GROWING PAINS?

Market Review **February 2016**

Investors should be happy to put January behind them. The New Year opened with the worst first week that global markets have seen in more than 20 years and the S&P 500 suffered its worst first week ever. The turmoil of that first week can be traced back to China, which continued to meddle with its currency and stock markets. Around the world, investors worried about the health of the Chinese economy, which has driven so much of the global economy in the past decade.

The Chinese government is working to manage China's transition from the type of manufacturing economy that is typical of an emerging market to a consumer services economy that is more common among developed countries. That transition brings some growing pains. Investors understand that but they are frustrated that the limitations on the Chinese stock market seem to be prolonging some of the more painful adjustments. Each hiccup renews worries that the Chinese economy will emerge wounded from this transition.

Some investors question whether China actually exerts this much influence on the global economy. Normally, China is a significant influence—as we saw during the summer's market correction—but its influence is being exaggerated by low oil prices. Investors are worried that soft oil prices are not just an indicator of oversupply, but also of declining demand for petroleum products in China. A decrease in demand for such a crucial commodity might indicate that the Chinese economy is in worse shape than it appears otherwise. This concern impacts investors worldwide, even in the US.

Traditionally, low energy prices are good for the US economy. Corporations benefit from decreased energy and transportation costs, and consumers are able to increase their discretionary spending by using their savings from the pump. Investors need patience when looking to profit from this relationship, a few months can pass before these effects show up on balance sheets and, in the meantime, the energy sector has a negative influence on the stock market.

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Over the past year and a half, oil has declined sharply. In fact, it recently fell below $30 per barrel, when it was more than $100 per barrel in June 2014. During that time, the US investors did not see much benefit from the price drop. Rather than seeing cheap oil as a driver of consumer spending, investors worried that it indicated a lack of global demand and that drove them to reduce the risk in their portfolios. This is why the global stock markets and oil prices have been moving in tandem for the last couple of months. When the supply of oil falls to the point that it matches demand, then that should allow investors to break out of this pattern.

In the meantime, investors will also be watching the US Federal Reserve (the Fed) for signs of another interest rate increase. You may recall that the Fed raised interest rates in December after months of speculation amongst investors. Some considered the move long-overdue and some believed that it was still premature. The events of January may seem to shed some light on that debate, but there is very little evidence that the Fed's decision had anything to do with January's volatility. At its January meeting, the Fed held interest rates steady, as most analysts expected. Investors will be paying careful attention to the Fed's signals in the coming months. Before the end of the year, we expect that rates will increase slightly, but not as fast as the Fed was predicting in December.

Market Movers

China, oil, and interest rates created difficult conditions for the financial markets in January. During the last few weeks, we positioned our Core Allocation portfolios into higher-quality and shorter-term assets which proved valuable during the turbulence of this past month. Further, the broad diversification offered much needed risk management relative to higher risk assets. Our Core Allocation portfolios fell roughly half that of the near-7% losses of many US and Foreign stocks. Similar to other World Allocation managers, the Core Allocation strategies provided attractive risk-adjusted returns. Please contact us for further information regarding the recent allocation changes made within the Core Allocation portfolios.

Asset Categories	*Jan 2016*	*YTD*
US STOCKS	-6.68%	-6.68%
FOREIGN STOCKS	-6.02%	-6.02%
US BONDS	0.19%	0.19%
FOREIGN BONDS	-0.72%	-0.72%
HARD ASSETS	-4.20%	-4.20%
HYBRIDS	-3.09%	-3.09%

The flight to quality was very apparent in US STOCKS. US Small Caps (VB) and US Mid Caps (VO) were both off about 7.5%, while US Large Caps fell roughly 5%. When the stock market is struggling, large cap stocks are considered less volatile than small cap or mid cap stocks. The larger corporations often have cash reserves and are able to weather these events better than their smaller competitors. Our decision to reduce our exposure to US Small Caps and US Mid Caps is already proving valuable.

FOREIGN STOCKS suffered a similar fate to their US peers. Investors moved toward lower risk stocks and reduced their exposure to both International Small/Mid Caps (VSS) and Emerging Large Caps (VWO). We biased large cap and developed country stocks within our Foreign Stock allocation, which was beneficial during January.

US BONDS held their value well in January, especially high-quality bonds like US Treasuries (SHY), US Corporate Bonds (VCSH), and Mortgage Backed Securities (VMBS). Amongst higher-yielding bonds, US High Yields (SJNK) and US Bank Loans (BKLN) retreated in value. Our move toward higher quality and shorter term bonds reduced investors' exposure to the underperforming asset classes. We are attracted to the floating rate feature offered by US Bank Loans, especially as we move into a rising interest rate environment.

As a category, FOREIGN BONDS did not perform as well as their US counterparts, but they did provide helpful risk management relative to higher risk assets. Emerging Market High Yields (HYEM) only declined slightly, while outperforming US High Yields. Meanwhile, Emerging Treasuries (PCY) were flat.

The fear of a slowing Chinese economy weighed on HARD ASSETS, in January. In recent years, China fed its enormous manufacturing industry by gobbling up commodities and raw materials from around the globe. As Chinese manufacturing appeared to decline, Master Limited Partnerships (AMJ) suffered due to concerns about flagging demand for oil. Precious Metals (GLTR) rebounded nicely as market volatility piqued investors' fears.

HYBRIDS outperformed stocks, but they lagged behind bonds in January. While Hybrids performed well in the uncertain climate of the past two years, investors prefer the safety of bonds and Precious Metals when uncertainty turns to fear. We expect that Hybrids will provide valuable diversification as the market stabilizes and investors set aside their fears.

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