INVESTMENT OUTLOOK

DIXON, HUBARD, FEINOUR & BROWN, INC. investment counsel

- Volatile first quarter for stocks.
- Crude oil and U.S. dollar stabilize.
- Earnings expectations lowered.
- Economic growth expected to pick up in second half of year.

First Quarter 2016 Review & Outlook

by Whitney Brown

Also in This Issue

Stocks covered a lot of ground in the first quarter, but much activity translated into very little progress. A volatile three months saw U.S. equity markets suffer the worst two weeks ever to start a year followed by a stunning six-week rally that brought most indexes close to even by quarter end. The best results came from the least likely areas. A strong counter-trend rally in gold, crude oil and other commodities produced solid quarterly gains and bolstered stocks in emerging markets, many of which are heavily dependent on exporting commodities. Treasury bond prices had been expected to fade in anticipation of Federal Reserve rate increases but instead spiked as yields dove on fears of global recession. Traditionally defensive sectors such as consumer staples, telecommunications, and utilities led for the quarter, but there were strong showings among industry groups within the consumer discretionary, industrials, and materials sectors.

The most welcome developments during the quarter were the stabilization of oil prices and easing of the U.S. dollar against other currencies. Trends in both had become unsustainable. Talk between the Saudis and Russians of limiting crude production along with a culling of smaller operators in the troubled U.S. shale oil industry were reasons enough for oil to find a bottom in the mid-$20s. Prices have rebounded and stabilized around $40 per barrel. While oil was in a tailspin, the dollar was trending higher against other currencies as tightening Federal Reserve policy began to diverge from increasingly easier monetary conditions in Europe, Japan, and China. Over the past two years, the high dollar has taken a toll on earnings of multinational companies as well U.S. exporters. Now that the Fed has backed off earlier plans for multiple rate hikes this year, the dollar has backed down.

Whether the January market selloff was justified on the basis of global recession fears or not, some adjustment was in order from the standpoint of valuation. Corporate earnings peaked over a year ago, yet the stock market had held flat through last year creating an elevated price-to-earnings ratio. Even with low interest rates, sluggish economic activity made it more difficult to rationalize the higher P/E ratio. Though the market has bounced back from the January swoon, earnings are still under some pressure. Corporate earnings are expected to decline again this quarter on a year-over-year basis. However, after being overly optimistic for the past few quarters, analysts have drastically cut earnings estimates for the latest period. To the extent that positive surprises are good for market sentiment, corporations look set to beat low expectations.

Our outlook is for the economy to regain momentum in the second half of the year. The labor market has continued to show steady improvement and should support consumer spending. The dollar and earnings should be less of a drag on the stock market although valuations will continue to be an issue for the longer term. The presidential primaries will be behind us soon enough, and the market can focus on a head-to-head contest between the eventual candidates. At this stage investors have more reasons to be in the market than out.

Market Measures	1st Qtr.	
S & P 500 (price)	0.8%	
Dow Jones Industrial Average	1.5%	
NASDAQ Composite	-2.7%	
Russell 2000	-1.9%	
MSCI EAFE	-3.8%	
Barclays Capital Inter Gov't/Credit Bond Index	2.5%	
	3/31/16	3/31/15
10-Year U.S. Treasury Bond Yield	1.8%	1.93%
Three-month U.S. Treasury Bill Yield	0.19%	0.03%

The Influence of Interest Rates on Equity Markets by Watt Dixon

Although the Fed raised the Fed Funds rate last December, interest rates on U.S. Treasuries and most other bonds have fallen. This article will discuss the four major reasons that interest rates affect the stock market.

Probably the most important effect of interest rate changes on equity prices comes from the fact that tight monetary policy associated with rising interest rates adversely affects business conditions, whereas falling rates usually stimulate the economy. Most businesses can adjust to higher rates, but when rates change quickly and unexpectedly, most companies have to curtail expansion plans and cut inventories. This has a negative impact on the economy and corporate profits. Higher rates and smaller profits mean stock prices must fall to maintain the same price-to-earnings ratio.

