A TALE OF TWO MARKETS

2015 was a year of contradictions and noise, along with a highly concentrated and narrowly-focused market. Oil prices dropped throughout the year, with West Texas Intermediate oil ending the quarter at $37 per barrel, down 18% for the quarter, extending the 23% decline in the third quarter, and down 39% for the year. This steep decline in energy prices slowed economic growth worldwide. The strength in the U.S. dollar continued to be a headwind for multinational companies, as the Federal Reserve's US Dollar Trade Weighted Index gained 2.3% for the quarter and 11% for the year, continuing the upward trend in place since July 2011.

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FOURTH QUARTER 2015 RETURNS

During the fourth quarter, we maintained maximum equity exposure for clients where we have the ability to allocate between stocks and bonds. Bond returns, as measured by the Barclays Government/Credit Intermediate Bond Index, were mixed, at -0.69% for the quarter and +1.07% for the past twelve months. In the U.S., and for large capitalization stocks, the Fourth Quarter reversed the market damage of the Third Quarter, but this did not hold true for smaller stocks or for non-U.S. stocks. Returns for the six months ranged from +1.6% for the Russell Large Growth Index, through +0.1% for the S&P 500, to -6.0% for the EAFE Index and -9.3% for the All Country World Index excluding the U.S. The S&P 500 returned 7.03% for the quarter and 1.37% for the year. The S&P 1000 returned 2.93% for the quarter and -2.13% for the year. The MSCI Europe, Asia, and Far East Index returned 4.71% and -0.81 for the quarter and the year, and the MSCI All Country World Index gained 5.03% for the quarter and lost -2.36% for the year. Looking at the U.S. market on a sector by sector basis also shows divergent returns, with Consumer Discretionary stocks returning 10.1%, and Energy stocks losing -21.1% for the year.

WE ARE WATCHING SEVERAL POTENTIALLY DESTABILIZING TRENDS CLOSELY

Many of our primary concerns are generated by the intersection of geopolitical and economic forces. The geopolitical turmoil that marked 2015 will continue in 2016. Slowing industrial demand in China exacerbates the structural imbalance between declining oil demand and rising oil production, leading to the steep drop in oil prices in 2015, and creating hardship and debt issues for countries and sectors dependent upon strong oil sales, including Russia, Brazil, Venezuela, the OPEC nations, and even the oil patch in the U.S. and Canada. In contrast to expansionary monetary policy in developed markets, Brazil and Russia are fighting persistent inflation with very contractionary monetary policies. Other significant concerns include the Syrian refugee crisis, tension between Saudi Arabia and Iran, and North Korea's recent claim of hydrogen bomb capability. Any of these could lead to destabilizing political change. For U.S. stocks, we are also closely following the appreciation in the dollar, as further significant appreciation will be a drag on both exports and on U.S. corporate earnings, both of which were weak in the face of the 11% rise in the value of the dollar in 2015 versus its trade-weighted index.

OUTLOOK

Since 2009, the worldwide economic environment has been characterized by pervasively low inflation rates, slow growth, and generally slow population growth. With persistently low inflation, low levels of nominal economic growth can be consistent with modest, and positive, levels of real, inflation-adjusted growth in Gross Domestic Product (GDP). In this environment, temporary declines in economic activity can

manifest as near-recession-level growth readings, making it more difficult to discern the overall economic trend, contributing to both investor uncertainty and stock market volatility. We base our preference for equity over debt on the following factors. Monetary policy continues to be expansionary in Europe, in Japan, and even in the U.S., even if slightly less so than before the Federal Reserve began to raise short-term interest rates above the near-zero level at which they have languished for nearly five years. Across developed markets, corporate and consumer balance sheets are strong, unemployment rates are falling, and both personal income and labor force participation are rising. Our forecast for emerging markets is more subdued. China's slowing growth rate creates a substantial headwind for all of its trading partners. Continued weakness in oil prices will substantially reduce economic growth for oil-exporting countries. Low levels of inflation and nominal GDP growth increase the risk of bonds and credit. In an inflationary environment, rising prices erode the real value of existing debt, and make it easier for debtors to repay their loans. Low inflation rates do not help debtors in this way.

VALUATION

Current valuations for U.S., European, and Japanese stocks do not look excessive to us. U.S. economic growth continues to be solid, even if moderately slow. Job creation has been strong, inflation is well contained, and our positive view on the U.S. economy should support current stock valuations, allowing for growth in line with earnings. The consensus on earnings growth for 2016 for the S&P 500 has moved up slightly from 10% to 11.75% in the last quarter. Currently, the S&P 500 index is at 15.4 times expected earnings for the next twelve months, just at the 25 year average of 15.7 times earnings. Yale Professor Robert Shiller's cyclically adjusted P/E ratio, or CAPE ratio, which looks at the average of ten years trailing earnings, is at 25.9 times earnings, 1.4 standard deviations above the average since 1881, but in line with the 25 year average of 25.6 times earnings. Compared to the current S&P 500 earnings yield of 6.5%, the yield on the 10 Year Treasury Inflation Protected Security is just 0.63%, indicating that stocks should return about 5.8% more than bonds. **With monetary policy continuing to be broadly expansionary, U.S. and developed market economic growth solid if slow, and valuations reasonable, we believe the balance of risk and reward favors stocks**. We do, however, favor stocks with strong balance sheets and attractive end markets.

ALLOCATION

Worldwide equity markets had a discouraging start in the first week of January, 2016. Chinese growth concerns, and the implications of falling growth in China for oil prices, once again absorbed investors' attention. Investors have reacted with confusion, moving stock prices sharply down. We believe these concerns are overblown for the United States, and continue to emphasize stocks of the U.S. and other developed markets over bonds, believing that the balance of risk and return for 2016 favors developed market stocks over bonds and cash.

We acknowledge that further temporary drops in the equity markets may be ahead, but we believe that one year from now, investors who calmly assess the supportive economic background in relationship to the potential risks will come out ahead of those dwelling on the threat of multiple potential risks.