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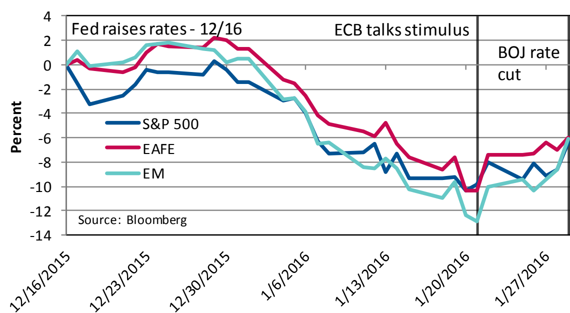
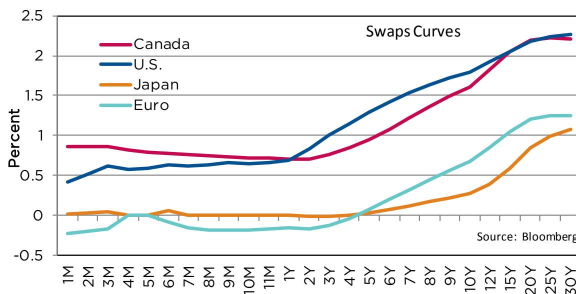
ECONOMIC REVIEW JANUARY 2016

During January, investors were reminded that unwinding the extraordinary liquidity extended by central banks, which started in August 2007, will be a painful process. Stocks tumbled as trading started in 2016, against the backdrop of the Federal Reserve's solitary position amongst central banks to see the need to raise interest rates. With the prospect of China entering a long-term period of slower growth, it leaves the U.S. as the driver of world growth. The Fed's interest rate hike implied that the bank was acting to cool off an economy that very few saw in need of monetary tightening. By January 21, the S&P 500 Index shed 9% from year-end, and 10.3% from the Fed rate hike in December. It was the worst start to a year ever for the index. On January 21, the European Central Bank announced that it stood ready to expand stimulus measures by March in order to battle very low inflation and increased market volatility. From then until month end, the S&P 500 rose 4.4%, aided by the Bank of Japan (BOJ), which cut deposit interest rates to -0.1% on January 29. The BOJ has tried desperately to get Japanese consumers and businesses to spend and invest in order to break a decades-long cycle of minimal inflation and weak growth. Weakening the yen versus the U.S. dollar should boost Japanese exports, especially autos, as the U.S. auto market is exceptionally strong. Because Japan must import nearly all of its energy and materials needs, which tend to be priced in U.S. dollars, a weaker yen hurts in this regard. Investors significantly pared estimates for Fed rate hikes in 2016, as the Fed reflected on the impact to the global economy. Central banks must wait for sustainable growth and inflation before tightening monetary policies.

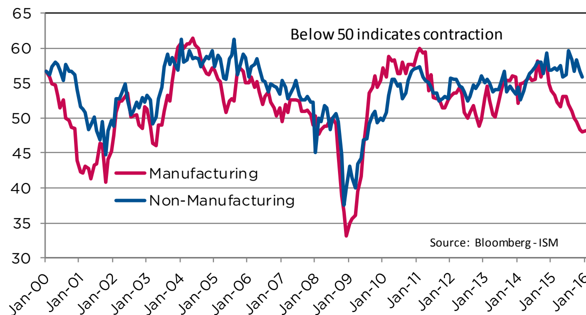
Markets React to Central Banks



Low Interest Rates Expected For Many Years



U.S. Manufacturing Continues to Contract



Market Returns

As of January 31, 2016

	January	3 Months	1 Year
S&P 500	-5.0%	-6.2%	-0.7%
Russell 1000 Value	-5.2%	-6.9%	-5.0%
Russell 1000 Growth	-5.6%	-6.7%	1.3%
Russell 2000	-8.8%	-10.6%	-9.9%
MSCI EAFE	-7.2%	-9.9%	-8.4%
Emerging Markets	-6.5%	-12.1%	-20.9%
Barclays Agg	1.4%	0.8%	-0.2%
3-Month T-Bills	0.0%	0.0%	0.1%

U.S. GDP grew at a subdued 0.7% rate in the fourth quarter. Annual GDP growth during 2015 was 1.8%, and was last above 3% in 2005. Over the past 10 years, GDP has averaged 1.4%. With a quarterly standard deviation of 2.7%, GDP has not had a prolonged period of strong growth in some time, further exacerbating frustrations with the Fed's decision to raise interest rates. Positive contributors to GDP in Q4 were recreational goods/vehicles, food (restaurants), defense and healthcare spending. Data showed that spending on gasoline and other energy showed little change throughout the year, suggesting that lower unit prices for gasoline are translating into more driving, mitigating the expected gains in disposable income. Restaurant spending is being driven by younger consumers, many of whom spend more on food and beverages than older consumers. Healthcare spending represented the single biggest contributor to GDP. The increase in patients seeking medical services and ever-rising prices of prescription drugs are expected to continue. Curtailed energy development remained a detractor to growth, with oil-field investment dropping and railroad investment shrinking amidst fewer coal and oil shipments.

China's Q4 GDP was 6.8%, its weakest quarter since 2009. The current trajectory suggests that growth should settle into a longer-term rate close to 6.5%. For the world's second largest economy, investors will be satiated when growth stabilizes. It will take several years for the downward course of Chinese manufacturing growth to be overtaken by Chinese consumer spending growth. In the meantime, China's demand for commodities will slow until stockpiles are drawn down. Emerging market economies that are prepared to handle the logistical and economic changes necessary to lure manufacturing should benefit as companies shift resources away from China in order to access lower labor and capital costs.

Many investors believe that economies have become too dependent on monetary and fiscal stimulus. While the U.S. mortgage-loan crisis was the trigger for nearly a decade of global stimulus, U.S. banks were forced to recapitalize and recognize bad debts, which led to a more rapid healing of their balance sheets. Banks in Europe may face a downturn if ECB stimulus wanes before European countries regain sufficient economic vigor to begin winnowing down the massive debt loads with which they are now burdened.

Crude oil prices fell to a low of $26.55/barrel during January, which was one day before the ECB announced the potential for additional stimulus. The last time oil was below this price was in May 2003. In 2008, oil bottomed at $33.87/barrel. Worries about Iranian oil coming to market and increased Iraqi capacity adding to the current oversupply kept prices moving downward. Saudi Arabia and Russia discussed cutting production by 5%, but it appeared both were reluctant to move forward until other oil producers agreed to a similar cut.

The Puerto Rican government was sued by bondholders after payments were missed in January. Money intended for infrastructure-bond servicing was diverted for other government uses. The territory has a high poverty rate and a large government work force, leaving minimal options to increase revenues.

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