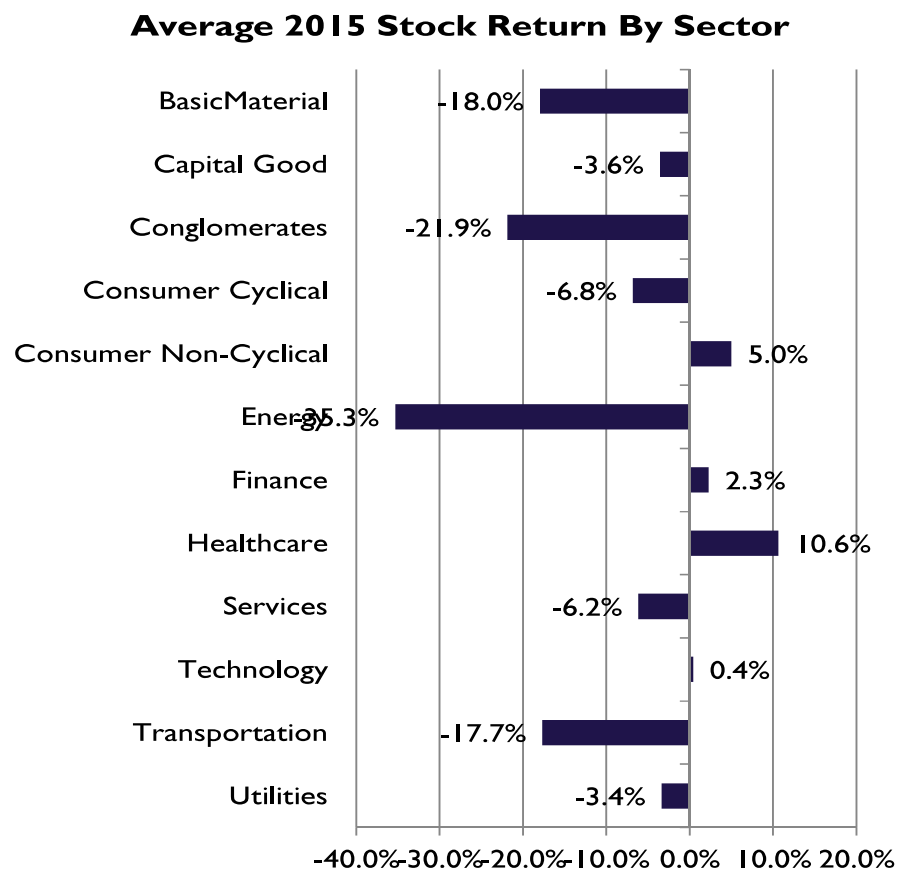
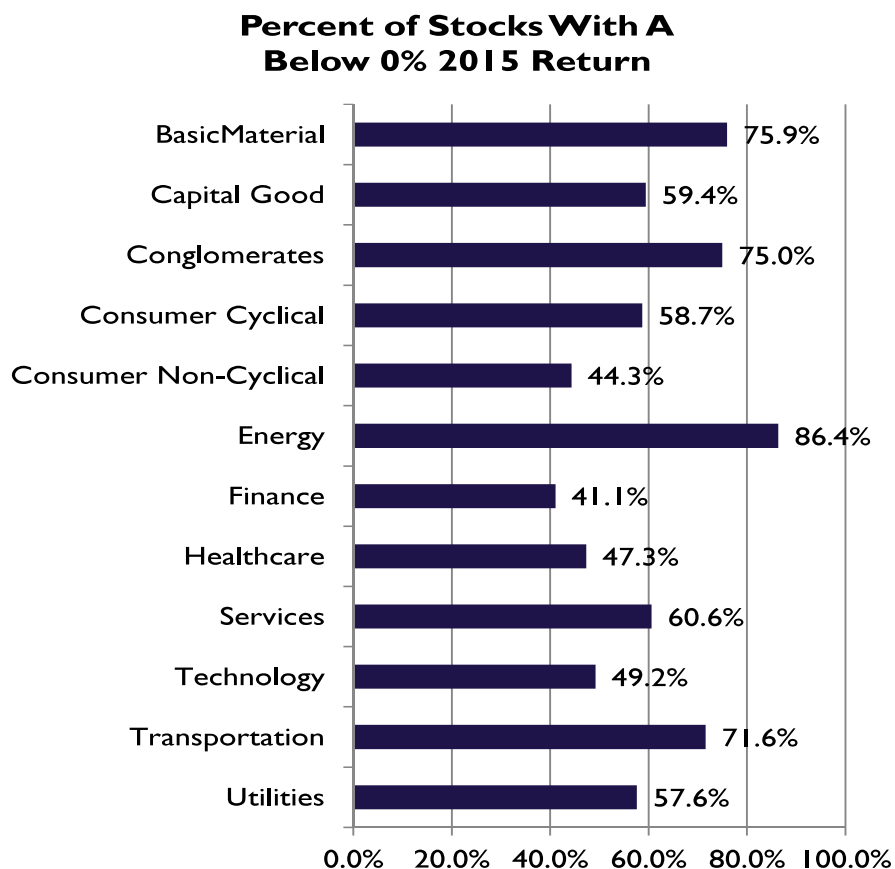
2015 Stock Market Returns



2015 S&P 500 Sector Returns



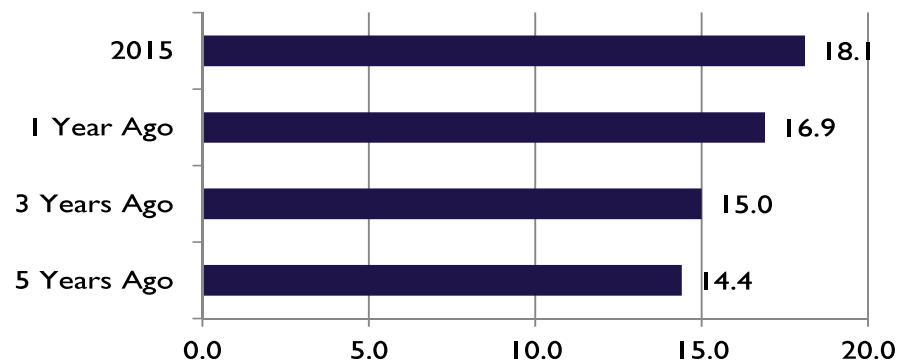
2015 Stock Returns By Sector



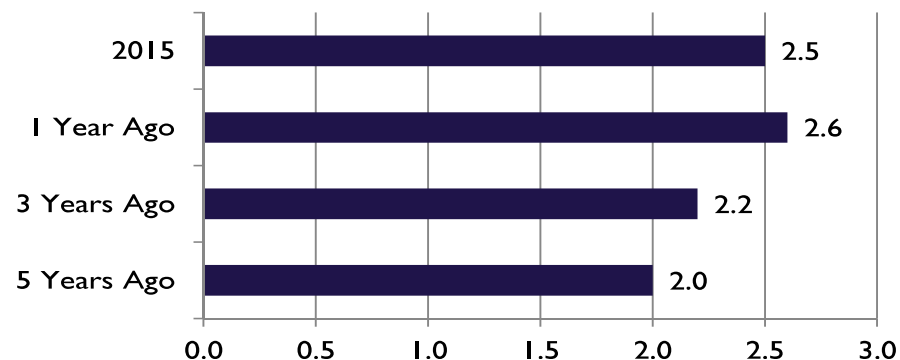
- For the broad stock market most stocks did not perform well during 2015. In only four of the twelve sectors did the average stock have a positive 2015 return. Losses in certain sectors were very significant (Basic Materials, Energy, Transportation).

