# DANN ASSET ADVISORS, LLC

## First Quarter 2016 Update

April 15, 2016

**1Q16 Highlights**

- U.S. economy avoids falling into recession as industrial sector stabilizes
- Fed moderates its view for rate increases – dollar weakens and commodities strengthen
- The U.S. stock market declines 15% from its May 2015 peak but rebounds strongly and finishes the first quarter with a small gain
- International central banks increasingly are implementing negative interest rate policies

The table below summarizes the performance of some key indices during the first quarter:

| Market Performance<br>Index | % Ch. 1Q16 |
|---|---|
| S&P 500 | 1.4 |
| MSCI Developed Markets (excl US) | -2.9 |
| MSCI Emerging Markets | 5.7 |
| MSCI All Country World | 0.4 |
| US Aggregate Bond (1) | 3.0 |
| Liquid High Yield (1) | 3.3 |
| US Dollar Emerging Markets Bond (1) | 5.3 |

(1) Barclays indices

Equities. The U.S. stock market (as measured by the large cap S&P 500) returned a modest 1.4% during a volatile first quarter. At its low in mid February, the S&P 500 was 11% below year-end 2015 levels and 15% under the May 2015 highs. The ensuing rebound was faster and larger than we expected, with many of the sectors that had declined the most over the prior six to twelve months leading the advance. We believe that reduced expectations for Fed tightening and a bottoming in oil prices and the U.S. industrial sector (indicating less potential for a recession) were the primary causes of the rebound.

The small gain for the quarter masked large differences in performance among sectors. Healthcare and many of the large cap technology/consumer type companies that led the market in 2015 had relatively poor first quarters. Small cap stocks continued to lag. And sectors perceived to benefit from lower interest rates – such as utilities – were by far the strongest performers during the quarter.

Internationally, the surprise for the quarter was emerging markets, which as a group registered their best quarter since spring 2014. We believe much of this advance stemmed from the decline in the U.S. dollar (which also contributed to higher commodity prices, a positive for a number of emerging economies). Brazil also saw a good rebound reflecting potential political change. Developed markets excluding the U.S. were negative, led by Japan which fell over 10% as the yen strengthened.

Fixed income. Similar to the stock market, 10-year U.S. Treasury bonds were volatile during the quarter. The 10-year yield began the year at 2.27% and declined significantly, hitting a low of 1.64% in mid February, roughly the same time the stock market bottomed. From there, the yield

increased to 1.79% at March 31. Movements in yields seemed to be driven by perceptions about the economy and potential Federal Reserve actions. In addition, low to negative rates in many large, developed countries likely drove demand for U.S. Treasuries, further driving down yields.

Reflecting the foregoing, high quality bonds (as represented by the Barclays U.S. Aggregate Bond index) generated strong returns of 3.0% during the quarter. Similar to stocks, high yield bonds exhibited substantial volatility but ended the quarter positive. With the decline in interest rates, long duration bonds were among the best performers with the Barclays 20+ Year Treasury Bond index returning 8.5%.

General comments. We continue to believe the market holds modest upside – on the order of mid single digits – over the remainder of 2016 despite the volatility of the first quarter. Assuming commodity prices bottomed during the first quarter and that the world economy doesn't significantly deteriorate, it's possible that the market will begin discounting easier earnings comparisons (to begin late 2016/early 2017) over the second half of 2016, which could lead the markets higher. Still, with the market trading at 17x 2016 estimated earnings at the end of the first quarter, we don't see a lot of near-term upside.

There always are items to worry about when considering stocks. Issues currently concerning us are the U.S. election and how the unusual and untested central bank policies in many developed economies will play out. It seems to us that these policies are having diminishing beneficial impacts. On the positive side, the Fed again recently made it clear that it will not significantly tighten monetary policy if it sees risks to the economy. And with continued respectable job growth – even if not high compensation jobs – it's hard to see the U.S. economy contracting meaningfully. Terrorism seems increasingly targeted at Western, developed countries but to date these attacks have not significantly impacted economies.

**Portfolio Positioning**

The fixed income component of most diversified (fixed income and equity) portfolios remains largely in short duration (three years and under), investment grade corporate and municipal bond funds. Complementing this conservative positioning is generally modest exposure to intermediate term (five-to-six year duration) investment grade funds and small positions in more aggressive, credit-sensitive short duration funds. We took no significant actions in fixed income during the quarter. With the decline in interest rates, intermediate term investments did better than those with shorter durations.

The best performing broad U.S. market sectors during the first quarter were utilities, telecommunications and real estate investment trusts. The stocks of each of these groups usually benefit from falling interest rates as their dividend yields become more attractive relative to competing fixed income investments – and this occurred during the first quarter.

The worst performing first-quarter sectors were healthcare, financials and technology. Healthcare was coming off a several year period of strong performance and we believe the first quarter pull back may have been due to relatively high valuations (especially in biotech), the U.S. election (with talk of price controls) and high-profile negative publicity about price increases by Valeant Pharmaceuticals. Financials likely declined due to the potential negative impact of lower rates on net interest margins. We don't attribute much significance to technology being the third worst sector as it still managed a small increase for the quarter, in line with the market.

For most equity-only accounts we had a relatively quiet quarter. We sold a homebuilding-focused exchange traded fund that was a small position and not owned by all clients – we sold as we became concerned about the economy (and its impact on the sector) early in the first quarter. For most accounts we also sold part or all of a mutual fund that performed less well than we'd expected during the market declines of August-September 2015 and January-February 2016. Proceeds from the sales were put into existing positions and a new mutual fund that focuses on high-quality businesses that generate excess cash flow and have perceived competitive advantages. Most equity-only accounts ended the quarter with approximately 5% in cash.

## Economy

U.S. GDP growth slowed from 2.0% in the third quarter of 2015 to 1.4% in the fourth. For all of 2015, GDP expanded 2.4%, the same pace as in 2014. Consumer spending continued to be reasonably strong during the fourth quarter, growing 2.4%. As in recent prior periods, inventory liquidation, exports and spending on capital equipment were negatives, reflecting the weakness in the manufacturing/industrial sector (driven by a strong dollar and low commodity prices) that restrained the economy through most of 2015.

Analysts currently are projecting first quarter 2016 GDP (to be reported later this month) to increase 1.0%-1.5%. Consumer spending appeared to weaken modestly early in the quarter, possibly in reaction to the stock market's decline. On a positive note, based on news out of industrial products distribution companies (real-time indicators of demand) it seems U.S. manufacturing businesses may finally have reached a bottom. We believe a combination of decent consumer spending and bottoming in the manufacturing sector will lead to a modest acceleration in growth during the spring, assuming no significant negative geopolitical events.

In its most recent statement on rates the Fed indicated it was less likely to raise rates in 2016 than it had anticipated in December 2015. The ECB and the Japanese central bank have instituted negative interest rate policies – depositors actually are paying the central banks to hold money. These policies may make it more difficult for the Fed to move U.S. rates higher even if warranted by the economy, as investors wanting safe, liquid fixed income will continue to be attracted to relatively higher yielding U.S. Treasuries.

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