Poor Showing in 2015 Gives Way to Opportunities in 2016

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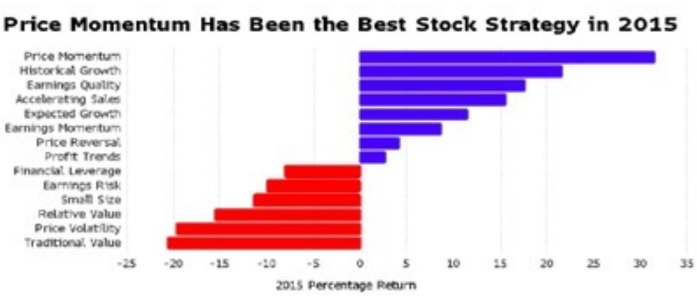
Review of 4Q 2015

The S&P 500 rose 6.81 percent, bringing the year-to-date return to 1.39 percent. Most investors would rather forget 2015, as diversification worked against them and resulted in negative returns. The only domestic indexes to have positive results for the year were the S&P 500 and REITs. If you take dividends out of the picture, none of the domestic indexes had a positive return except for cash and the Russell 1000 Growth.

As you can see from Chart 1, momentum and revenue growth were all the rage in 2015, while traditional metrics like relative value, price volatility and traditional value were not important.

Chart 1: 2015 Stock Strategies

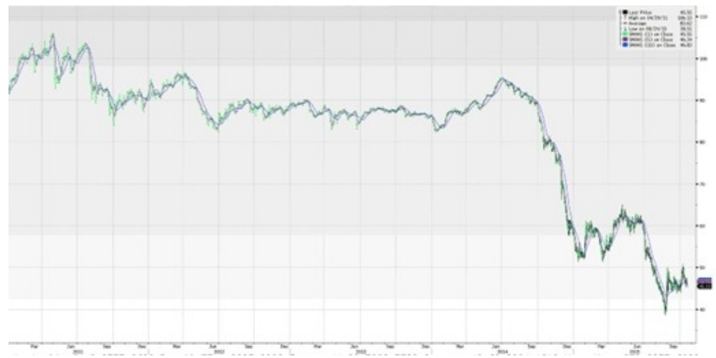


Source: Bloomberg

A number of other factors also drove the lackluster returns for the markets in 2015:

1. Only a few high-flying momentum stocks like Amazon and Google, which were up 119 percent and 47 percent, respectively, helped the S&P 500 achieve a positive return in 2015.
2. A profit drought where most large corporations experienced an earnings slow-down driven by a strong dollar that diluted foreign sales and profits.
3. Uneven consumer spending.
4. Recession-like conditions in energy and industrial stocks driven by falling commodity prices, down 22 percent, while oil was down 62 percent (Chart 2).

Chart 2: U.S. Crude Oil Spot Price 5-year View



Source: Bloomberg

Third quarter GDP came in above our estimates at 3.0 percent. The bright spot for the economy was consumer spending on durables which, resulted in robust spending on housing and automobiles. Auto makers sold 17.5 million cars in 2015, the highest sales level since 2000. Home prices rose 5 percent in 2015 on a national basis, and estimates are for prices to grow by 4+ percent in 2016.

The Federal Open Market Committee (FOMC) raised the federal funds rate by 0.25 percent on Dec. 16 and indicated that it would raise rates in 2016 an additional 0.50 to 0.75 percent.

Chart 3: U.S. GDP Estimates

'14 Act.	'15 Est.	1Q '16E	2Q '16E	3Q '16E	4Q '16E	'16 Est.	'17 Est.
2.4%	2.4%	1.6%	1.9%	1.7%	1.9%	1.8%	1.8%

Source: Pinnacle Investment Advisory

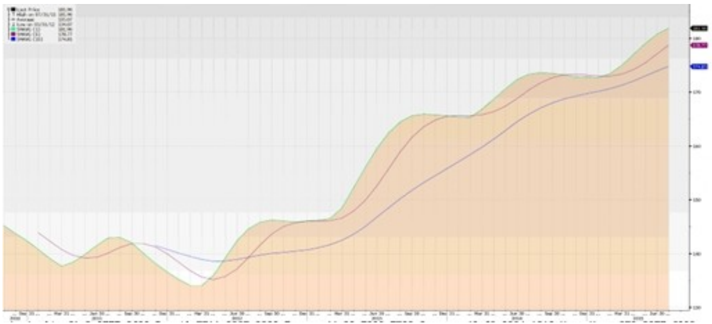
Chart 4: U.S. Housing Starts

'14 Act.	'15 Est.	1Q '16E	2Q '16E	3Q '16E	4Q '16E	'16 Est.	'17 Est.
1,001	1,102	978	1,164	1,222	1,312	1,239	1,369

In thousands seasonally adjusted

Source: Pinnacle Investment Advisory

Chart 5: Case-Shiller Home Price Index 5-Year View



Source: Bloomberg

Chart 6: U.S. Unemployment Rate

'14 Act.	'15 Est.	1Q '16E	2Q '16E	3Q '16E	4Q '16E	'16 Est.	'17 Est.
5.7%	5.0%	5.0%	4.9%	4.8%	4.8%	4.8%	4.7%