SP 500 Index: Fundamental Characteristics

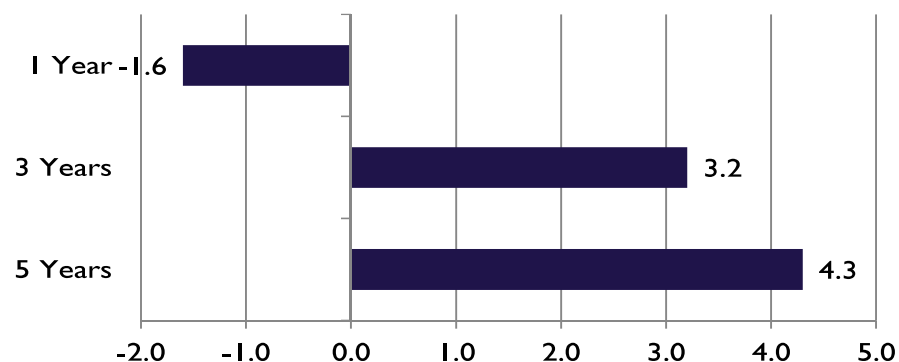
Price to Operating Earnings



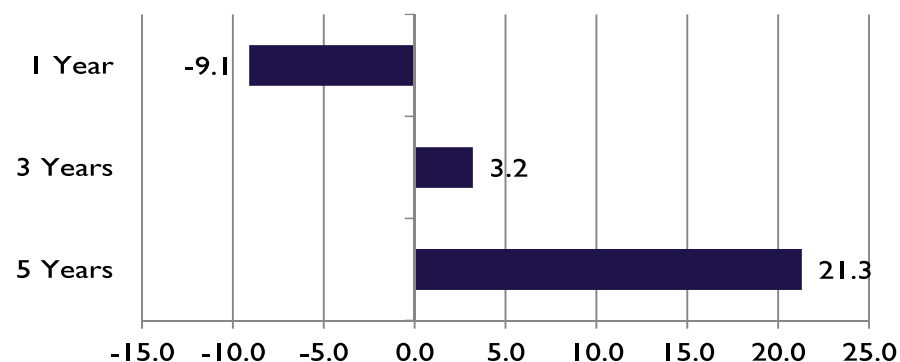
Price to Book Value



Sales Growth

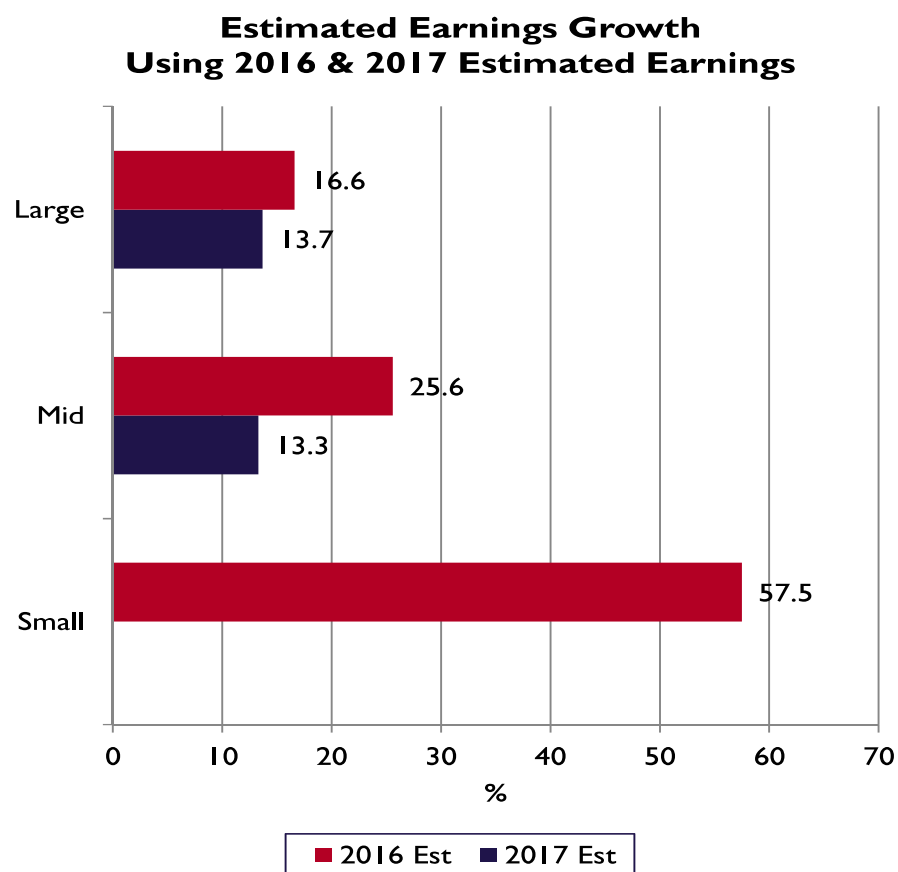
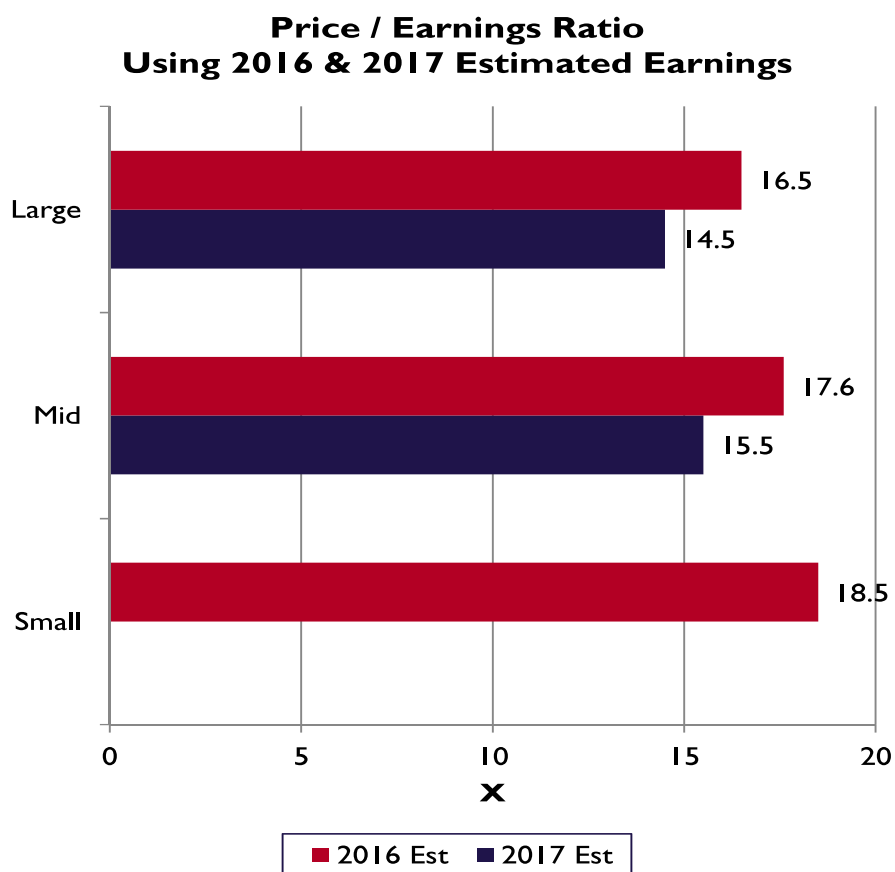


Operating Income Growth



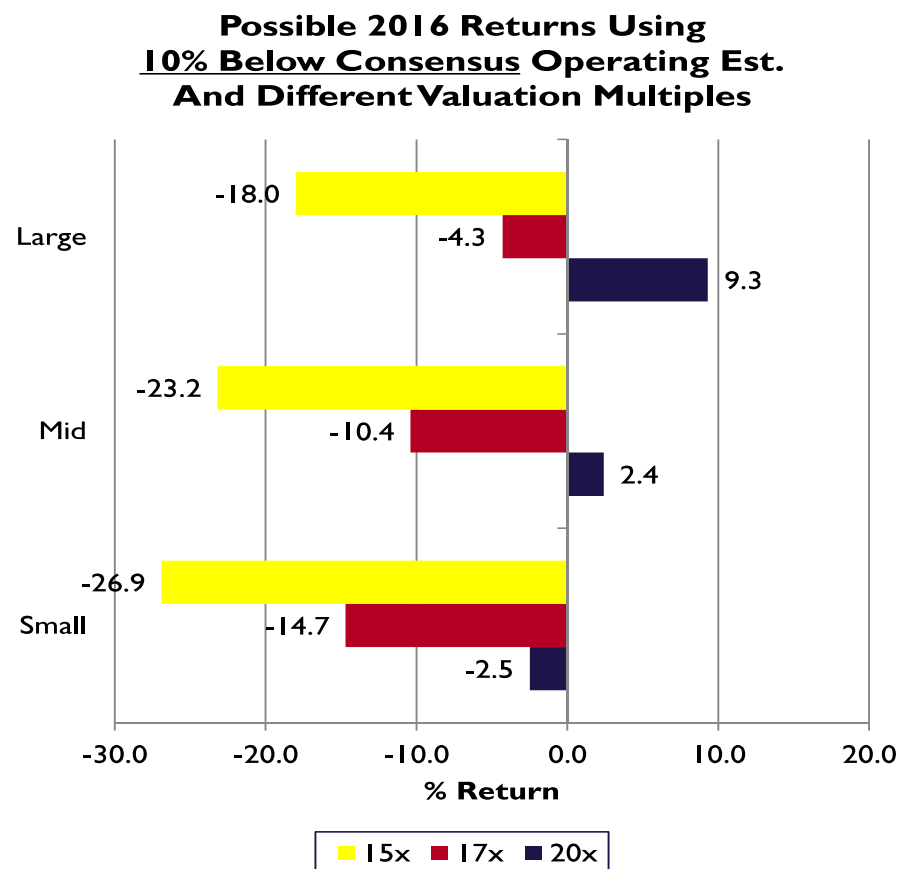
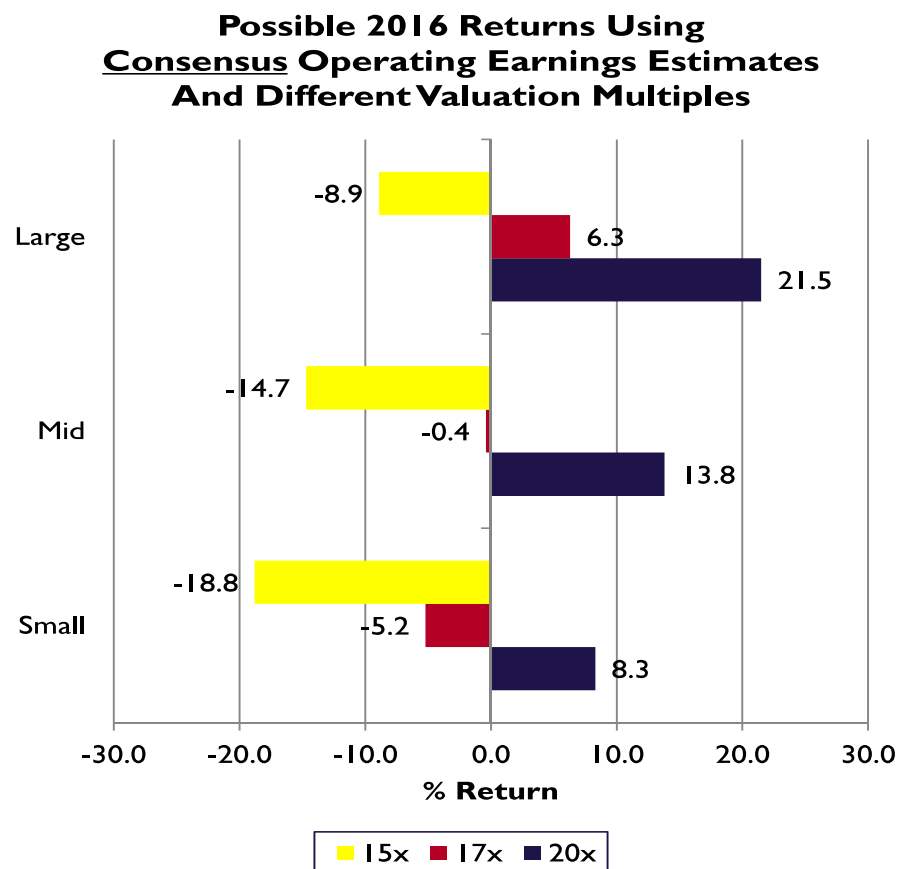
- JIC believes it is difficult to make the case that the current stock market is significantly undervalued. In addition, JIC believes continued stock market multiple expansion is less likely.

Price / Earning Multiples & Expected Earnings Growth By Company Size



- We believe analyst earnings growth expectations are way too optimistic and do not reflect the broad macro-economic environment.

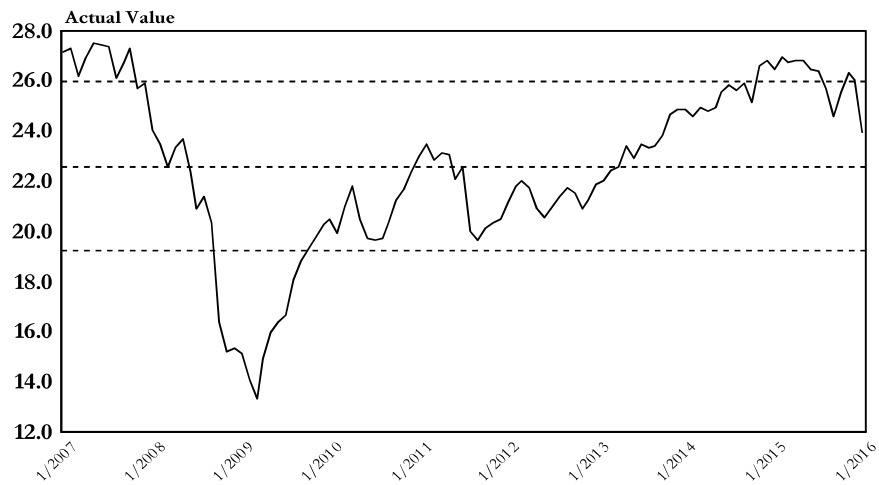
Possible 2016 Stock Returns By Company Size (Consensus & 10% Below Consensus Estimates)



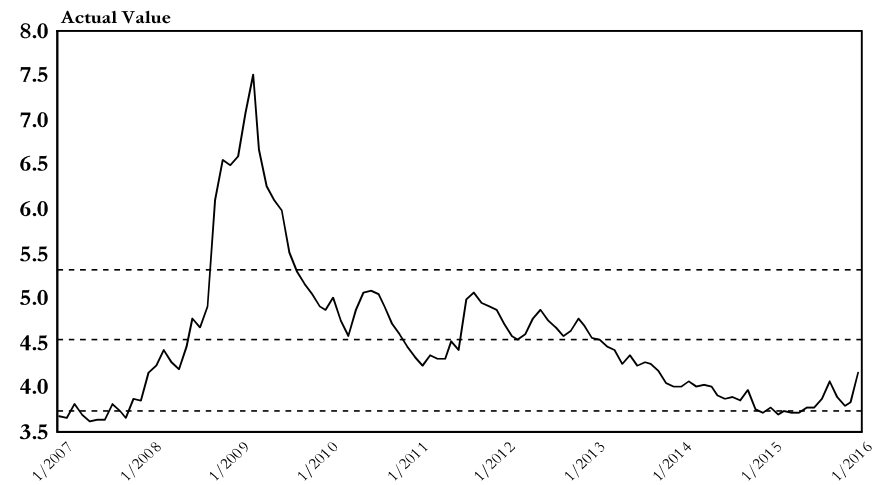
- Often times, as the year progresses, earnings estimates are reduced. If 2016 consensus earnings were reduced by 10%, it will be extremely difficult for stocks to produce a positive return (without multiple expansion).

