INVESTMENT COMMENTARY: Q4 2015

January | 2016

Two major forces exerted significant pressure on stock and bond prices in 2015, making it the most challenging investing environment since the Global Financial Crisis of 2008. First, the US Federal Reserve transitioned from monetary easing to tightening as the US job market strengthened. Although the actual interest rate hike finally came in December, the anticipation led to some unease in the late summer and fall. Second, a renewed global economic slowdown, particularly in China, fueled concerns that a global recession could be coming. Commodity prices plunged as supply and demand imbalances widened. These macro forces caused a spike in stock price volatility, sent the US dollar soaring, and pressured bond prices.

After 6 years of positive returns for US stocks, 2015 served as a bit of a wake-up call. US large-cap stocks, as measured by the S&P 500 equal-weight index, finished down 4.1% for the year. US small-cap and International stocks were also down more than 4%. US corporate bonds experienced negative returns due to rising interest rates and widening credit spreads. Commodity prices were hit the hardest, with crude oil declining more than 30% in 2015.

These forces are still with us as we head into a new year. In our view, 2016 is set up as a year where the markets will generate modest returns and the US economy will avert a recession, but growth will be scarce and volatility will remain elevated. Successful investing will require patience, flexibility and a time horizon of more than one year.

The first flashpoint to watch is China. Fears that its economy could slow abruptly have persisted for at least a decade and reached a fever pitch in 2015. In August, these fears were palpable as the Chinese stock market fell 40% from its highs and the US stock market sustained its first official “correction” since 2011, declining over 12% from its July highs. China moved to support its market and managed to stabilize prices, which led to a subsequent recovery in the US market. More shocks could occur in 2016.

China’s newly stated priority is to continue their economy’s shift towards consumer spending and services, moving away from heavy industry and construction, two areas plagued by excess capacity. Since infrastructure build-out (heavy industry and construction) has been a key driver of investment, this shift could make it difficult for the Chinese government to achieve its 6.5% growth target. Still, the Chinese have shown a proclivity to intervene and (so far) prevent broader financial crisis.

The second flashpoint is oil. Saudi Arabia kicked off a price war to recapture market share from American producers, causing the price of oil to crater from over $100 per barrel to $36.60 at the close of 2015. Even if the price of oil stabilizes, geopolitical and financial repercussions are severe. US corporate bond markets weakened as debt tied to US oil production and distribution came under pressure. Globally it has pushed Russia and Venezuela into deep recessions and even contributed to the defeat of Canada’s Conservative government.

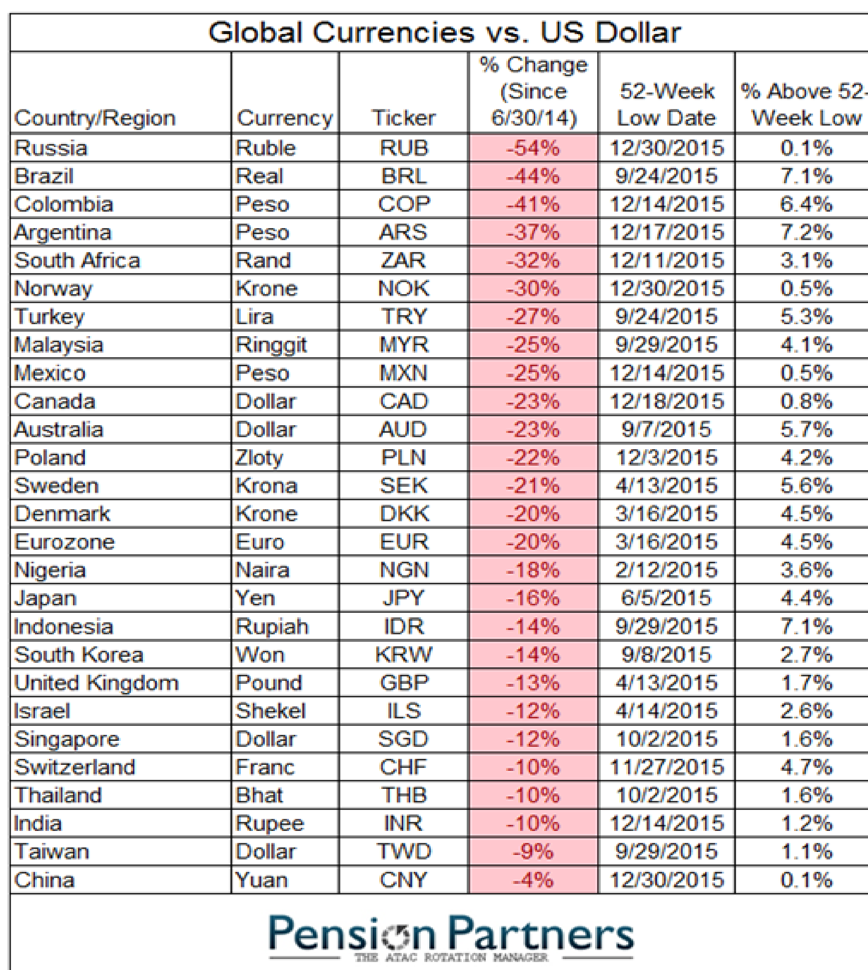
In 2016, the country to watch is Saudi Arabia. Plunging oil revenue drove the country’s budget deficit to 20% of GDP, and it has already spent almost $100 billion of its foreign reserves; at this pace, the kingdom will run out of reserves in 2020. The government has responded by paring subsidies to its citizens, but this risks further aggravating social tensions. Further complicating Saudi Arabia’s predicament is that the kingdom pegs its currency, the riyal, to the US dollar.

