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The Market Outlook

2015 in review and a look at 2016

Bitten by FANGs

Like the military, Wall Street loves its acronyms. The trendiest one on the Street today, "FANGs," refers to the high-performing stocks of Facebook, Amazon, Netflix and Google. In 2015, the FANGs alone accounted for more than 10% of the S&P 500's total performance. However, the S&P 500 Index gives larger companies (based on market capitalization) greater carrying weight than smaller ones. While many investment professionals consider the S&P 500 Index the best representation of broad market performance, its method of weighting can sometimes distort market realities — as we saw in 2015 with the effect of the FANGs.

The "Stealth" Bear Market: What you didn't read in the newspapers

While the FANGs posted a terrific year — Facebook +34.2%, Amazon +118%, Netflix +134%, Google +44.3% — the rest of the S&P 500 struggled. For example, if you assign an equal weight to each stock and recalculate the Index, the average S&P 500 stock **lost** 4.5% in 2015. This "real" performance contrasts greatly against the widely reported 1.4% positive return for the S&P 500 Index in 2015.

Overall market performance in the second half of 2015 looks like a **bear market**, defined as periods where stock prices decline — from the highest to the lowest point —– more than 20%. Since mid-2015, many stocks fell into this definition of bear market returns, even while the "market average" showed a small gain. Some market sectors that peaked in May, declined 10 to 20% by December. Small and mid-cap stocks in energy, raw materials and industrial started a downward trend as early as the summer of 2014 that lasted through the end of 2015.

Finance experts call this phenomenon a "stealth" bear market — a market with the prolonged downward trend characteristics of a bear market, but without a 20% or greater decline from the high point. What makes this kind of bear market stealth? The press generally doesn't report declining prices of average stocks, it only reports the headline index numbers. So while oil markets and merger and acquisition activity captured plenty of headlines, the daily press rarely dug deeper than the S&P 500 Index in reporting average stock prices, even though it did not reflect overall market performance in 2015.

In spite of the stealth bear market of 2015, do not fear: Historically, declines of 15 to 20% recover in an average of eight months. Declines of *more than 20%* usually take about three years to recover to their previous highs. With a starting point of mid-2014 to mid-2015, we are well into that timetable.

A rough start to 2016

The first week of January 2016 made history as **the worst performing first week, ever**.
Think about that for a moment: The worst first week in market history did not occur during the Great Depression, Great Recession, Internet Bubble or any other well-known period of negative performance. Instead, the worst first week in market history occurred during a time of low inflation, very low interest rates, average price valuations and low energy prices. **This does not make fundamental economic sense.** Decades of history show that the stock market performs well when you combine low inflation with average and below average valuations — just not at the moment.
Any number of factors can create periods of market distortion, which can result in emotional trading decisions. However, sometimes emotional trading by irrational investors can benefit the portfolios of more rational investors. Emotional selling can lead to undervalued stock prices, creating great opportunities to buy good companies at a discount and also to rebalance portfolios.

Some AAFMAA Members expressed concerns about the recent degree of volatility and the speed of market price changes. However, the market's current **yield curve**, a graphic representation of interest rates, shows that we are NOT looking at an extended bear market. The slope of the curve reflects the market's view of inflation. An inverted yield curve, when short-term rates are higher than long-term rates, signals economic and market distress. The yield curve has not yet inverted and, based on current stagnant labor costs, retail sales and lower energy prices, we do not expect to see it invert in 2016.

This brings us to the price of oil. In days past, when oil prices declined 80% experts saw that as a positive development for the economy. Today, however, with oil prices around $30 a barrel, energy-related lending, certain regional employment and business capital related purchases are under stress. Furthermore, the average consumer used the "savings" from lower gasoline prices to pay down household debt rather than make purchases. Although this behavior will decrease retail demand and slow the economy in the short-term, it will eventually lead to higher levels of consumer spending.

2016 Outlook

Continued slow but positive GDP growth. A country's GDP growth stalls when its ratio of national debt to GDP reaches 90% or greater. The U.S. ratio currently exceeds 100%, which will lead to slower economic growth, *though not a recession.*
The U.S. Federal Reserve will move gradually to a more neutral monetary policy. The market will focus on the path or rate of change, not on the timing of policy change. The Fed will take a very gradual, data-driven path back to normalized rates.
Expect to see diverging monetary policies around the world. As the U.S. Federal Reserve slowly raises interest rates, other central banks, such as the European Central Bank, will initiate their own quantitative easing policies.
Look for **positive long-term market returns**. The current stock market declines made a fairly-valued market far less expensive. History shows us this pattern increases probabilities of above-average market returns in the coming ten-year period.

What should you do?

- Stay fully invested and diversified based on your own unique target asset allocation. **Don't try to time the market;** it doesn't work.
- Plan for volatility. **Market swings are normal**, **corrections are normal**. Don't trade based on emotions.
- Stay diversified and **avoid sources of new risk.** In other words, don't stretch for yield by extending bond maturities or lowering credit standards. Monitor equity concentrations to avoid big-name or sector bets.
- Think "Goldilocks" **— not too cautious, not too aggressive, but just right to achieve your goals.** If you invest funds at 0.3% when inflation runs at 2%, you won't reach that secure financial future you envision. Develop and maintain a mix of assets that aligns with your investment goals, time horizon, and risk tolerance.

For any professional advice, including a complimentary portfolio review, please contact AAFMAA Wealth Management & Trust by calling 1-800-522-5221 or by emailing wealthmanagement@aafmaa.com.

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