LADENBURG THALMANN

ESTABLISHED 1876

Market Commentary
January 2016

Intro

For investors, 2015 was not for the faint of heart. Since the S&P 500 bottomed in March 2009, investors had become accustomed to exceptional returns from equities with very little interruption. But over the summer, headline risk (mostly tied to an overseas slowdown) sparked investor anxieties and helped trigger the first U.S. equity market correction since 2011. Historically, a market correction has happened every 18 months on average, so to a degree, the equity markets had been living on borrowed time. Despite the challenges, 2015 was far from doom and gloom. In fact, one could argue that it was the first year the U.S. economy performed better than the U.S. stock market over the course of this seven year bull market. The U.S. economy expanded as labor markets and consumer spending strengthened. The first U.S. interest rate increase in nearly a decade reduced some of the uncertainty markets had been wrestling with and U.S. equities and fixed income still managed to end the year in positive territory. 2015 was not a smooth ride, and despite numerous obstacles, we believe the investment outlook remains constructive going forward.

Domestic Equities

The positive total return for the S&P 500 disguised much of the pain that was felt throughout equities last year. If you looked "under the hood" of the S&P 500, you would find that a select few stocks drove the positive performance. The top 10 stocks within the index were up 14%, while the other 490 stocks were down 6%. The average stock in the index was down 4%, excluding the technology giant "FANG" stocks – Facebook, Amazon, Netflix, and Google. As large cap growth stocks rallied, mid-caps and small caps were not able to keep pace. The Russell Mid-Cap Index finished the year down -2.43% and the Russell 2000 Small Cap Index finished the year down -4.41%.

Considering the significant headwinds the market faced throughout the year, we would argue that the positive return on the S&P 500, albeit small, is a testament to the strength of the U.S. equity market. Remember, bull markets don't die of old age, but from a recession, and that does not appear to be on the horizon at this time. In 2015, the economy continued to benefit from lower oil prices (the average driver saved $550 at the gas pump last year), a strengthening labor market and rising home prices. Because of these positive indicators, we allocated more to U.S. equities throughout the year. Looking ahead, continued gains in employment and consumer spending should continue to drive stocks in 2016.

International Equities

As the U.S. is starting to tighten monetary policy, Europe and Japan are looking to stimulate their economies after years of slow to negative growth. Both Europe and Japan are in the midst of aggressive quantitative easing that is beginning to bear fruit. As an example, the Eurozone and Japan are both expected to turn in positive annual GDP growth for the first time since 2010. We believe the accommodative central banks within international developed countries pose a similar investment opportunity to U.S. stocks when the Fed launched its quantitative easing programs.

Conversely, emerging markets were plagued by volatility from a slowdown in China. International developed stocks (MSCI EAFE Index) finished the year down -0.81%, whereas Emerging Markets (MSCI Emerging Markets Index) plunged -14.92%. China's economic deceleration should not have come as such a surprise, as the days of annual double digit growth are over and a slowdown was inevitable as their economy grows. We turned sour on emerging market equities and eliminated them from our portfolios in early 2015.

Fixed Income

The wait is finally over. After casting a shadow over markets for the better part of 2015, the Federal Reserve raised interest rates in December for the first time in 9 years. However, with the exception of U.S. high yield, which suffered due to weakness in the energy sector, fixed income markets finished the year flat as investors opted for safe-haven investments in a volatile stock market environment. The Fed's decision to increase interest rates 0.25% signifies that the U.S. economy is healthy enough to withstand slightly higher borrowing costs. A quarter of a point increase will not halt our economic recovery.

Despite the onset of a hiking cycle, the Fed has assured investors that any further hikes will be done at a gradual and modest pace. This is an important point because while bonds are defined by regular interest payments, over the long term, more than 90% of a bond's total return is generated by income rather than price movements. If the Fed raises rates gradually over a longer period of time, as expected, the income on an investment can offset the decline in price. Because of this, focusing portfolios on yield potential and reducing sensitivity to changes in interest rates can be great defense against a moderately rising rate environment. We continue to position our portfolios with a shorter duration by holding short-term bonds, as well as lower interest rate sensitive bonds, such as floating rate and high yield bonds.

Alternatives

Alternatives had trouble finding their footing as U.S. large cap equities were the top performer in the fourth quarter (S&P 500 +7.03% in Q4) led by one of the best October equity market rallies in the last 15 years. When the S&P 500 is the leading asset class, we do not expect alternatives to perform in line with index. The Credit Suisse Hedge Fund Index finished the quarter down -0.69%, while our lower-risk equity-based alternatives in the Long/Short Equity space were flat to slightly positive.

Unlike other alternative asset classes, master limited partnerships (MLPs), which store, process and transport oil and natural gas, remained under significant pressure, with the Alerian MLP Index down -17.56% for the quarter. MLPs continued to trade in line with oil prices, which fell -18.43% during the quarter from $49.63 per barrel to $37.04 per barrel. Because of this volatility, we decided to sell our MLP position late in the fourth quarter. We hold alternatives for their correlation benefits, which can sometimes drag down the performance of a portfolio when equity markets rally. Further, we believe the value they provide in protecting against long-term market corrections outweighs short-term volatility and so we will continue to allocate to the asset class.

Real Estate

After an extended period of expansion in the past year, the housing market finally took a breather in the fourth quarter. Existing-home sales dropped off in the quarter to nearly the slowest pace in two years, but sales were still positive on the year. Since housing data can be volatile on a month to month basis, it is more important to look at the trend over a longer time period. According to the 2016 National Association of Realtors forecast, existing home sales are expected to continue their positive trend from the past year.

Conclusion

2015 will be remembered as a difficult year for investors as market volatility picked up and most asset classes struggled to make gains. The year was dominated by headline events and a series of crises which took a toll on many asset classes. It is important to remember that the majority of uncertainty last year was tied to a slowdown in global growth. We have a positive outlook because 87% of U.S. GDP is related to domestic activities and only 13% is tied to trade with other nations. Because of this, the U.S. has the ability to weather the storm of an overseas slowdown. This was proven in 2015 as we saw our economy grow modestly and unemployment declined significantly from 5.7% to 5.0%, despite the struggles overseas. Consumer spending (70% of GDP) remained strong, our housing and banking sectors continued to improve, and the annual federal deficit fell sharply. And in spite of the downward pressure, equity markets managed to squeeze out modest gains. Turning over the calendar to 2016, our portfolios are positioned conservatively with a sizable cash position. We plan to invest the cash as soon as cooler heads prevail and volatility subsides. The coming year will not be without challenges, but we expect modest improvements for investors.