Valuation Using 10-Year Average Earnings

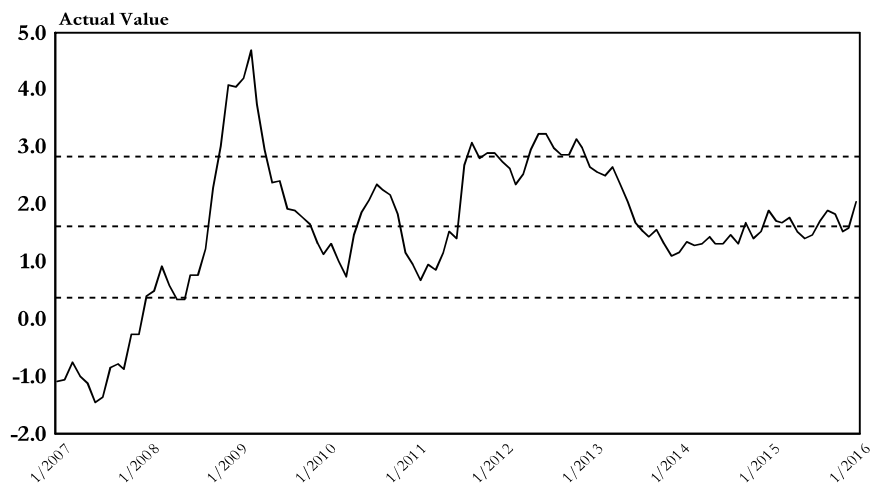
S&P 500 PE Using 10-Year Average Real Earnings



S&P 500 Earnings Yield Using 10-Year Average Real Earnings

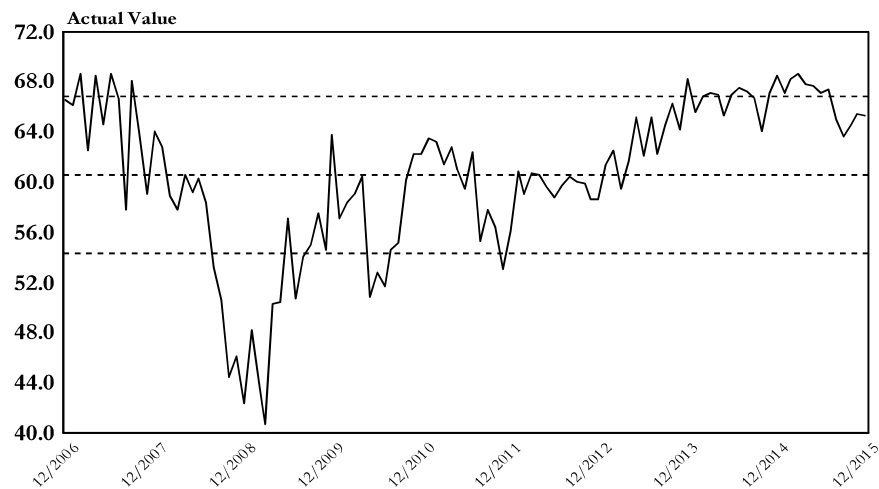


S&P 500 Earnings Yield Using 10-Year Average Real Earnings Less 10-Year Treasury Yield

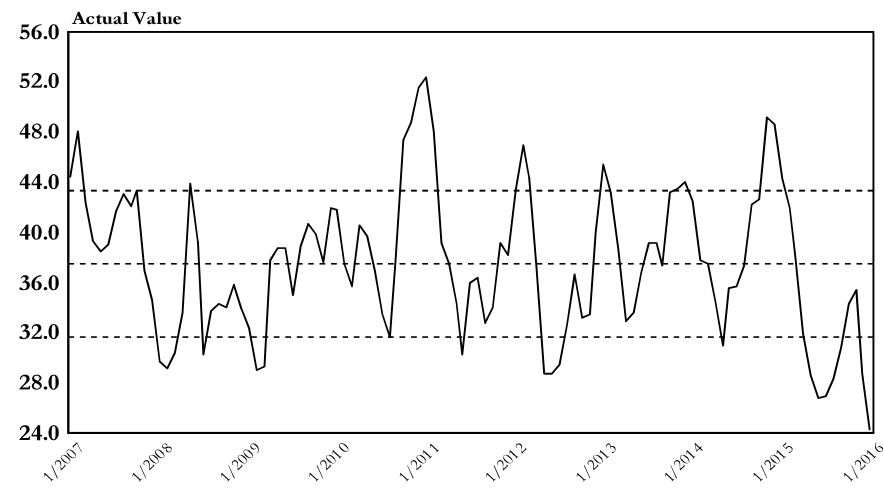


Stock Market Sentiment

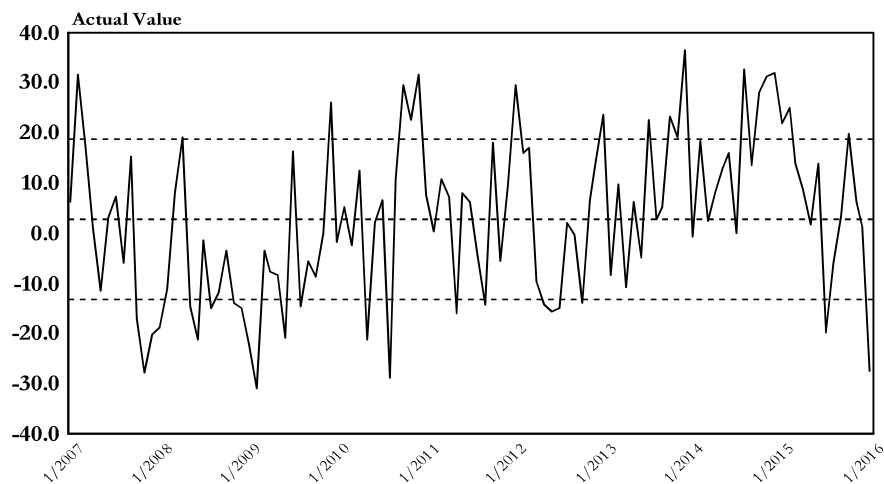
AAII Survey: Stock Allocation



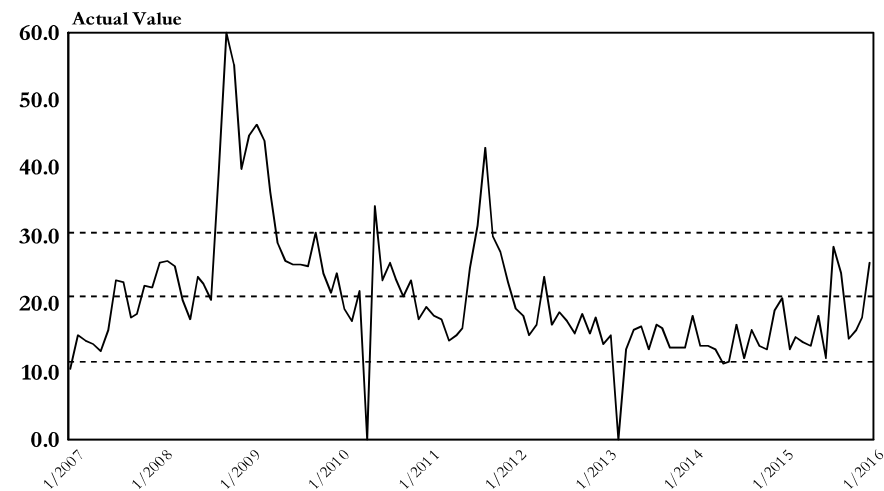
AAII Percent Bullish 8-Week Average



AAII Bull/Bear Investor Sentiment Spread



CBOE Volatility Index



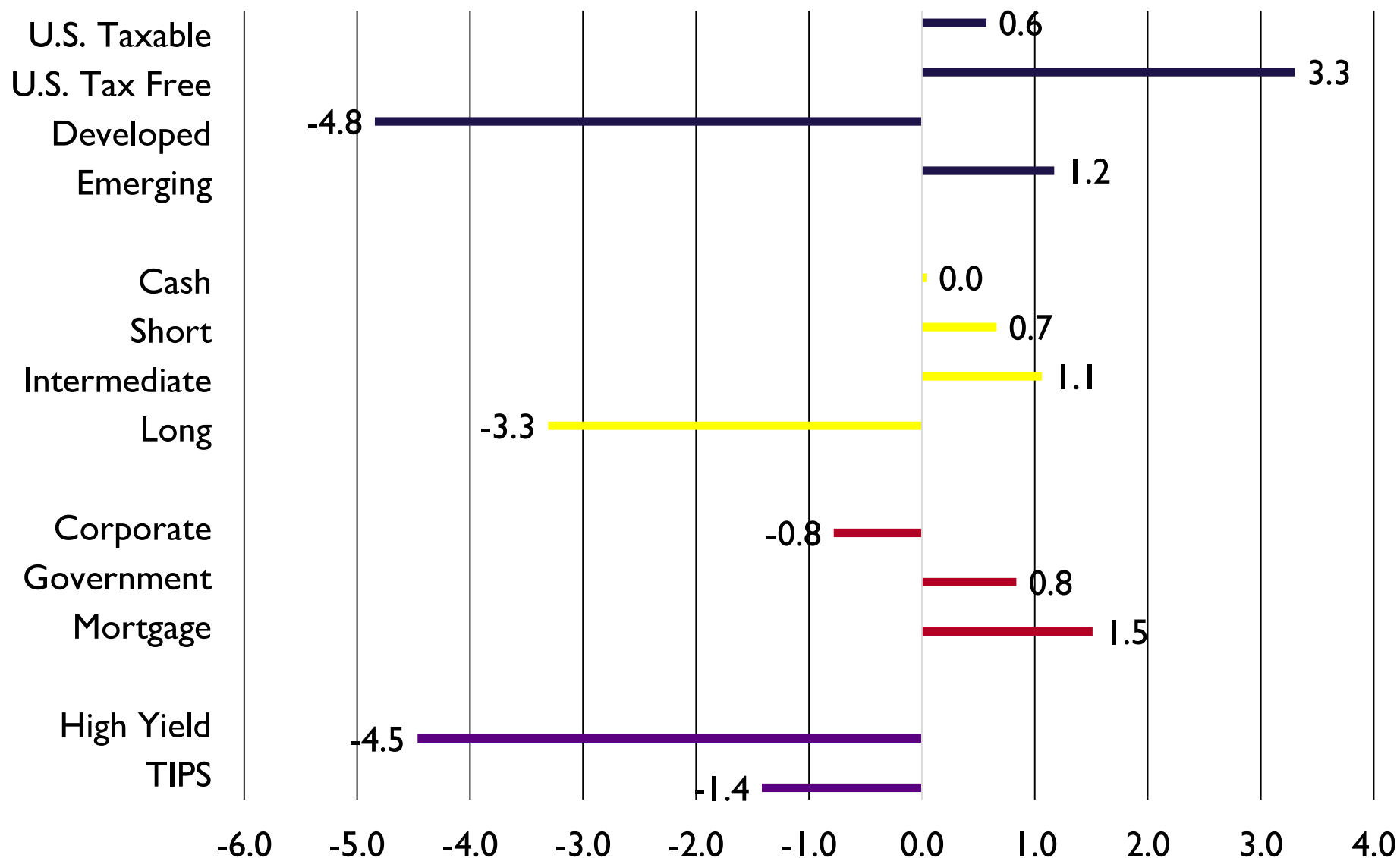
- There has been a recent change (likely due to the October correction) in stock investor “bullishness”. Investors appear to be much more skeptical on the outlook for the stock market.
- For the past several years, the volatility index has been quite low. However, in October, during the correction, we saw it spike significantly. We expect the volatility index to generally increase from recent-year levels.

