MARKET
PERSPECTIVES

STC Investment Committee

Bruce L. Swanson, Ph.D.

January 2016

December Report

Almost every asset class posted negative monthly returns in December. Global equities saw profit taking after recent gains; the high-yield debt market fell on plunging commodity prices and liquidity concerns; and even safe-haven Treasury bonds fell with the first Federal Reserve Board ("Fed") rate hike since 2006. While equity markets initially easily digested the mid-December Fed move, they fell back on concerns over China growth and yet another double-digit move down in energy prices. The dollar was mixed, but weaker against most major currencies as investors became increasingly skeptical that the Fed would actually raise rates an additional 100 basis points in 2016 given the contagion risk that the manufacturing contraction spreads into the broader economy.

U.S. stocks slightly underperformed, with the Russell 3000 index down 2.1%. Smaller capitalization and value stocks continue to struggle, with smaller stocks down 5% for the month. Interestingly enough, aspects of the U.S. stock market performance were eerily similar to the bubble year of 2007. Momentum factors (price momentum and earnings revisions) were the top drivers of outperformance, while low (i.e. attractive) valuation metrics were the biggest detractors from returns. Market gains were narrowly concentrated, with the Russell 200 Growth Index outperforming the Russell 2000 Value Index by nearly 16% (+8.2% compared to -7.5%).

Global equities fell 1.8% in December, giving back 30% of earlier quarterly gains. European equities fell 2.6% in dollar terms despite, and because of, a 2.8% Euro rally following European Central Bank policy announcements that disappointed some investors. Japan actually posted positive returns after investors were encouraged by the upwards revision in third quarter gross domestic product to 1.0%. Emerging markets ("EM") fell 2.2%, as investor outflows continued in the face of weak EM currencies, plunging commodity prices and Chinese growth fears.

Looking Ahead

We entered 2016 wondering how the gap in a two-tiered U.S. economy - a buoyant service sector and a stagnant manufacturing sector - would resolve itself. This tug-of-war is being played out within the context of a strong dollar, a plunge in commodity prices, hard-landing risks in China and the start of a new Fed rate-tightening cycle. Equity markets have already declined 10% as continued falls in the price of oil and the Chinese currency have been extrapolated into fears of a U.S. recession. In contrast, I believe global growth should be in line with last year as developed markets may grow at above-trend levels. In addition, with service sector inflation persistent and the U.S. already at or beyond full employment, inflation is likely to surprise to the upside and exceed 2% by year-end.

While equity valuations have improved and the economic backdrop remains more benign than current sentiment and market-moves would suggest, this is hardly a bullish call on the overall market. Despite the decline, domestic equities remain overvalued in an absolute sense and unattractive against high-yield bonds in a relative sense. They likely will encounter continued headwinds from earnings disappointments as wage gains squeeze profit margins. Nonetheless, with economically sensitive investments marked-down and a Fed likely to remain accommodative, bargains are available, although generally encumbered with the baggage of exposure to downside tail-risk outcomes. So, staged purchases are appropriate.

Sentinel Trust Company

2001 Kirby Drive, Suite 1200

Houston, Texas 77019-6081

713.529.3729

sentineltrust.com