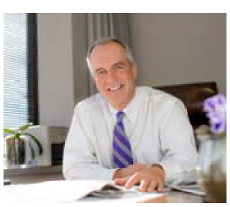
Interest rates affect profits in two ways. First, almost all companies borrow money to finance capital equipment and inventory, so the cost of money, that is, the interest rate they pay, is of great importance. Second, a substantial number of sales are in turn financed by customer borrowing. The level of interest rates therefore has a great deal of influence on the ability and willingness of customers to make additional purchases.

Interest rate changes also have an impact upon the relative appeal of various investment sectors. The most significant relationship is that of stocks to bonds. For example, at any point there is usually a balance between bonds and stocks in the judgement of investors. However, if bond interest rates rise faster than stock dividends can increase, bonds will become more attractive, and money will flow out of stocks and into bonds. Stocks then will fall in value until the relationship is perceived by investors to be more reflective of the higher level of interest rates. Utility stocks and "dividend stocks" will be more sensitive to movements in rates, because they are often held for their current dividend yields rather than potential capital appreciation. On the other hand, companies in a dynamic stage of growth are usually financed by corporate earnings and for this reason pay smaller dividends. These stocks are less affected by fluctuations in the cost of money, since they are purchased in anticipation of fast profit growth and future appreciation rather than an immediate dividend return.

Margin debt is money loaned by brokers for which securities are pledged as collateral. Normally, this money is used for the acquisition of equity securities, but sometimes margin debt is used for the purchase of consumer items, such as automobiles. Rising rates increase the cost of borrowing, so there is reluctance on the part of investors to take on additional debt as its cost rises. When the interest charges become excessive, stocks may be liquidated to pay off the debt. Rising interest rates have the effect of increasing the supply of stock for sale with consequent downward pressure on prices.

The long term trend of interest rates has been down since 1981. With bond prices and interest rates moving inversely, this 35 year period has been a great time to own bonds; as rates have dropped, bond prices have risen. While a rising interest rate trend is bound to happen at some point, it is the rate at which interest rates change that should be monitored closely. Stock prices have moved upward with rising rates at times in the past. If the rise in interest rates is slow and expected, stock prices could rally right along with interest rates. Please see the article on page 3 regarding the challenges of investing in the current low interest rate environment.

Government Debt and the U.S. Economy by Jim Hall



Obviously, we are in the throes of another election season. Even though the field has been winnowed, there are still enough candidates vying for nomination that campaign rhetoric continues to dominate the news. The candidates promise to spend more on education, infrastructure, or defense. Some have touted the accomplishment of "halving" the deficit. Unfortunately, all seem to be missing the big picture. Halving the deficit doesn't mean the amount the U.S. government has borrowed is half of what it was; it means our government's tendency to spend more than it collects continues, but only half as fast as in prior years.

As of February, 2016, our national debt was $19.2 Trillion and growing, although at a slower pace than before. For some perspective, in 1900, our national debt was only $2.1 *Billion*. It took 82 years to grow to $1 *Trillion*. However, in only 4 more years (1986), it doubled to $2 Trillion. 1992 brought us to the $4 Trillion mark. $8 Trillion was exceeded in 2006 and by 2012, $16 Trillion was owed. (See the sharply steepening trend line in the graph on page 4).

It is unfortunate that campaign promises involve increasing spending in order to garner favor with certain groups or sectors of the electorate rather than offering ways that we could begin to reduce our national debt. Because interest rates are near historic lows, the debt service tied to our growing balance hasn't yet created a huge drag on our economy. It is unlikely that low rates will continue

(Continued on page 4)

Investing in the Low Interest Rate Environment by Stebbins Hubard

The Federal Reserve keeping its Federal Funds target near 0% for more than six years has been a godsend for homeowners looking to refinance and for first time home buyers. However, for investors and retirees, the perpetually low lending rate environment hasn't been as welcoming. With short-term (less than 2 years) Treasury rates yielding less than 1%, savers have been forced to branch out into new investment opportunities in order to grow their wealth.