Bond Market

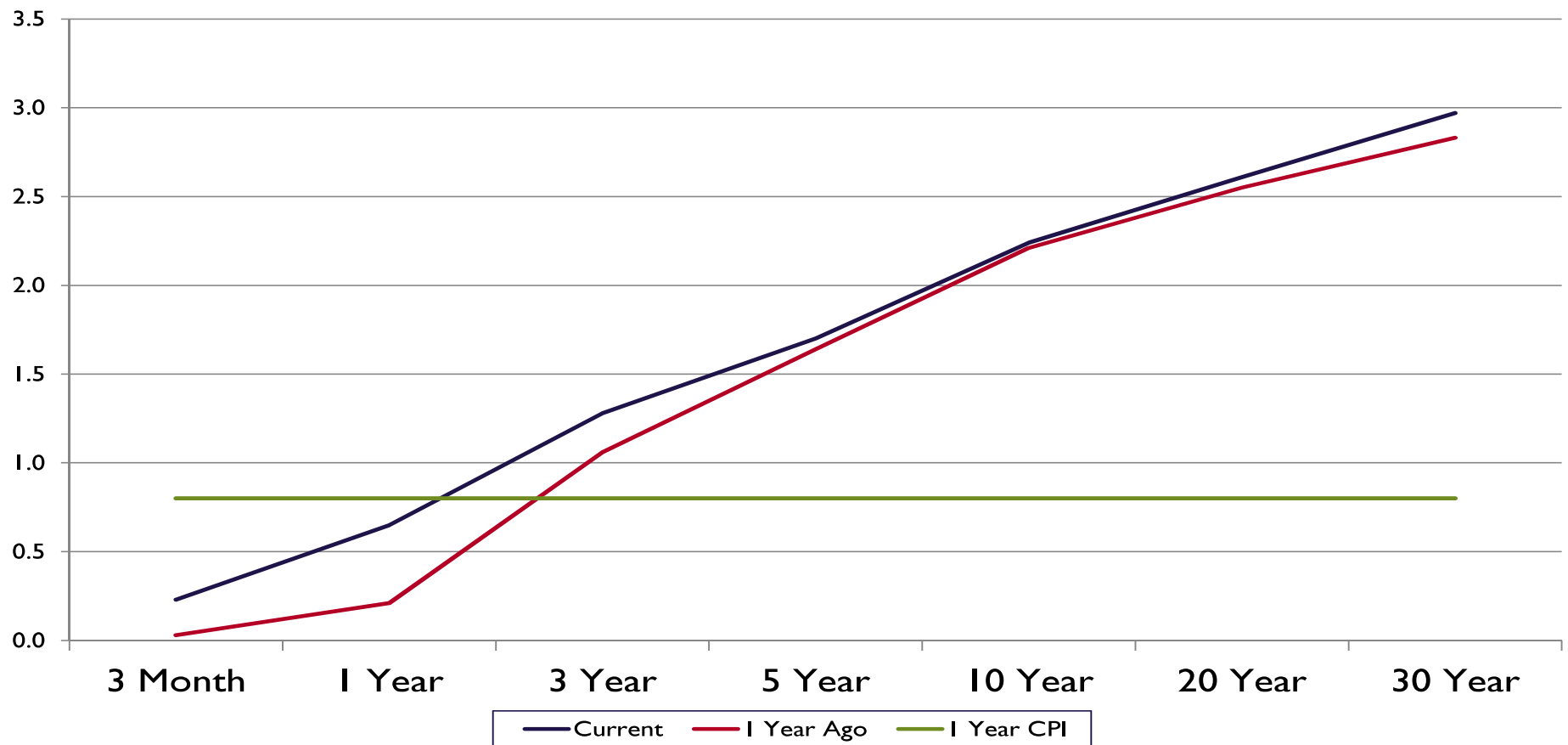
Observations

- Municipal bonds were the best performing bond segment during 2015 with a return of 3.3%. The broad U.S. bond market returned a disappointing 0.6%. Developed bonds returned -4.8% (due to U.S. dollar appreciation) and emerging market bonds (dollar denominated) returned 1.2%. High yield bonds, in part reflecting quality concerns among energy companies, returned -4.5%.
- The intermediate segment was the best performing maturity range with mortgages being the best performing sector. Corporate bonds were the worst performing bond sector.
- For the first time in nearly a decade, the Federal Reserve increased short-term interest rates by 0.25%. Going into 2016, market expectations are for perhaps up to four additional interest rate increases in 2016. While future interest rate increases are perhaps likely, we expect fewer increases -- unless the economic data improves. If there are future increases, we believe most of them will be in the second half of the year.
- Headline inflation (including energy) has been too low (below 1% for 2015). Excluding energy inflation still remains “well contained” and has generally been below 2%. The FED would probably like to see somewhat higher inflation.
- During 2015, interest rates rose in the short-maturity segment of the yield curve. The intermediate maturity segment saw very little yield change.
- The maturity spread (difference between 10-year and 1-year Treasury yields) is essentially at its longer-term historical average. Relative to its ten-year history, Treasury yields provide a below-average yield premium over inflation-protected securities. This is the result of low inflation expectations. If one believes inflation could rise, inflation protected securities offer some value.
- For the past several years, municipal bond yields have been higher than taxable bond yields. This is not a “normal” long-term condition and reflects the fragility of state / local governments budgets as well as the FED’s influence on short-term interest rates. In today’s environment, there is very little yield difference between taxable and tax-free bonds. Nevertheless, for taxable accounts, tax-free bonds remain somewhat more attractive.
- Corporate bond yields increased across the quality spectrum during 2015. The increase was particularly significant in the lower quality bond segments. High-yield bonds saw an over two percentage point increase in their yields. The quality spread (high yield less ten year Treasury yields) is now above its ten-year average. High yield bonds currently offer more value than at any time over the past several years. We will likely begin to re-establish small positions.

2015 Bond Market Returns

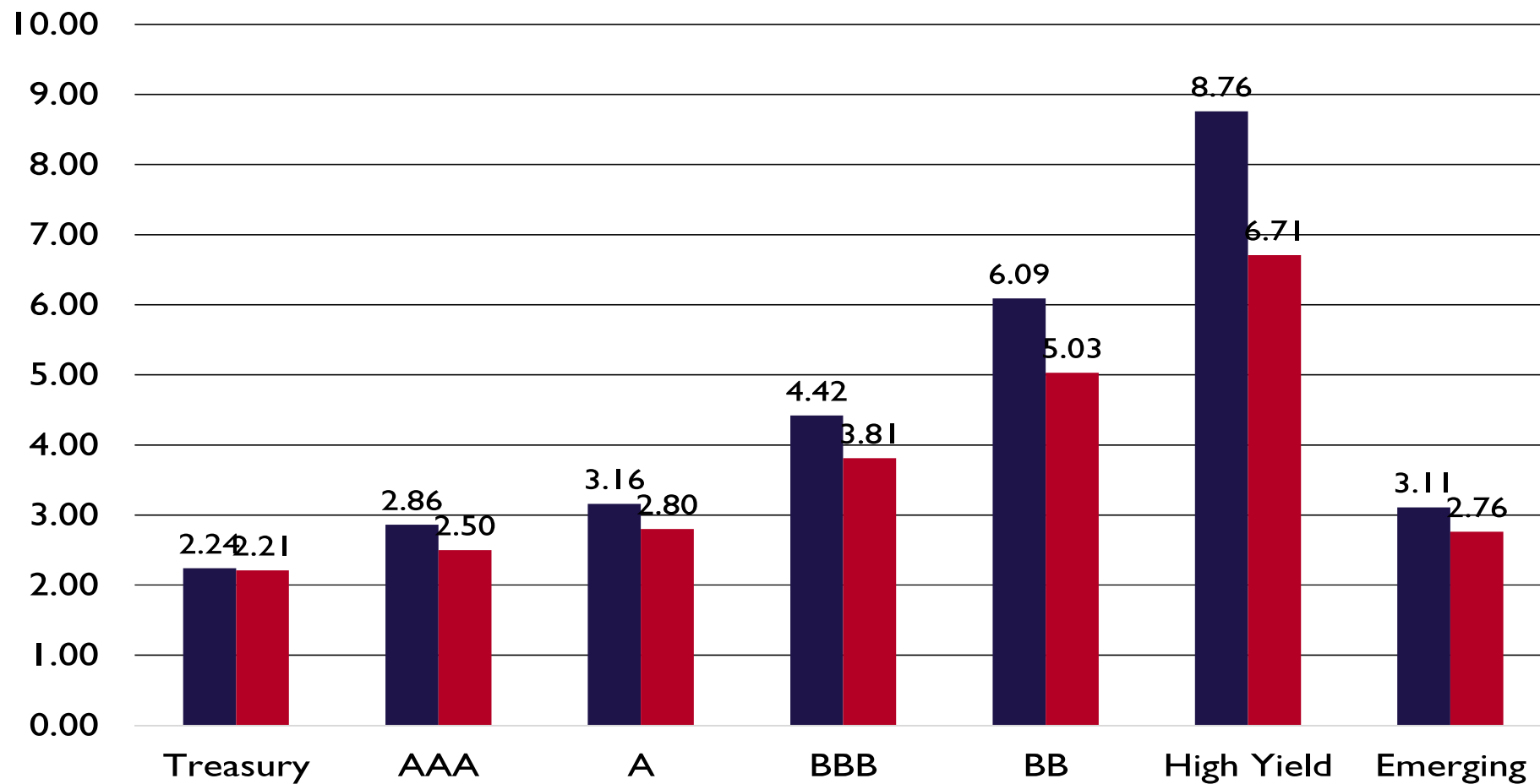


Treasury Yield Curve



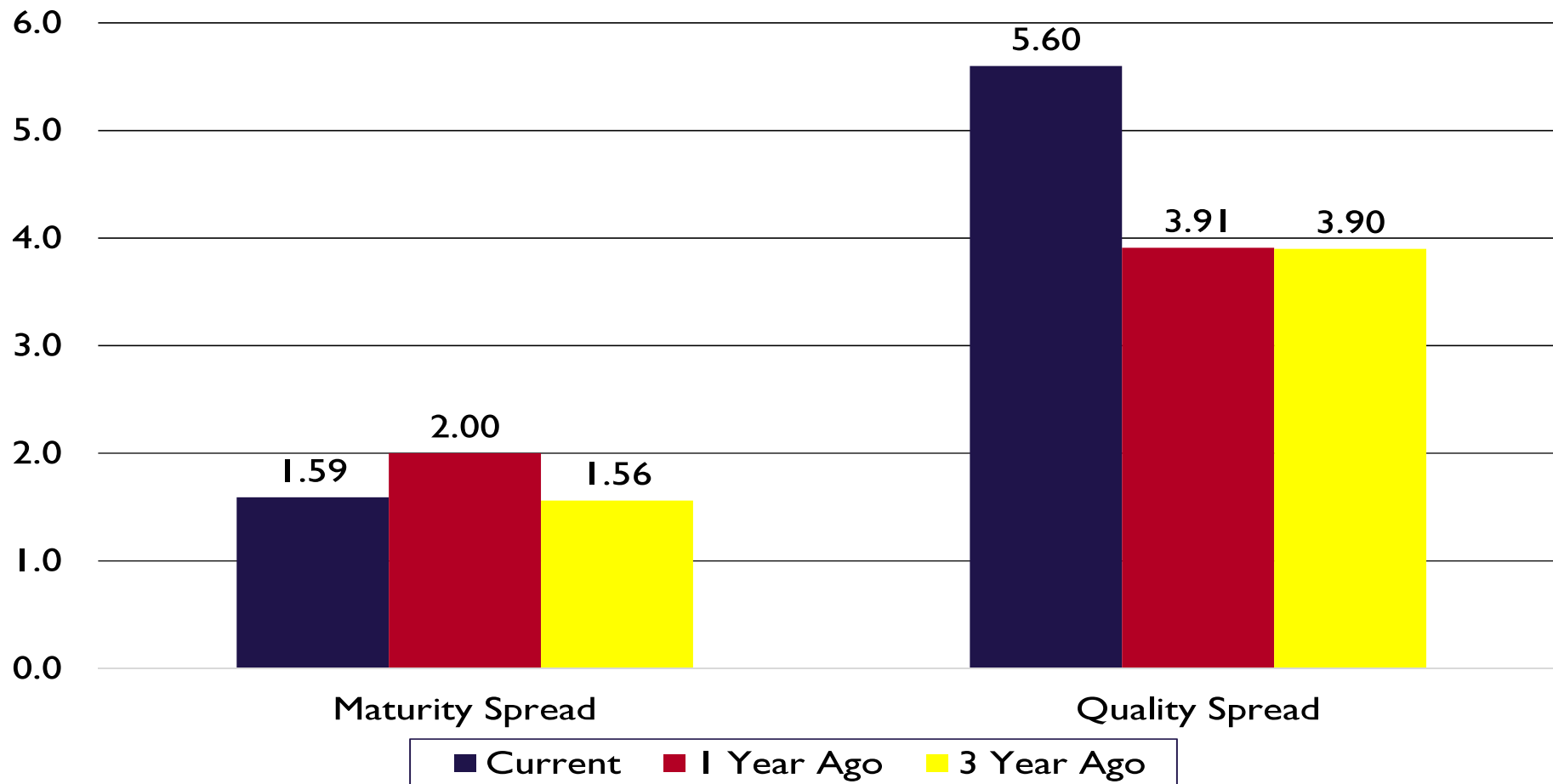
- Compared to a year ago, Treasury interest rates increased at the short-end of the curve with very little change in the intermediate section of the yield curve.

