DANN ASSET ADVISORS, LLC

Fourth Quarter 2015 Update

January 15, 2016

4Q15 Highlights

- Fed raises federal funds rate one-quarter point – first increase since 2006
- U.S. economy continues to grow modestly
- The U.S. stock market rebounds strongly from the third quarter but declines 6% in the first week of 2016
- Oil and many industrial commodities prices continue to fall

The table below summarizes the performance of some key indices during the fourth quarter and for full year 2015:

Market Performance		
Index	% Ch. 4Q15	% Ch. 2015
S&P 500	7.0	1.4
MSCI Developed Markets (excl U.S.)	4.8	-0.4
MSCI Emerging Markets	0.7	-14.9
MSCI All Country World	5.2	-1.8
US Aggregate Bond (1)	-0.6	0.6
Liquid High Yield (1)	-1.5	-5.0
US Dollar Emerging Markets Bond (1)	1.4	0.8

(1) Barclays indices

Equities. The U.S. stock market (as measured by the large cap S&P 500) bounced back strongly in the fourth quarter, returning 7.0%. The gain was quicker and larger than we anticipated and, while it's impossible to know why markets move over the short term, we believe the increase was due to greater comfort around anticipated Fed policies and continuing easy money conditions abroad. The 1.4% return for 2015, while smaller than recent years, marked the seventh straight year of positive total returns making the current bull market the third longest on record. As discussed below, much of the fourth-quarter gain was given back during the first week of the new year.

Looking a bit deeper at 2015, it's worth noting that the S&P 500 would have had a negative return if four very strongly performing large technology/consumer type companies (Alphabet, Amazon, Facebook and Netflix) were excluded from the index. And the Russell 2000 index, the benchmark for stocks of smaller U.S. companies, generated a negative 4.4% return for the year. So all in, it was year in which a very narrow group of stocks led to the market's positive return. This lack of breadth often is a sign of a mature bull market.

As indicated in the table, most international markets lagged the U.S., a continuation of the trend of the past several years. Emerging markets were especially weak, hit by deteriorating economies (in part due to falling commodity prices) and the strengthening U.S. dollar. To put the performance of the U.S. equity market (as measured by the S&P 500) relative to international markets in a longer-term perspective, the U.S. has compounded at a 12.6% annualized return over the past five years. In comparison, non-U.S. developed and emerging markets have compounded at 4.1% and negative 4.8% rates, respectively, over the same timeframe.

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Fixed income. Yields on 10-year U.S. Treasury bonds increased from 2.06% on September 30 to 2.27% at quarter end. The increase likely reflected modestly more optimistic expectations for U.S. economic growth as well the Fed's having finally raised rates. However, the 10-year yield is up only 10 basis points from December 31, 2014. Yields on two-year notes, which are more sensitive to Fed actions, increased from 0.67% to 1.06% during 2015. As indicated in the table, high quality bonds (as represented by the Barclays U.S. Aggregate Bond index) generated a very small positive return for the year but high yield debt experienced its first negative return since 2008 (in part due to stress on energy company bonds).

General Comments. Summarizing 2015 results: it was a tough year to make money. 2016 has started out even more challenging, with stocks declining of 6% through the first week. While China has been the headline focus as a cause of U.S. stocks' falling we believe the key issues for stocks are the strength of the U.S. economy and market liquidity. China, in our opinion, is important (for U.S. stocks) only as it impacts the U.S. economy.

With respect to the U.S. economy, the unemployment rate ended 2015 at 5.0% and hiring over the last three months was strong. 2015 auto sales reached record levels. These are positives indicating a relatively strong U.S. consumer. On the negative side, the U.S. industrial/manufacturing sector has been in recession for much of the past year, hurt by declining commodity prices, the strong U.S. dollar and weakening developing market economies. Generally speaking, employment and consumer spending are coincident to lagging indicators of the economy's direction; commodity prices more of a leading indicator.

Over the past six months we've noted the conflicting signals coming from the U.S. economy, writing in October that, "[i]f the U.S. does have a recession, we believe it largely will be imported – spurred by weak international economies and commodity price deflation pressuring large U.S. multinational company results and gradually filtering down to U.S. employment and consumer spending." At this point we believe the odds of the U.S. economy being flat to down in the first half of 2016 are about even. Although the stock market is not an especially reliable indicator, it is considered a leading one and, in our opinion, its recent decline may represent the market anticipating potential economic slowing.