In theory, low interest rates may not be quite as problematic as they seem. Even if you're earning a low interest rate, your real return might not suffer too much if inflation is also low. Real return represents what your money earns once inflation is taken into account. With an annual inflation rate of 2.15%--the average over the past 20 years based on the Consumer Price Index--a bond that pays 2.5% would produce the same real return as a bond that pays 3.5% when inflation is 3.15% a year.

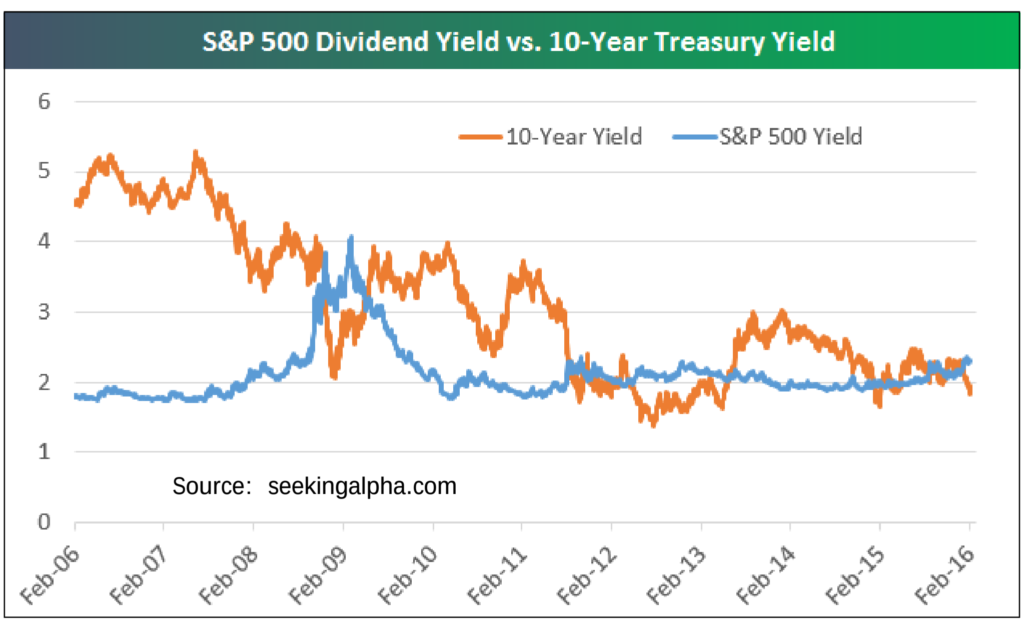
In general, long-term bonds pay a higher interest rate than bonds with a shorter maturity. However, the difference between long-term and short-term rates can change as investors assess changing economic conditions. For example, when it seems likely that interest rates will rise in the near future, investors often are reluctant to tie up their money in longer-dated maturities and gravitate to short-term debt. As short-term demand rises, the difference between the interest rates paid by different maturities can also increase.

Bonds have a strong inverse correlation to interest rates. That is, when market interest rates increase, the prices of existing bond issues decrease. In addition, the longer it is to the bond's maturity, the more sensitive its price is to changes in the market interest rate.

Due to these facts, long-term bonds are usually a bad choice in a low interest rate environment. There is nowhere for interest rates to go but up. As interest rates climb, long-term bond prices will fall significantly, resulting in losses on long-term bond portfolios. However, short-term bonds can be a good choice because they are much less sensitive to changes in the market interest rate. In fact, if you are able to hold a short-term bond to maturity, you don't even have to worry about changes in a bond's price. This is because bond investors have an option that stock investors do not - rather than selling the bond, they can simply wait to get the principal amount back at maturity. Therefore, a modest positive return is still a good result as you wait for more promising investment opportunities.