Bond Yields By Quality



- Corporate bond yields increased, regardless of quality during 2015. The increase was higher in the lower-quality segments.

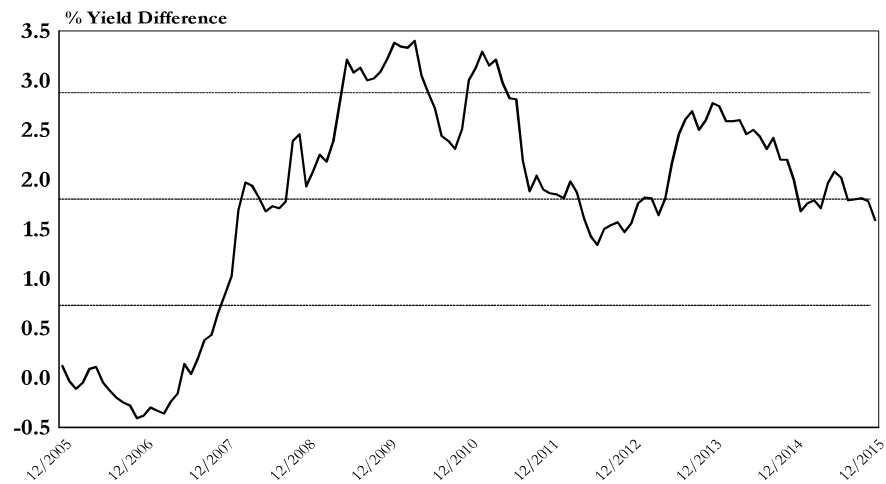
Quality & Maturity Spread



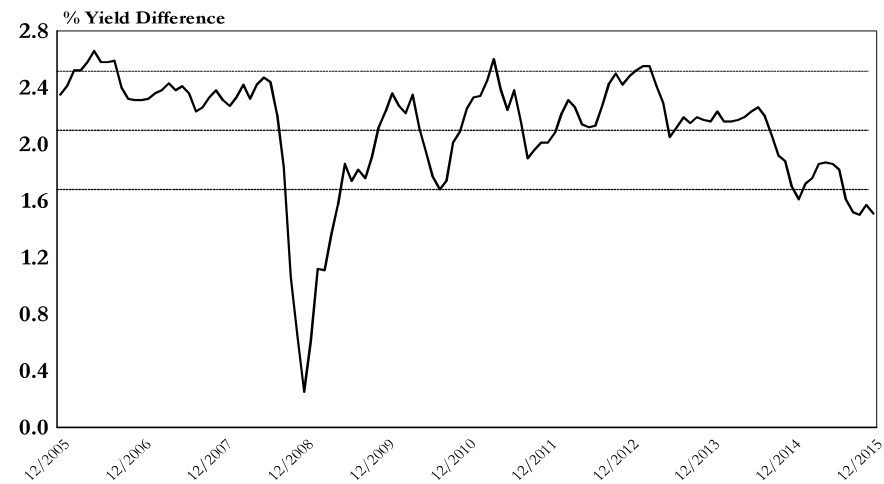
- The maturity spread narrowed during the past year, but is similarly to the spread of three years ago. At the margin, shorter-term bonds may be somewhat more attractive.
- The quality spread has significantly increased during the past year making high yield bonds more interesting.

Bond Market

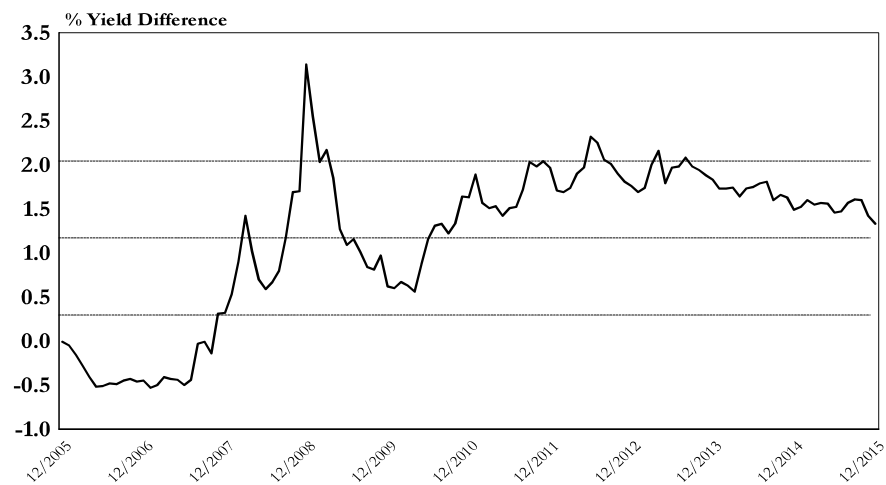
10 Year Treasury Less 1 Year Treasury



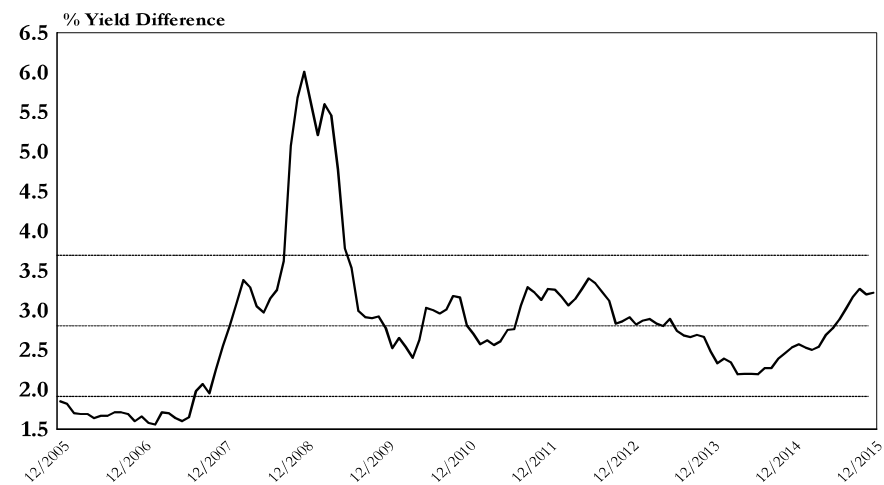
10 Year Treasury Less 10 year TIP



Bond Buyer 20-Bond Municipal Bond Index Less 10 Year Treasury

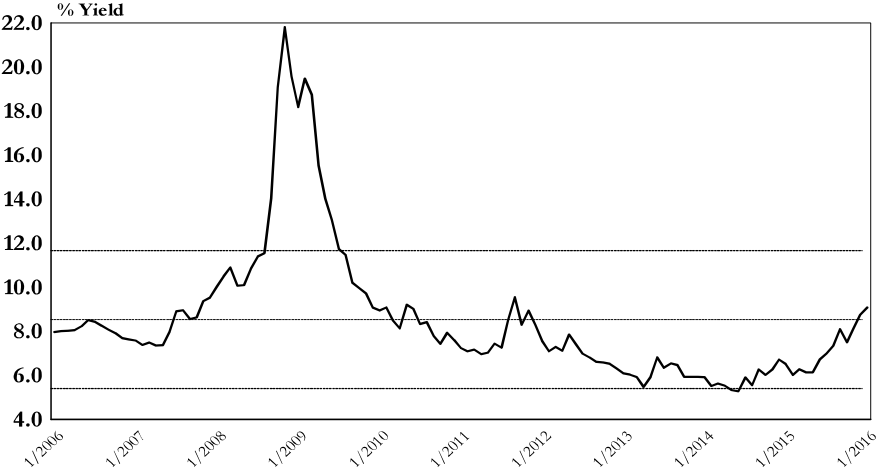


Moody's Baa Less 10 Year Treasury

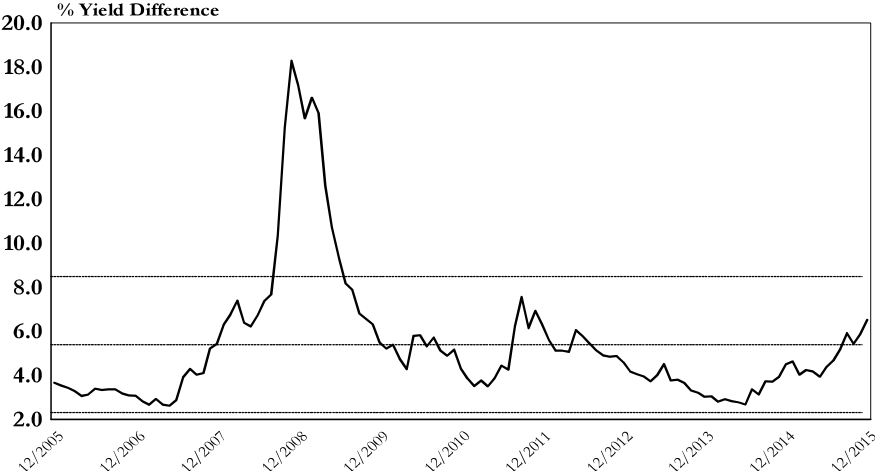


Bond Market

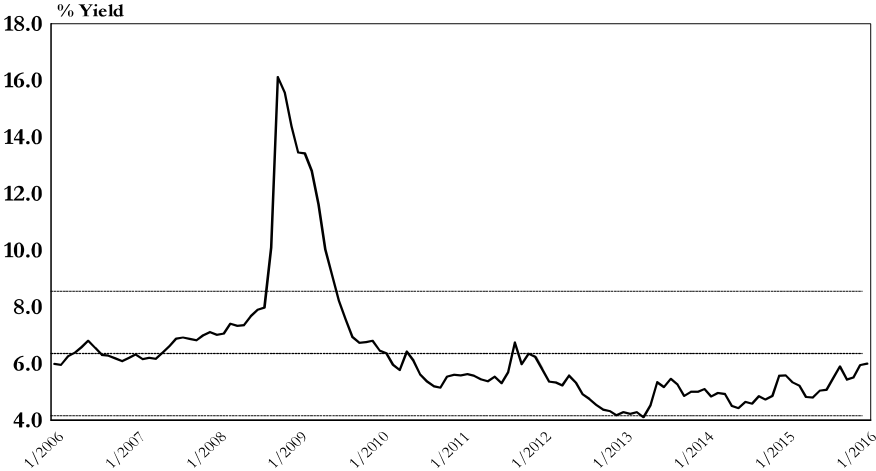
ML High Yield



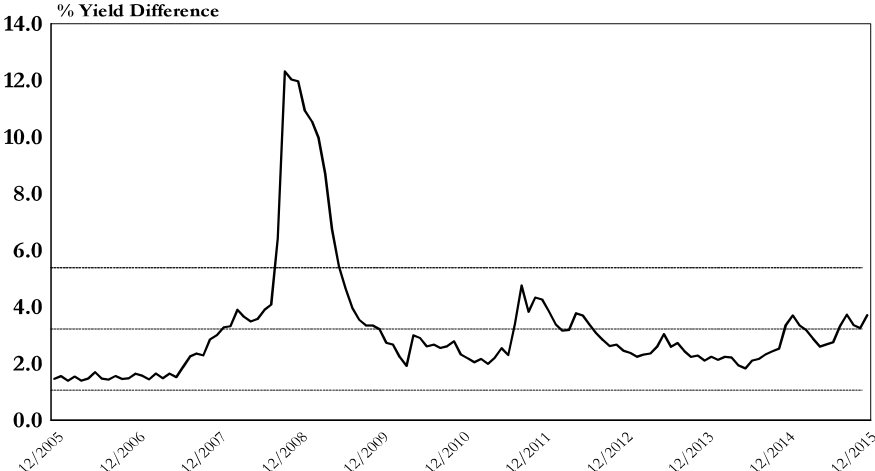
ML High Yield Less 10 Year Treasury



ML Emerging Market Corporate



ML Emerging Market Corporate Less 10 Year Treasury



Economic Conditions

Executive Summary: Economic Conditions

General Economy & Financial Conditions

- The U.S. economy continues to grow modestly. We do not foresee dramatically higher growth than current levels. Recent indicators of future economic activity have suggested a potential slowdown in growth. This does not mean a recession is imminent -- just slower growth.