That means as the Federal Reserve raises interest rates, Saudi Arabia must follow suit. Yet slumping oil prices will pressure Saudi Arabia to change or abandon its currency peg or take some more aggressive actions.

Just as in 2015, the Federal Reserve is likely to be a central driver of the markets in 2016. After nearly pulling the trigger in September, the Fed finally hiked rates in December, raising the Fed Funds rate by 0.25%. The Fed is raising rates because it thinks that, with unemployment down to 5%, it's only a matter of time before prices and costs pick up. It's likely to see its judgment affirmed, at least initially. According to an analysis by the Federal Reserve Bank of Atlanta, the typical worker's wage is already growing at a 3.1% pace, up from between 2% and 2.5% in early 2014. Core inflation excluding food and energy, now just 1.3% by the Fed's preferred index, is similarly likely to edge higher only when downward pressure from the dollar and commodity prices (energy, copper, food, etc.) abate.

While the Federal Reserve has hinted at more rate hikes in 2016, the market disagrees. Fed officials think their target rate will be between 1.25% and 1.5% by the end of 2016, but the futures market is predicting that it won't climb above 1% in 2016. Pushing back against the inflation expectations are continued low oil prices, which may keep overall inflation below the Fed's 2% target, and the economic drag from weak exports and declining energy investments. With the economic expansion now relatively mature, the bond market could come to worry that further Fed tightening will push the US economy into recession. By the second half of 2016, the Fed may well agree and call off further rate hikes.

In our estimation, the key determinant for the market's direction in 2016 will be the US dollar. The combined effects of Fed tightening, global (non-US central bank) easing, and a commodities crash created a powerful force in driving nearly every currency in the world lower against the US dollar.



Global Currencies vs. US Dollar

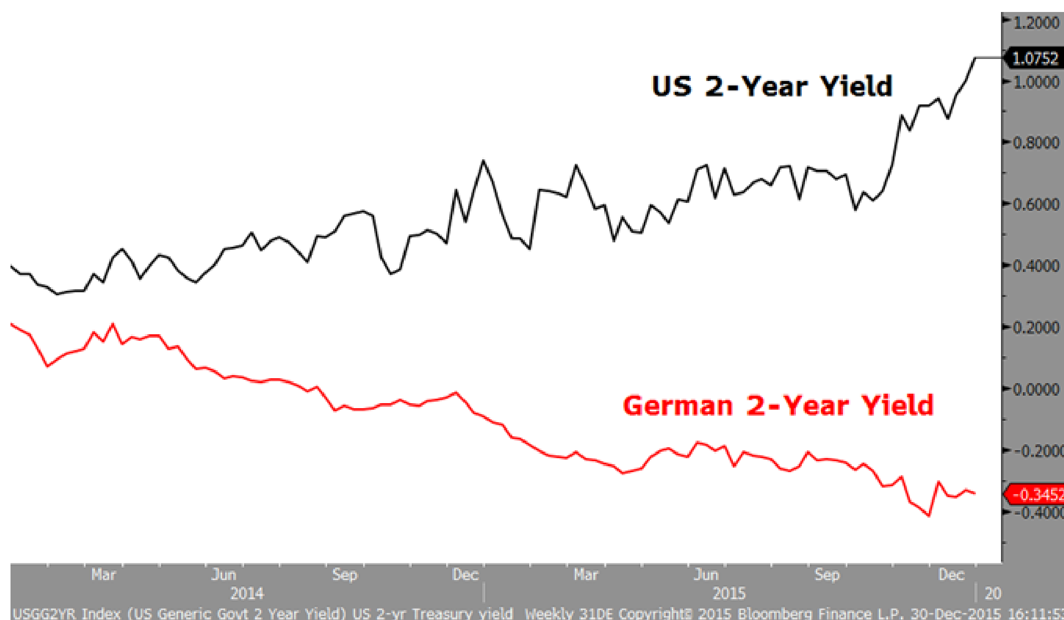
Country/Region	Currency	Ticker	% Change (Since 6/30/14)	52-Week Low Date	% Above 52-Week Low
Russia	Ruble	RUB	-54%	12/30/2015	0.1%
Brazil	Real	BRL	-44%	9/24/2015	7.1%
Colombia	Peso	COP	-41%	12/14/2015	6.4%
Argentina	Peso	ARS	-37%	12/17/2015	7.2%
South Africa	Rand	ZAR	-32%	12/11/2015	3.1%
Norway	Krone	NOK	-30%	12/30/2015	0.5%
Turkey	Lira	TRY	-27%	9/24/2015	5.3%
Malaysia	Ringgit	MYR	-25%	9/29/2015	4.1%
Mexico	Peso	MXN	-25%	12/14/2015	0.5%
Canada	Dollar	CAD	-23%	12/18/2015	0.8%
Australia	Dollar	AUD	-23%	9/7/2015	5.7%
Poland	Zloty	PLN	-22%	12/3/2015	4.2%
Sweden	Krona	SEK	-21%	4/13/2015	5.6%
Denmark	Krone	DKK	-20%	3/16/2015	4.5%
Eurozone	Euro	EUR	-20%	3/16/2015	4.5%
Nigeria	Naira	NGN	-18%	2/12/2015	3.6%
Japan	Yen	JPY	-16%	6/5/2015	4.4%
Indonesia	Rupiah	IDR	-14%	9/29/2015	7.1%
South Korea	Won	KRW	-14%	9/8/2015	2.7%
United Kingdom	Pound	GBP	-13%	4/13/2015	1.7%
Israel	Shekel	ILS	-12%	4/14/2015	2.6%
Singapore	Dollar	SGD	-12%	10/2/2015	1.6%
Switzerland	Franc	CHF	-10%	11/27/2015	4.7%
Thailand	Bhat	THB	-10%	10/2/2015	1.6%
India	Rupee	INR	-10%	12/14/2015	1.2%
Taiwan	Dollar	TWD	-9%	9/29/2015	1.1%
China	Yuan	CNY	-4%	12/30/2015	0.1%