Source: Pinnacle Investment Advisory

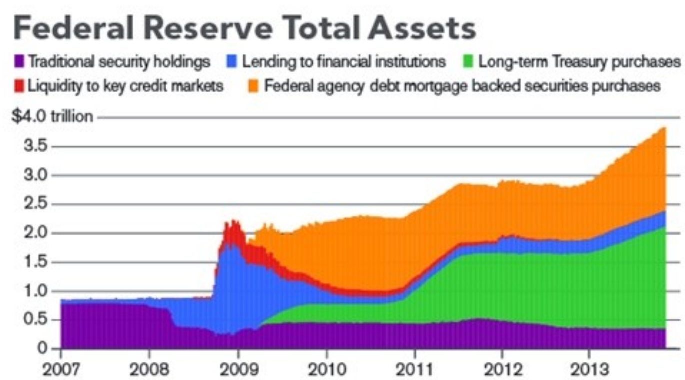
Outlook

As we look forward into 2016, the world remains a dangerous place. Europe is struggling to grow in 2016 as member countries resist taking additional refugees due to limited resources and fear of terrorist attacks. China, which devalued the Yuan during 2015, saw its stocks decline 43 percent over the summer. In addition, the critical reforms used to boost a slowing Chinese economy stalled. Combined with the market turmoil of 2015, the Chinese government binged on debt to finance its GDP shortfall. That translated into a debt load of 211 percent of GDP, approximately twice the deficit level of the U.S. Finally, the Middle East continues to suffer from ISIS and civil wars in Syria and Yemen.

So what does this mean for U.S. investors? Both the market and the economy struggled during 2015 as a profit recession hit U.S. corporations. Consumer spending did not increase substantially with the decline in oil prices as would typically be expected. We believe that during the second and third quarter of 2016 China's economy will either have a soft landing, providing a springboard for the bull market to continue with higher global GDP rates, or they will experience a hard landing, in which case U.S. GDP growth will slow to zero in 2017 and threaten economic growth in 2018.

In November 2010 when the FOMC decided to begin quantitative easing and purchased $600 billion in Treasury and mortgage-backed securities, it set in motion a recovery for banks and securities markets. It took the FOMC three rounds of QE to fully heal the U.S. from the effects of the recession. As we look forward into 2016 and 2017, the FOMC has started raising rates, and the tide is going out on securities markets. Investors will need to focus on traditional measures, and value stocks will likely come back into favor. As you can see from Chart 7, the effect of quantitative easing on the FOMC's balance sheet and asset levels remain elevated.

Chart 7: Federal Reserve Total Assets



Source: Bloomberg

Our 2016 S&P 500 anticipated earnings growth rate is 5-7 percent, and our year-end S&P 500 target is 2165, or up 6.5 percent. A number of factors could cause this number to be lower or higher. If the FOMC is more aggressive in raising rates, it would be a negative for investors, but if they move very slowly and China has a soft landing, 2016 could be a very good year for investors. In addition, if the GDP growth in the European Union improves the euro will rally, thus lowering the dollar's relative value, which could drive earnings even higher. A move lower in the dollar would spur commodity prices higher, thus causing inflation rates to move higher and allowing the FOMC to raise rates more aggressively without impacting the economy.

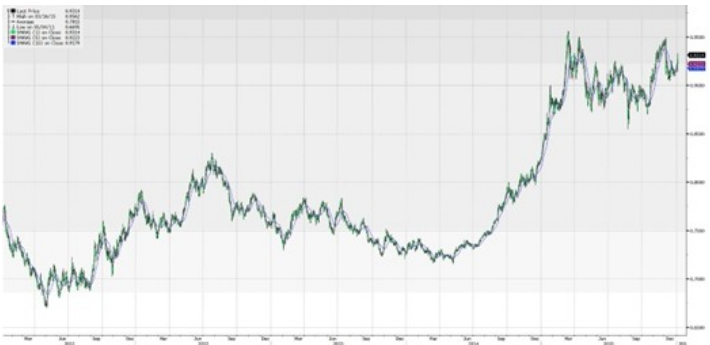
OPEC voted in December to maintain its increase in oil production, which was a negative for oil markets. The effect on Saudi Arabia is that it is going to have to borrow billions to finance its budget shortfall unless crude prices recover to $50 per barrel. We expect for OPEC to cut production in 2016.

Chart 8: Consumer Price Index Estimates

'14 Act.	'15 Est.	1Q '16E	2Q '16E	3Q '16E	4Q '16E	'16 Est.	'17 Est.
1.6%	0.2%	1.3%	1.6%	1.7%	1.7%	1.6%	2.3%

Source: Pinnacle Investment Advisory

Chart 9: Euro/Dollar 5-year View



Source: Bloomberg

Portfolio Strategy

During the fourth quarter we were bullish on technology, healthcare and consumer discretionary. We were bearish on telecom, utilities and materials. The best-performing sectors for 2015 were consumer discretionary, up 9.92 percent; consumer staples, up 6.88 percent; and health-care, up 6.84 percent. For 2016 we are bullish on energy, financials and industrials.

Our purchases and sales for the quarter were:

- **Recent purchases:** US Bank (USB), Danaher (DHR)
- **Recent sells:** IBM (IBM), Quanta (PWR), Las Vegas Sands (LVS) and Now Inc. (DNOW)

All of these trades were made to harvest losses so that clients' gains would be lessened in 2015. In addition, we swapped our international and emerging markets ETF's from iShares to Vanguard to harvest additional losses.