Consumer

- The consumer appears to be in relatively good shape. Durable goods growth, while lower, remains positive. Disposable personal income is growing slightly higher than its ten-year average. Consumer sentiment is pretty high. Inflation is under control.

Business

- Business growth seems to have stagnated. The growth in industrial production is declining and manufacturing and non-manufacturing purchasing managers clearly have less-robust outlooks. There is less optimism with respect to future new orders.

Labor

- The labor market has seen improvement. The unemployment rate has fallen dramatically. In addition, employers appear to be interested in hiring additional workers. However, actual new hires, while growing, are not as robust.

Real Estate

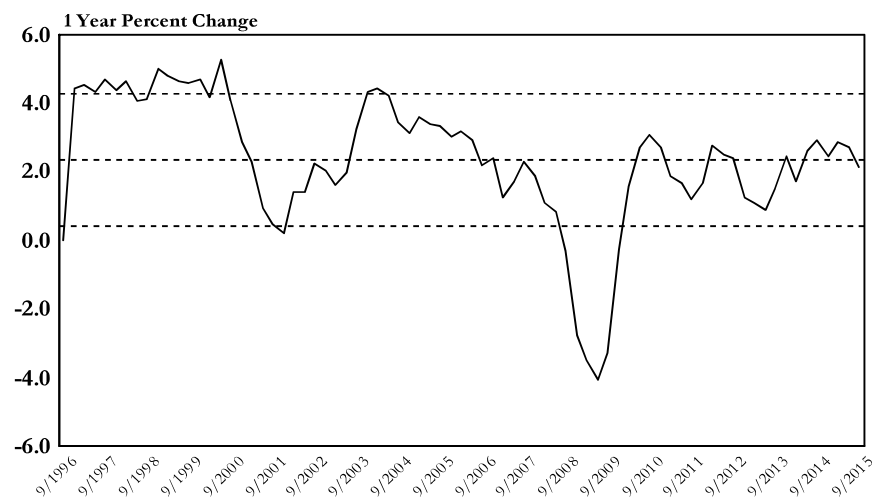
- Real estate activity appears pretty strong as sales, prices, and housing starts are all increasing. The number of months a house is for sale has declined to near ten-year lows.

Summary

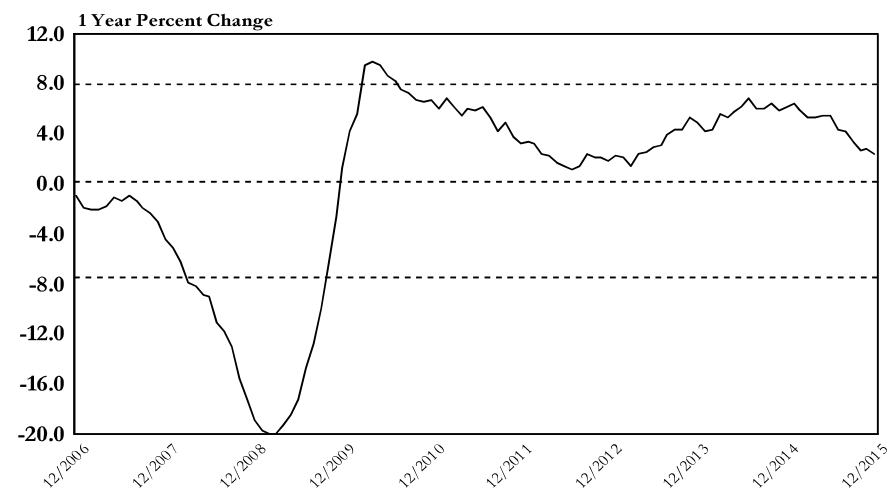
- The economy has been improving. But, it appears that in certain segments (business) we are / will be going through a slower-growth period. We expect consumers, given the dramatic decline in energy prices, to pick up some of the slack. Perhaps a recovering Europe could help. But demand from the emerging markets will clearly be a negative. It appears that modest economic growth is what should be expected.
- Given the levels of economic activity, it appears the FED believes inflation may become a concern and have hinted at additional interest rate increases. However, while the unemployment rate is low, wage growth (so far) has been moderate. Inflation continues to be below the FED's target rate. In this environment, we believe there will be more modest interest rate increases.

Economic Conditions: General Economy

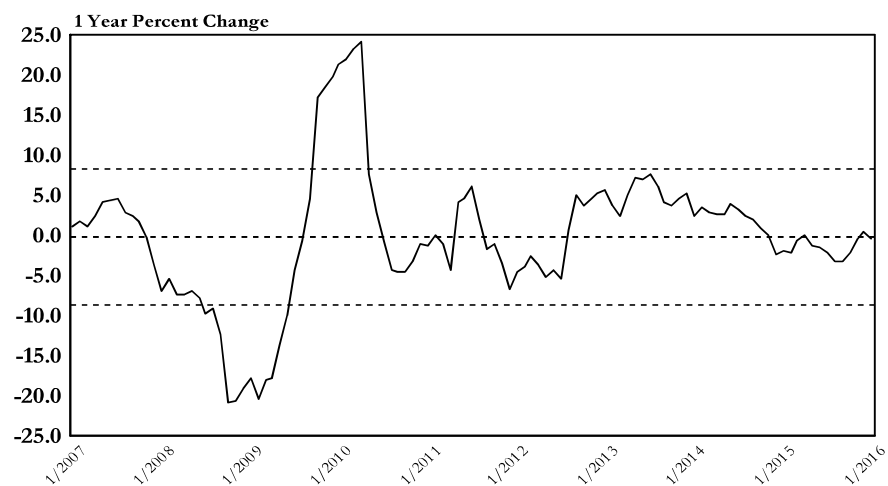
Gross Domestic Product



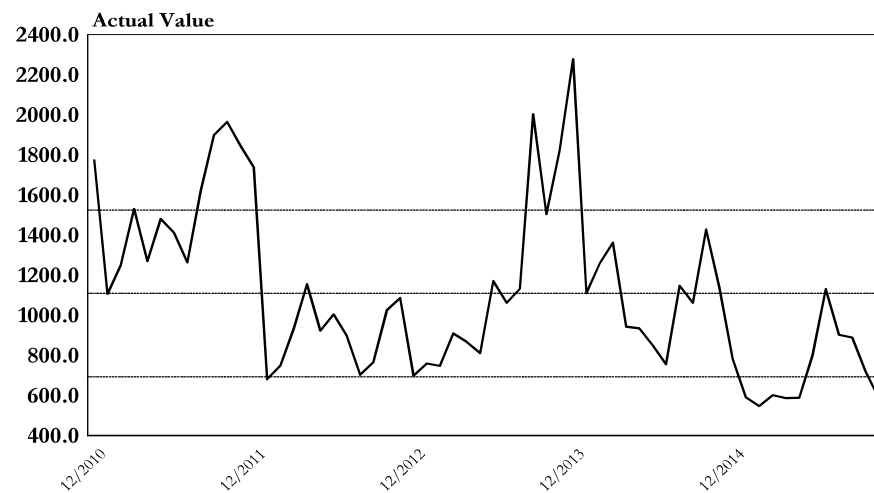
Leading Economic Indicators



ECRI Weekly Leading Index

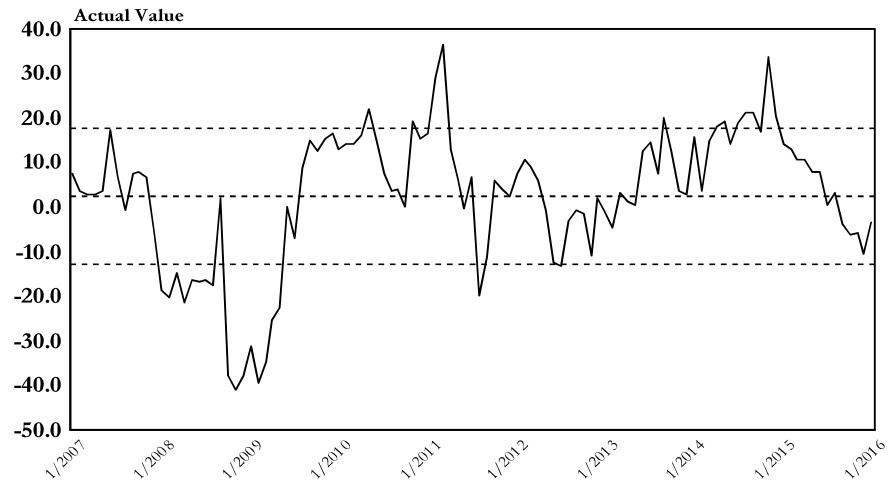


Baltic Dry Index

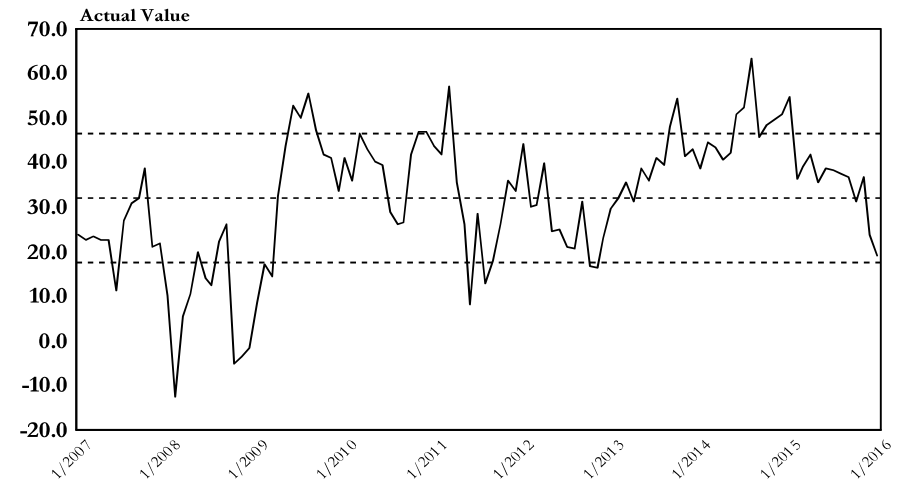


Economic Conditions: General Economy / Consumer

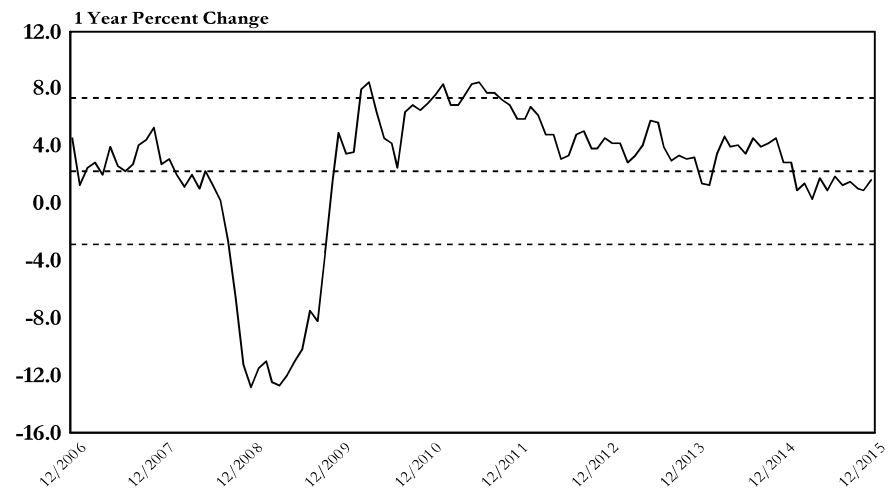
Phili Fed: General Activity - vs. Prior Month (Diffusion)