Pension Partners
THE ATAC ROTATION MANAGER

While a stronger US dollar is beneficial for those traveling abroad, it is a negative for US companies selling goods abroad. Companies in the S&P 500 Index derive over 46% of their sales overseas, so translating those sales back into US dollars makes their profits less valuable. Additionally, the prices for their goods are more expensive in the foreign currencies, so they can either cut their prices or lose market share to cheaper competitors.

The strong US dollar is exacerbating a problematic commodity cycle. Since most global commodities are traded in US dollars, a stronger dollar tends to reduce commodity prices. This is particularly true for oil, where the strong US dollar has combined with supply increases and flagging demand to drive the price of oil to recessionary levels.

There are several reasons why the US dollar has been so strong versus all other currencies, but the primary factor right now is the divergence in global interest rates. All else being equal in terms of credit quality, global capital will flow into the currency with higher interest rates. While the rest of the world is cutting interest rates, the US Federal Reserve is raising rates. One of the best illustrations is the difference between 2-year rates in the US and Germany:



Given the dollar strength and the divergence in global interest rates, we think that the US Federal Reserve will not be aggressive in hiking interest rates in 2016. As mentioned above, while the Fed is projecting up to 4 rate hikes this year, the market – as indicated by Fed Fund futures – thinks that there will be no more than 2 rate hikes in 2016. If the Fed is stubborn and hikes too aggressively, it will place tremendous strain on global currencies and commodities.

As the first half of 2016 unfolds, we will be listening to the Federal Reserve, watching events in Saudi Arabia, and the observing the actions of both the European Central Bank (ECB) and the Chinese government for indications

of US Dollar direction. We will also monitor supply and demand imbalances in commodities. If commodity prices are a leading indicator, then stock prices have not yet fallen enough.

While most of this commentary addresses the challenges and macro forces that roll into 2016, if our assumptions prove to be accurate then some investing areas should still have tailwinds.

- Existing real estate investments (income properties and development projects already in process) should continue to produce good results.
- CA municipal bonds which are supported by strong tax receipts should continue to produce superior tax-free income.
- So-called "value stocks" experienced a decline in 2015 underperforming growth companies by 8.8%. These companies offer attractive dividend yields and lower price multiples.
- Companies with predominantly US-based sales.
- Companies with innovative technologies.

Additionally, for the longer-term horizon, some world class basic materials and commodity companies are being thrown overboard along with their over-levered and poorly run peers. These investments may not be for everyone, but the survivors of major cycles tend to be lean, well-managed and have fewer competitors when they enter a new uptrend, which can lead to very good long term results.

As always, we will monitor, research and analyze the investment landscape. No matter how tough the global landscape, there are places to allocate money that make sense in 2016.

VAN HULZEN ASSET MANAGEMENT

Investment Committee

4370 Town Center Blvd Suite 220, El Dorado Hills, CA 95762
Tel: (916) 608-4284 | Fax: (916) 608-4296
www.vaminvest.com