Despite the foregoing we believe clients should maintain their existing stock exposures and add in a measured way if prices continue declining. Our reasoning is that for now at least stocks continue to offer more value than bonds. Further, there's no predicting what the Fed will do if the economy weakens but the message of the last seven years is that they'll do what they can to provide liquidity (good for stocks) and help the economy. And while it hasn't happened yet, an argument can be made that the decline in commodity prices over the past 12-18 months should lead to acceleration in other discretionary spending by consumers – and at some point that could lead to a significant pick up in growth.

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. For most clients we took no significant actions in fixed income during the quarter.

The best performing broad U.S. market sectors during the fourth quarter were healthcare,

technology and materials. In terms of market leadership we don't attribute much significance to this top three, as each of the top six (of 11 total) sectors was up between 7% and 9% in what was a strong rebound quarter for stocks. For the year, the market leaders were healthcare, consumer discretionary and consumer staples. Healthcare benefitted from acquisition activity and strong performance in the biotechnology and managed care subsectors. We believe the two consumer sectors benefitted from investors concluding that lower energy prices would free up consumer dollars for spending on non-energy related items.

The worst performing fourth-quarter sectors were energy, utilities and consumer discretionary stocks (with the last still up 4% in the quarter). For energy stocks, the fourth quarter was a continuation of full-year weakness with the sector down 23% in 2015. Materials and industrial stocks were the next two weakest sectors for the full year. Energy, materials and industrials all were hurt throughout 2015 by declining commodity prices, the strengthening U.S. dollar and economic slowdowns in developing countries.

For most equity-only accounts we had an active quarter. We sold several individual stocks, reducing exposure to the industrial/manufacturing sector, and added to existing mutual funds and exchange traded funds. The one new position added was a small-mid cap mutual fund with a value focus. This fund has a strong ten-year performance record and has held up better than many other smaller cap funds during volatile markets.

<u>2016 stock market outlook</u>. In our outlook for 2015 we wrote, "[w]e expect volatility to increase further in 2015 and believe the likelihood of a decline of 10% or more during the year is high." Volatility did increase and the S&P 500 experienced its first 10%-plus decline since 2011. Despite the higher volatility, if you had ignored the market and checked prices only on December 31 of both 2014 and 2015 you would have thought it had been a quiet year with the modest 1.4% total return.

Given the start to 2016, 2015 is old news at this point. We believe volatility will continue increasing in 2016 – although this is just a return to normal after the very low volatility of the past several years. As we're writing, the S&P 500 is close to 10% off the highs of summer 2015 and valued at 15.3x projected 2016 earnings. Given where interest rates are, this represents a fair value – assuming earnings come through as expected. With company profit margins still near record levels and our view that the U.S. economy may be weakening, earnings may not rise as expected and this, in our opinion, represents the near-term vulnerability for the market.

Acknowledging that we (like others) have no idea where the market's headed near term, our best guess is the first half of the year will continue difficult with additional downside – spurred by reductions in earnings expectations and our belief that the Fed will not immediately provide additional liquidity. We're optimistic that the second half of the year could see a decent rebound due to some combination of Fed actions and/or an improving economy spurred by lower commodity prices. For the year, and with fingers crossed, we're hoping for modestly positive returns.

For now, on the whole we're staying focused on the stocks of higher quality, larger-sized companies. We believe stocks of companies with strong balance sheets and/or a U.S. sales focus likely will perform best near term. Our current thinking is that increased exposure to more economically sensitive and international stocks may make sense over the second half of the year. And although not yet cheap, small cap U.S. stocks (which have underperformed the past two years) are beginning to look more interesting.

Economy

U.S. GDP growth slowed from 3.9% in the second quarter to 2.0% in the third. While the industrial side of the economy remained weak, consumer spending was relatively strong, coming in at a 3% increase. A drawdown in inventories restrained third-quarter growth but inventories ended the quarter at still high levels, which likely will be a negative for fourth quarter GDP. Analysts currently are projecting fourth quarter GDP (to be reported later this month) to increase 1%-2%. If accurate, this will bring all of 2015 to about 2% growth.

At its December meeting the Fed raised the federal funds rate by 25 basis points, the first increase since 2006. The Fed stated that it expects the economy to continue growing moderately in 2016 and, assuming that occurs, that it expects to continue gradually raising rates – most likely by a full percentage point during the year. However, in recent years the Fed consistently has been too optimistic in its growth and inflation projections. In addition, all central banks in developed economies that have raised rates since the financial crisis have ended up reversing those increases. We believe the Fed will raise rates less than anticipated in 2016 and that consumer spending will be the key to the economy throughout the year.

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