High-quality dividend stocks may provide an additional source of income; dividends historically have contributed significantly to total equity returns. In fact, since the 1940s, they have accounted for 56% of total returns. While high-quality dividend stock prices may lag the overall stock market during periods of significant growth, dividends can provide some downside protection in negative market environments through the relatively stable income they provide. Given our expectations for continued market volatility, many investors may welcome this added protection. With the dividend yield of the S&P 500 index higher than the yield on 10-year Treasury bonds, as illustrated in the exhibit below, high-quality dividend stocks have emerged as a way for investors to expand their sources of current income.

The combination of attractive yields over Treasuries and the potential for companies to raise dividends in the future creates a unique opportunity for investors. This environment presents an opportune time to uncover companies, both domestic and foreign, that look likely to further grow their dividend payments. Historically, foreign companies have provided higher dividends. Thus, a combination of both domestic and international investments can provide a diversified source of income as well as the potential for capital appreciation.



Despite the low interest rate environment and potential risks associated with rising rates, investors should not abandon their core investment grade short-to-intermediate bond holdings. These holdings will help protect principal during stretches of market volatility. However, some caution on new purchases is advised, given the long bull market in Treasuries. A combination of diversifying fixed income assets and adding high-quality dividend stocks should help generate additional cash flow.

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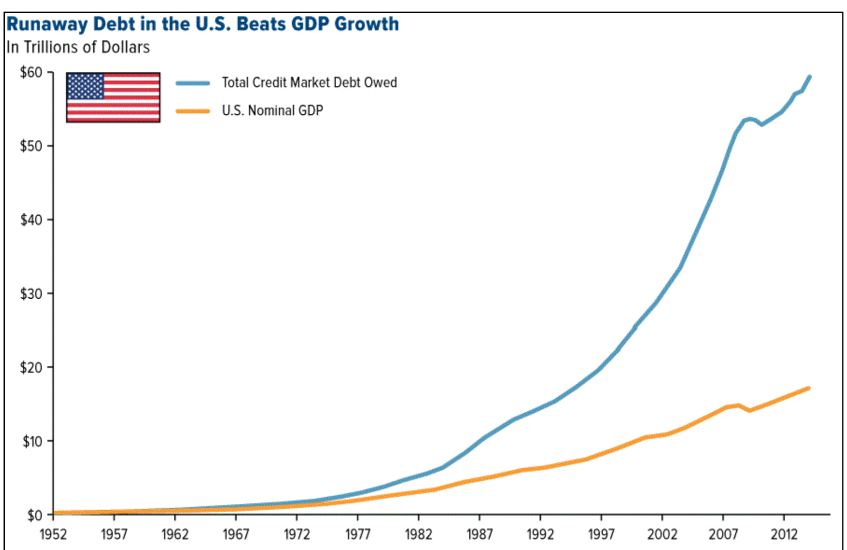
Government Debt and the U.S. Economy (continued)

(Continued from page 2)
indefinitely; when rates do begin rising, our debt service requirements could easily double or even triple!

The argument has been made that there is no need to worry about the size of the debt as we can simply "print" more money as needs require. That strategy would eventually fail as an ever increasing supply of dollars into the economy would make inflation too difficult to control.



The level of debt is an issue that should be addressed now rather than leaving it for future generations to contend with.

One would have hoped all of that deficit spending would have strengthened our economy in some significant way; however, when measuring using the widely recognized "Gross Domestic Product" (GDP), it appears to be a very inefficient way of creating economic stimulus. GDP is calculated by adding Consumption (consumer spending), Investment (businesses investing in plants and equipment), Government Spending (transfer payments like Social Security, unemployment benefits, and health care subsidies are subtracted), and Net Exports.

In 2000, the U.S. GDP was $10.3 Trillion. It is currently $18.5 Trillion ($8.2 Trillion more than 2000). U.S. Debt was $5.7 Trillion in 2000 and is now $19.2 Trillion ($13.5 Trillion more than in 2000). It doesn't seem we are getting the complete "bang for our buck" as every new $1 in debt only yielded 61¢ of increased GDP.

Hopefully, our politicians will realize we can't allow our debt to increase at this unchecked pace as the funds to repay can't be generated as quickly as the debt has been growing.