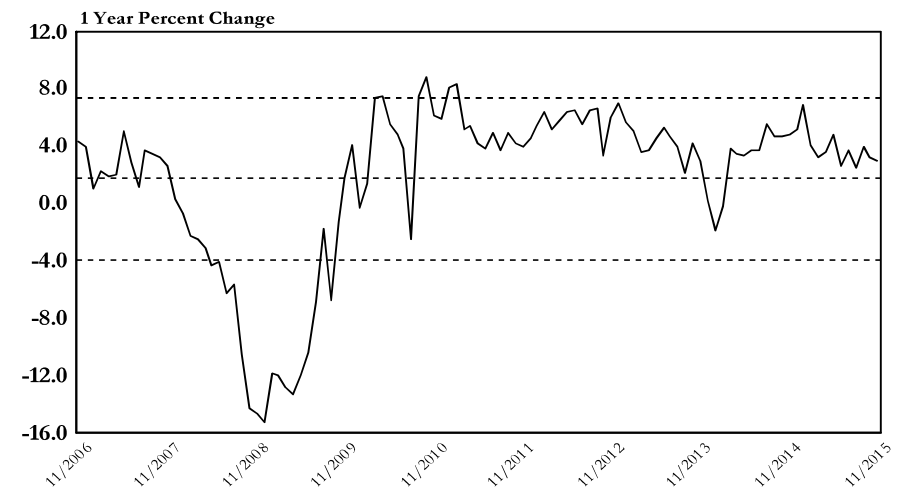
Phili Fed: General Activity - 6 Months Ahead (Diffusion)



Retail Sales

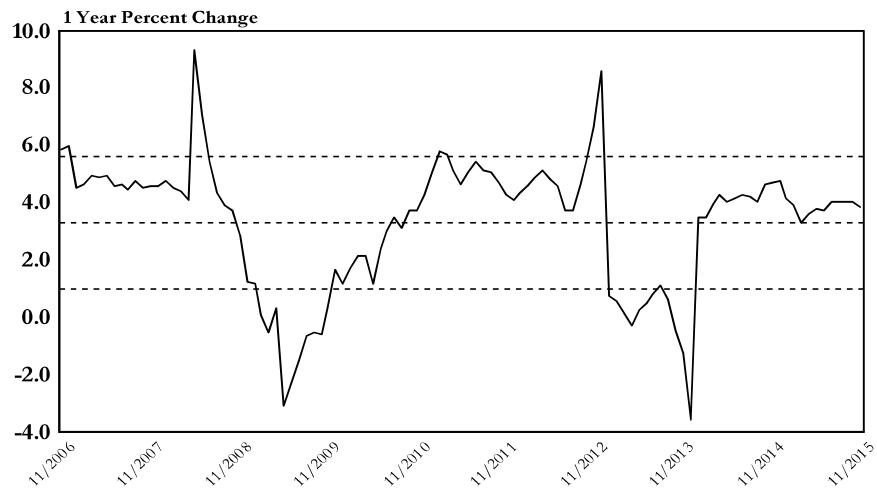


Personal Consumption Expenditures: Durable Goods

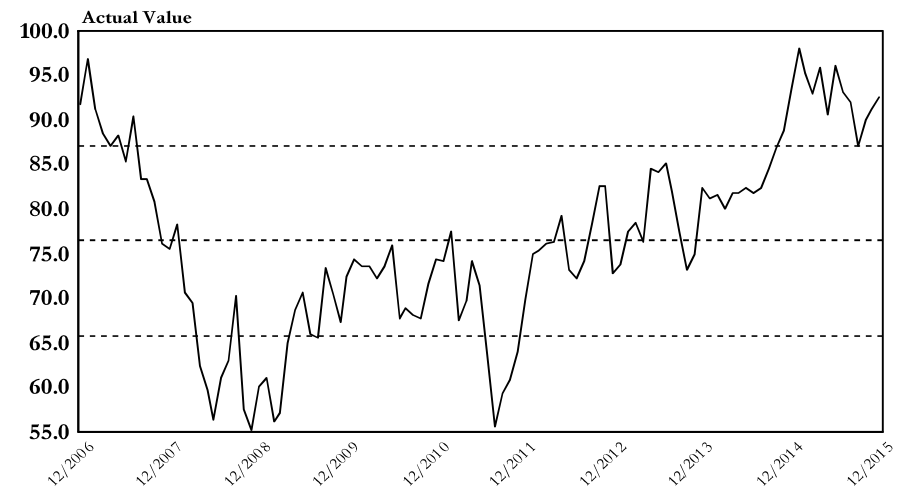


Economic Conditions: Consumer

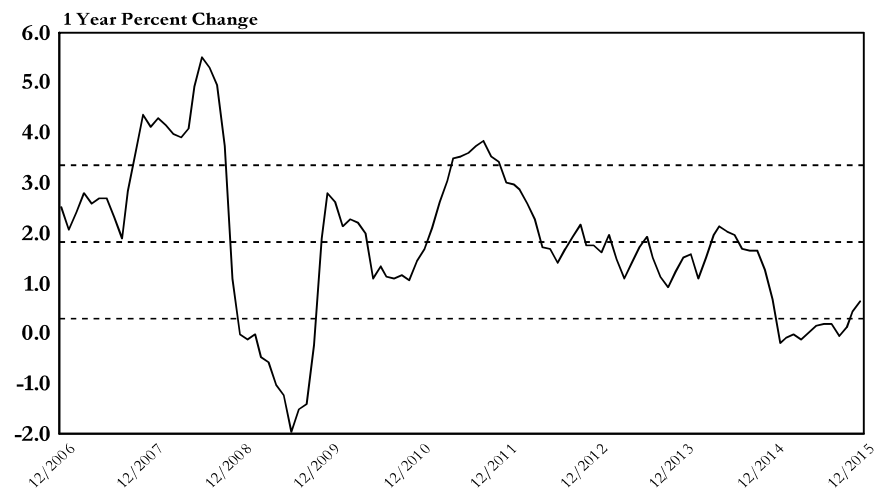
Disposable Personal Income



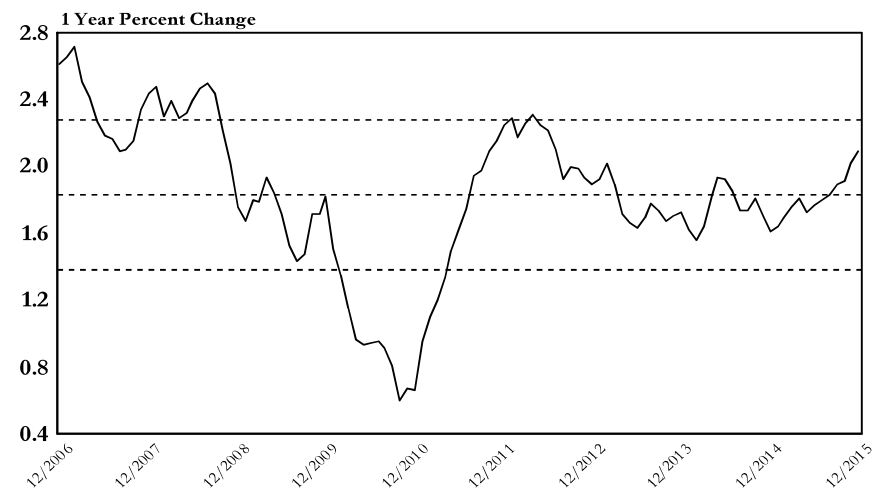
Consumer Sentiment



Consumer Price Index

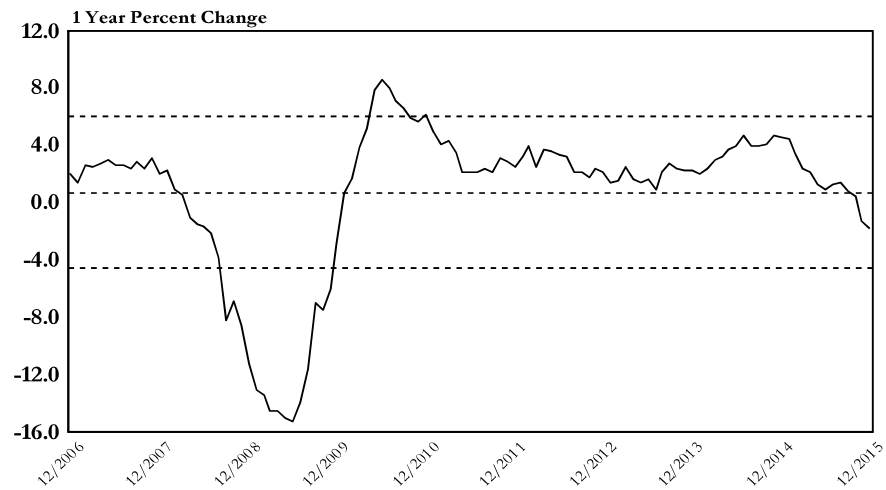


Consumer Price Index Less Food and Energy

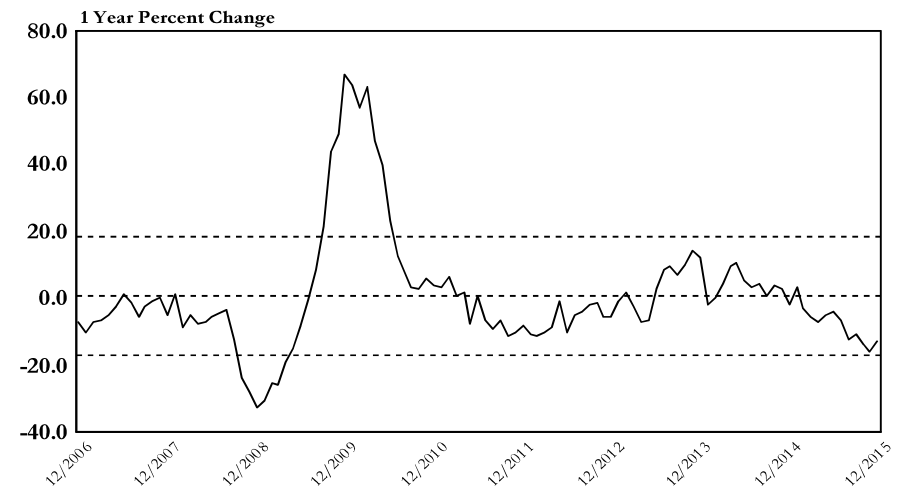


Economic Conditions: Business

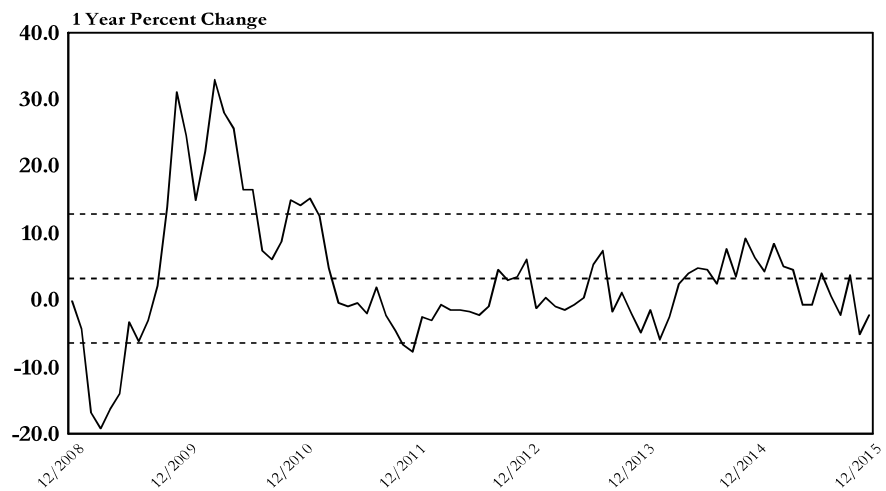
Industrial Production



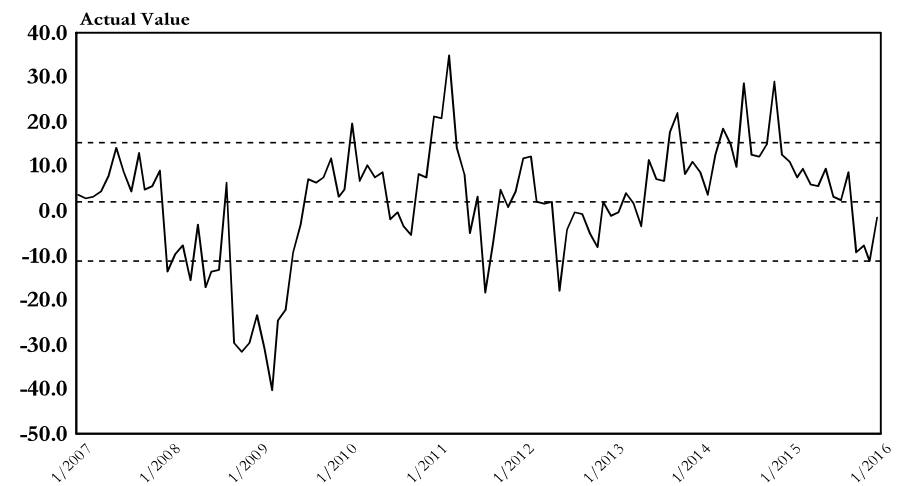
ISM Manufacturing: Purchasing Managers Index



