BEGIN AGAIN

April 2016

The fresh start of spring with milder temperatures, longer, sunnier days and green shoots seems to be reflected in the stock market these days. After a tumultuous three months stocks finished the first quarter on a modestly positive note. The year that began not as a lion but a bear has indeed morphed into a lamb as we enter April. While one quarter does not make a year it seems like the fears of global recession in January and February have given way to at least some muted optimism. We have been given a fresh start to 2016.

There was enough drama in the first quarter of 2016 for a full year but at the end the stock market as measured by the S&P 500 closed at 2059.74, a modest gain of 0.8%. The Dow Jones Industrial Average (DJIA) closed the quarter at 17,685.09, a gain of 1.5%. In order to eke out year to date gains the S&P 500 and DJIA had to rally in March by 6.6% and 7.1% respectively. Perhaps the sanest course for long term investors would be to check the markets only on a quarterly basis to avoid the angst of the daily churn. Indeed, quarterly checks may be too frequent as the S&P 500 has been basically flat since November 2014 according to Argus Research, a span of 16 months. Unfortunately, it is almost impossible to ignore the daily fluctuations in our world of connectivity and 24/7 news. For all of us watching during the quarter the view at times was quite disconcerting.

The S&P 500 declined over 5% in January and the talk was of how a poor January usually led to a down year. The decline continued at a much faster pace as the S&P 500 reaching a low of 1829 on February 11, 2016, an additional 6% decline over just 9 trading days for a year to date decline of 11%. According to Argus Research this market low point correlated very closely with the low in crude oil prices year to date and as oil prices recovered through February, the S&P 500 regained a lot of the lost ground.

This close correlation of oil price declines and weakness in the S&P 500 has been a concern to investors. One might expect more visible positive benefits to lower oil prices across a broad spectrum of industries and consumers. With the exception of energy companies, the large portion of the economy using energy should be enjoying some tangible and measureable benefits of lower energy costs. Perhaps this will ultimately be reflected in better than expected earnings and allow stocks to progress in spite of any continuing price weakness in crude oil. As for the energy company stocks, while we don't know whether crude oil has seen its lows, there does seem to be more price stability. We are comfortable buying and holding select energy stocks.

If the recovery in the stock market is going to continue there needs to be improvement in earnings. We have seen four straight quarters of lower revenues and earnings. Any benefit of lower energy prices has been overwhelmed by the negative impact of the stronger dollar over the past few years for many multinational firms. According to a report by BCA Research, the Federal Reserve believes the strength of the dollar may have reduced GDP by as much as 2.70%. This may be changing in 2016 as the dollar is declining versus many major currencies. In a recent Barron's article, Ross Margolies of Stelliam Investment Management noted that the DXY, an Exchange Traded Fund tracking the performance of the U.S. dollar versus six major currencies, rose 23% from January, 2014 to March, 2015. Since March of 2015, the index has declined by 2%. He concludes that this relative weakness in the dollar versus other currencies will have a positive effect on corporate earnings, particularly when compared to earnings per share numbers posted during the "strong dollar" period.

Just how much earnings will grow in 2016 is subject to debate but after the difficulties of the past few quarters perhaps earnings can surprise on the upside for the balance of the year. The consensus estimates for the S&P 500 earnings for 2016 seem to be around \$120 or so. At current levels that would give the S&P 500 a Price/Earnings (P/E) ratio of about 17X forward earnings. This is not cheap by historical standards but with the 10 year U.S. Treasury Note yielding 1.78% and inflation somewhere around 2%, a P/E ratio of 17 is reasonable. The dividend yield of the S&P 500 is 2.0%.

While ultimately it is earnings and dividends that matter most in stock valuations many would argue that the recovery in stocks from the February lows was due to the recovery in oil prices and the reluctance of the Fed to raise rates in the face of what appeared to be deteriorating worldwide economic conditions. That may be true in the short run but it seems that economic fundamentals are not as shaky as they may have appeared a little over a month ago.

The consensus late last year was that the Fed might raise interest rates three of four times in 2016 after the initial .25% (one quarter of one percent, 25 basis points) in 2015. After the turmoil of the first six weeks of 2016 the Fed gave signals that they would defer any additional increases until they believed conditions were right and now many expect only one or two increases for the balance of the year. According to Ned Davis Research, after deferring another increase in March the Fed's projection for rates was reduced to a level of 0.875% for year end 2016 from 1.375% and to 1.875% for 2017 from 2.375% and 3.00% from 3.25% by year end 2018. These are not targets but projections by Fed members. In our view the market and the economy should be able to withstand these gradual increases.

We have been overly and incorrectly concerned for years about the potential impact of rising interest rates on fixed income investments. In early 2014 the yield on the ten year U.S. Treasury Note was around 3.0% and now it is 1.78%. This was not what we expected. Over this period we have been reluctant to make significant commitments to bonds as we expected interest rates to rise. Now that we have begun a very gradual rate increase cycle does that mean we will finally see the pullback in bonds we have been worrying about? In a recent presentation to the Maine CFA Society, Ashton Goodfield of Deutsche Asset Management noted that during the last rate hike cycle of 2004-2006 the Fed increased rates by 425 basis points (bps) and while the effect was felt most by the two year Treasury, up 248 bps, the ten yield Treasury yield rose only

59 bps and municipal bond yields across varying maturities rose an aggregate average of only 12 bps as measured by the broad based Barclays Municipal Bond Index.

It appears then that bonds might not be severely impacted by the Fed's rather modest interest rate increases over the next two years but with the ten year Treasury Notes at 1.78% it is hard to get too excited about the opportunities in fixed income investments. Bonds remain a part of a balanced asset allocation strategy but we would still favor shorter to intermediate maturities and a cautious approach.

While one swallow does not make spring and one quarter does not make a year there have been some interesting trends over the past three months. In our January 2016 newsletter we discussed the outperformance of the FANG stocks, Facebook, Amazon, Netflix and Google versus the flat or negative performance of the majority of the rest of the S&P 500 in 2015. We readily acknowledged the strength and promise of these companies but we were somewhat concerned about valuations. Since January 1, 2016, Netflix and Amazon are down 10.6% and 12.1% respectively, Google is up slightly and Facebook is up 9%. We compared the valuation of Apple (up 4.0% in 2016) and Netflix, with Apple selling at a P/E ratio of 11.4 and Netflix at a P/E ratio of 301. Even granting a much higher potential earnings growth rate to Netflix it still makes sense to us to focus on valuations and metrics we can comprehend. Those in the Netflix and Amazon camps will remind us that the two stocks advanced 134% and 118% respectively in 2015. We understand the enthusiasm over these extraordinary companies but we have to be true to what we know.

A year that began in turmoil may still hold negative surprises but we remain optimistic. Many good quality stocks with steady earnings and dividend growth seem to be selling at reasonable if not inexpensive valuations. We continue to believe that foreign developed and emerging markets remain an important component of a long term strategy.

We wish you the very best and deeply appreciate your confidence in Knox & Downing Advisors.

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