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## Fourth Quarter 2015



Fig. 1 – S&P 500



Fig. 2 – MSCI Emerging Markets

Equity markets rebounded in the fourth quarter after sharp losses in August and September. Concerns about the Chinese economy and slowing global growth abated, and investors bought oversold stocks. The S&P 500 logged a total return of 7.0%, finishing the year with a marginal gain of 1.4%. The Dow Jones Industrials were up 7.7% to finish the year +0.2%. Small caps lagged materially, as the Russell 2000 index gained only 3.6% in the quarter, ending 2016 down 4.4%. International markets also posted gains, but failed to finish positive for the year. The MSCI Europe, Australia and Far East Index of developed economies rose 4.4%, finishing the year -3.3%, while the MSCI Emerging Markets Index (**Figure 2**) recovered only 0.3%, ending 2015 down 17.0%. Chinese stocks were among the biggest gainers for the quarter. The MSCI All China index gained 10.6%, but still finished -2.4% for the year. In a repeat of 2014, local currency returns were generally better than those earned by U.S. investors, due to the strengthening dollar (**Figure 3**).

The third quarter earnings season was somewhat disappointing. According to market research firm Factset, 74% of S&P 500 companies reported better than expected earnings, but only 45% beat sales expectations. Once again the Energy sector was the largest contributor to the earnings drop, with earnings down 65%, even worse than the second quarter decline of 59%. The other nine sectors of the S&P 500 eked out an aggregate earnings increase of 1%. Telecom Services companies scored the highest earnings growth by far, at 27.3%. Financial sector earnings growth was also robust, rising 10.4%. Aggregate earnings in the fourth quarter are now expected to decline 4.3%, much worse than the 0.6% drop forecast on September 30<sup>th</sup>. Given the softness in the global economy, investors will be focused on company expectations for 2016, especially when management is able to provide guidance for the second half of the year.

Third quarter growth moderated in the U.S. as Gross Domestic Product (GDP) grew 2.1%, following a 3.9% jump in the second quarter. Consumption expenditures were steady, supported by continued strong employment gains. Jobs numbers for October and November were much stronger than expected, with gains in services and construction, and the jobless rate dropped another notch to 5.0%. Wages rose slightly, posting a 2.5% increase for November, the biggest increase since June of 2009. Consumer sentiment readings continued to rise, supported by job and wage increases. Although by some measures retail spending this year has disappointed, MasterCard reported a 7.9% increase in holiday spending this year, on top of a 5.3% gain in 2014, indicating strengthening as the year drew to a close. This should be a positive for selective consumer-facing companies.

In other areas of the economy, fourth quarter performance varied. Manufacturing has shown signs of slowing and even contraction. Exporters have been hurt by the stronger U.S. dollar and by sluggish overseas demand. Also, the sharp slowdown in energy exploration has reduced the need for new equipment. Services have held up better, with surveys still indicating growth, although more muted than earlier in the year. Housing data had been weak in September and October, but new home starts and permits sharply exceeded expectations in November, and home prices have risen steadily. Like consumer spending, the housing sector may be the beneficiary of improving consumer confidence.

Foreign economic performance also diverged in the quarter. European Union manufacturing surveys indicated growth. Exporters there appear to be aided by the weaker euro, which makes their products cheaper than those of U.S. competitors. In addition, because European countries are energy importers, producers and consumers there are enjoying lower cost crude and other commodities. Emerging markets, on the other hand, still show signs of slowing. Some of these countries, like Russia and Brazil, are heavily dependent on commodity prices, and are facing budget shortfalls and slowing or contracting economies. Others, like India and South Korea, should benefit over time from the lower energy prices, but as of this writing, investors seem wary of the entire group.



**Fig. 3 – U.S. Dollar Index**



**Fig. 4 – S&P Retail Index**

Overall, the U.S. economy appears to be stable but growing slowly. Against this backdrop, the Federal Reserve finally raised interest rates 0.25% in December, the first increase since 2006. This increase was well-telegraphed by Fed communications and well-received by equity markets as a sign of confidence in the U.S. economy. The Fed will probably increase rates again in 2016, which may pressure bond values, but with persistently tame inflation in the U.S. and abroad, interest rates probably won't rise rapidly enough to shock the economy. 2016 has begun with many of the same pressures overseas that plagued 2015, including a sharply dropping Chinese stock market and new geopolitical trauma from Saudi Arabia and Iran. While these concerns may add to market volatility, prudent investors will resist the temptation to time the market, stay invested according to their long-term asset allocation, and look for opportunities to add attractive investments to their portfolios.

We hope that the New Year brings much happiness to you and your families, and look forward to speaking with you soon.

Sincerely,

Kenneth M. Bernard, CFA