ISM Non-Manufacturing: NMI Composite Index

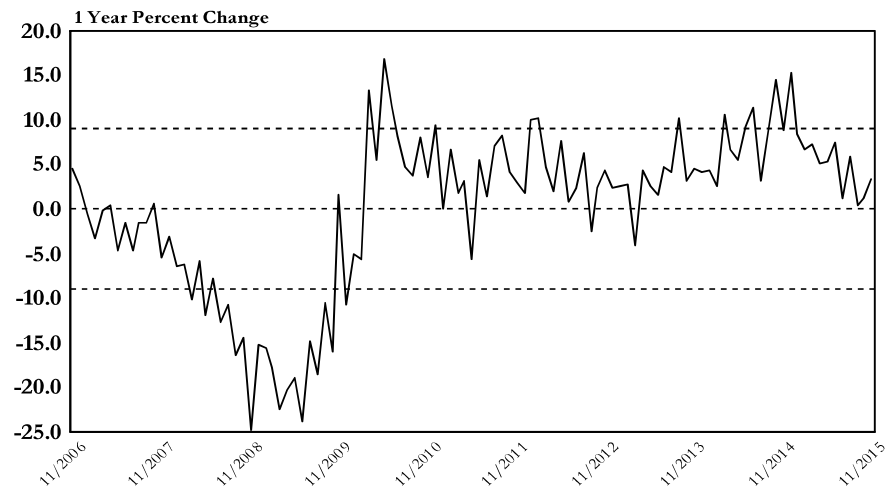


Fed: New Orders - vs. Prior Month (Diffusion)

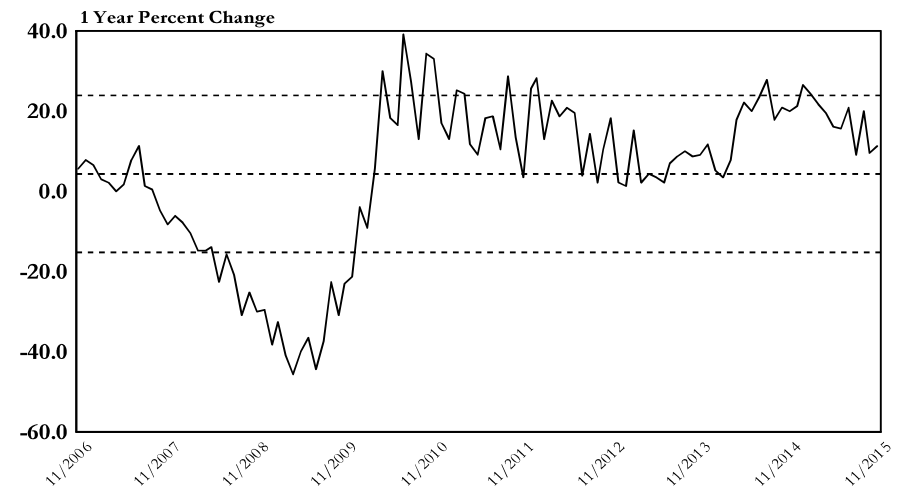


Economic Conditions: Labor

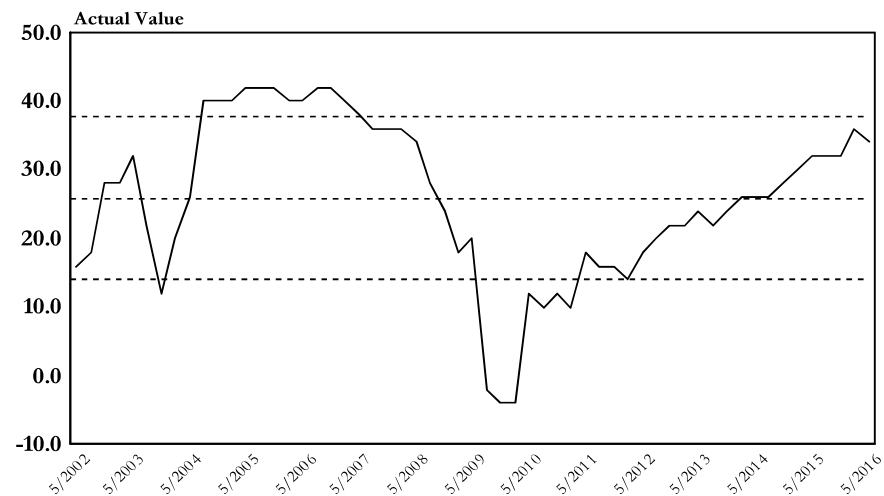
Hires: Total Nonfarm



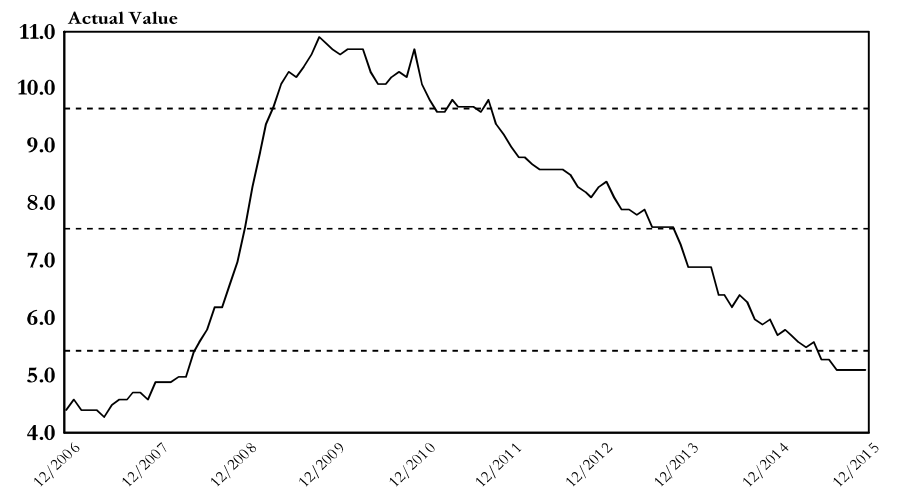
Job Openings: Total Private



Manpower Employment Outlook (Net % Hiring)

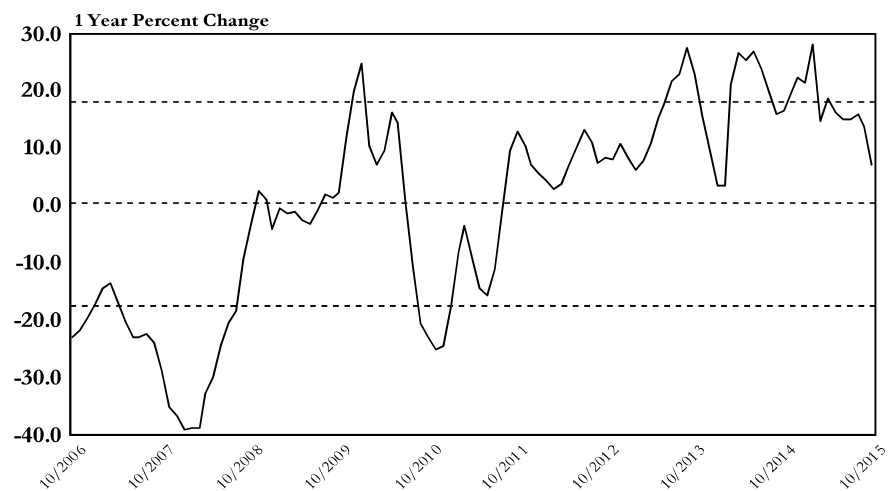


Unemployment Rate

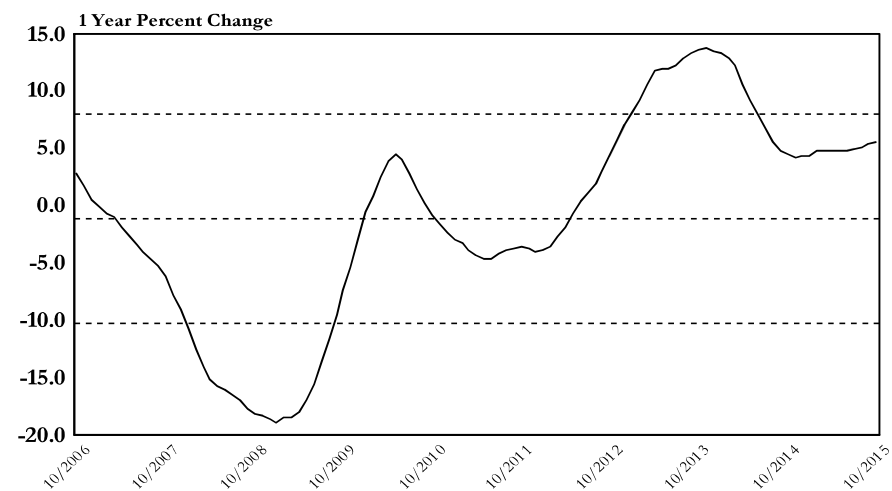


Economic Conditions: Real Estate

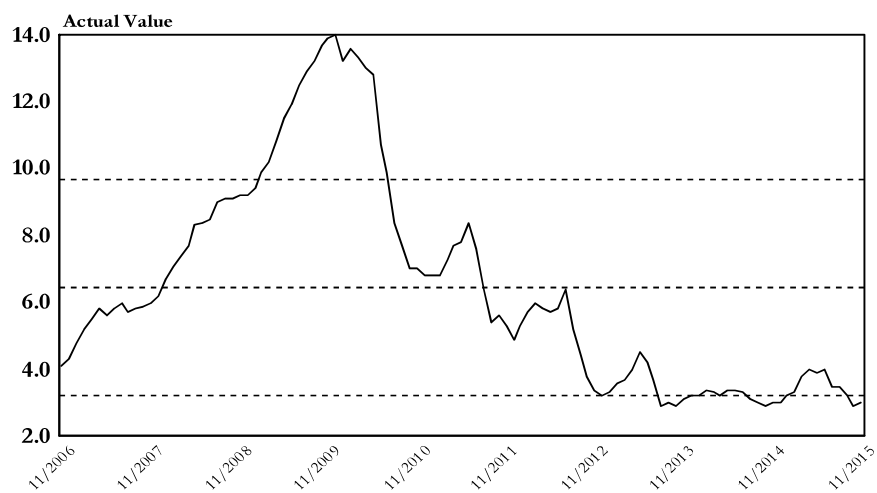
Case Schiller Sales In 20 Largest Markets



Case Schiller Home Price Index: 20 Largest Markets



Median Number of Months on Sales Market



Housing Starts

