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2015 Year End Review
"Market Smitten then Bitten by FANG "

After all of the usual gyrations, the year of 2015 was not a good one in general for stocks or bonds. The Dow Jones Industrial Average lost 2.2% while the stocks of smaller companies fell harder; down 5.7% as measured by the Russell 2000 Index. The NYSE Composite Index (which includes more than 2,000 stocks) went down 6.4%. Bonds fell as well as the Barclays 20 Year Treasury ETF declined by almost 5% in price for the year, while high yield bonds, like those in the iShares ETF, fell by 10%. The decline in bonds was exacerbated by the Federal Reserve Board's decision in December to raise interest rates a mere ¼ of a percent on short term funds. This year more than most, there was much more going on in the financial markets than is told by the major index numbers.

As often happens in aging bull markets, the average stock lagged the performance of the indexes. Those indexes were held up to a great extent by the stocks of a few large, high-profile companies while most stocks were already topping out and starting to decline. Wall Street is fond of coining new words and phrases to describe the currently popular trend. We recall the "Nifty Fifty," which were the "one-decision stocks" of the go-go nineteen sixties. The "one decision" was to buy and then hold them forever. That didn't work out very well. Just recently there was TINA ("There Is No Alternative" – to stocks, that is) and FOMO ("Fear Of Missing Out"). The stock market of 2015 gave rise to the dominance of the "FANG" stocks: Facebook, Apple, Netflix, and Google (now called "Alphabet"). Some pundits included Tesla and joked that the name should actually be the TFANG stocks, the "T" being silent of course. Until recently, these stocks continued in uptrends and, because of their size and weighting in some major indexes, partially masked deterioration in the performance of stocks in general. When market sages talk about the "narrowing leadership" of the market (also referred to as "bad breadth!"), this is what they mean. New investment money seems to crowd into fewer and fewer market leaders as the number of stocks still advancing continues to dwindle. It appears that investors have been smitten by, and now perhaps bitten by (T)FANG as even those favorites have rolled over and declined into the beginning of 2016.

By year's end nearly 40% of the stocks in the S&P had fallen by at least 20% from their recent highs, and almost 70% of stocks in the NYSE were no longer in uptrends. Two great forces having an impact include commodity markets and the Federal Reserve Board. The Commodity Spot Index fell 19% and was led by a drop in crude oil of over 30%. Other commodities fell sharply as well: copper down by 25%, iron ore down 24%, and aluminum down 19%. Gold continued its decline, but by falling "only" 10%, it ending up being the best performing precious metal.

So energy and commodity stocks were obviously poor performers. But pharmaceuticals, healthcare, and retail started to join the down trend later in the year as the selling spread. Only four of the 10 major industry sectors were up for the year, and they have all turned negative since year-end.

The behavior of the financial markets worldwide has been dominated by the actions of the central banks to an extent never before seen. Short term interest rates have been held at near zero (or at negative rates!) and massive amounts of liquidity have been pumped into the economic system in an attempt to stimulate economies back into health. Seemingly, at every sign of a downturn in stocks, the Fed (or one of the other major central banks) would step in and provide a new program of liquidity which would once again buoy prices and postpone "natural price discovery." In other words, markets have been artificially supported by central banks for so long now that the natural course of the "creative destruction" of free markets hasn't been able to run its course. The central banks may have run out of tricks. The Fed eventually stopped providing mountains of extra liquidity to the markets and appears to have been almost shamed into acting at the December meeting to raise short term interest rates by 1/4 of a percent. This action was not bold as it was taken a full 7 years into an economic recovery. The trouble was that the Fed had been so timid in acting before that this may turn out to be "the right move at the wrong time." The current fear is that the economy will weaken and the Fed will have to leave rates "lower for longer" than previously anticipated, or perhaps reverse this hike completely. That would not be good for banks or for savers. It would also mean that the economy may not be as strong as the Fed assumes after all.

We have had our share of disappointments during the year as well. Any investment related to energy or precious metals did poorly (except for oil refiners whose profits come from the difference between the price of crude oil and the price of gasoline). We also had our own specific problems in such diverse areas as technology and mortgage related stocks. Even one of our favorite values that remains profitable as a company, pays a good dividend and produces an essential ingredient for the essential food supply for the world (Potash Corp.) has declined much more than we expected. The investing climate has become decidedly more turbulent and difficult to navigate as of late.

As many of you know, we have been frustrated over the last few years as we waited for the normal cycles of downturns to produce bargains that we could take advantage of, only to see the central banks cut short the nascent declines and artificially inflate prices once again. This, however, may be the beginning of a downturn that produces some real bargains. The good news is that we can take advantage of any subsequent carnage to position ourselves to profit in the several years ahead. The bad news is that the ride is rocky and sometimes uncomfortable if not downright painful. The cash reserves we have maintained partially shield your portfolio from decline and provide the ability to make purchases when sellers get panicky. Those reserves have held us back in up markets, but may provide more than compensating benefit in the time ahead.

Typically, investors become more brave and aggressive as markets make new highs and more timid and panicky as prices decline. We try very hard to match the investments in your portfolio to what we understand your tolerance for volatility and risk to be. This is not only for your comfort, but also to avoid putting you under so much pressure during a decline that you feel forced to liquidate during climactic sell-offs. Those times often prove to be better for buying if the courage and the cash remain available. Conserving both of those assets will remain key to our actions in the coming year.

Please give me a call whenever convenient for you if you would like to discuss investment levels and your specific tolerance for risk and volatility in what may become a more turbulent market in 2016.
Enclosed you will find your year-end statements and reports. Capital gains reports are included for any taxable accounts as well. However, your Schwab capital gains report is the one that you should refer to in regard to the preparation of your taxes. Please have your tax advisor contact us directly if you would like us to save you the trouble of forwarding the information to them.

Thank you again, and we look forward to working with you to take advantage of the opportunities the coming year may bring.

Sincerely,

Claude R. Carmichael CFA