

Shifting Sands

Paul Hancock, CFP® | January 13, 2016

Baseball is a funny sport. Just when you thought you have seen everything, something happens in the course of a game that has never happened in the history of the sport. The same could be said for the stock market. Case in point was the first week of 2016. In the United States, the Dow dropped 6.1%, the S&P 500 6.0% and the Nasdaq 7.3% all in one week, making the decline the worst on record for the start of a year. U.S. markets were heavily impacted by a weak Chinese stock market and a devaluation of their currency. China has been in the global market spotlight for much of 2015 and certainly carried over into 2016. Whatever the case for the decline in the first week, this is a good reminder that bear markets happen!

Statistically speaking a bear market occurs once prices decline at least 20% from their peaks. On average, a bear market has occurred about every 3.5 years. Our last bear market in the U.S. was nearly 8 years ago meaning we are more than due for a bear market. The actions of the Federal Reserve keeping interest rates low has certainly had an impact on keeping the stock market afloat.

One of my favorite writers, Ben Carlson recently wrote an article discussing truths about bear markets. Below are some excerpts from his article as he discussed bear markets.

“They happen. Sometimes stocks go down. That’s why they’re called risk assets. Half of all years since 1950 have seen a double-digit correction in stocks. Get used to it.”

“They’re a natural outcome of a complex system run by emotions and divergent opinions. Humans tend to take things too far, so losses are inevitable.”

“Buy and hold feels great during a long bull market. It only works as a strategy if you continue to buy and hold when stocks fall. Both are much easier to do when stocks rise.”

“These are the times that successful investors separate themselves from the pack. Most investors mistakenly assume that you make all of your money during bull markets. The reason so many investors fail is because they make poor decisions when markets fall.”

Are the sands shifting towards a bear market for stocks in the United States? No one really knows. Whether or not we are in for our next bear market in 2016, it’s important for investors to understand and be prepared for the next bear market. Tried and true investing disciplines help during difficult markets:

- Don’t panic. Keep a long term perspective relative to your stock holdings. Remind yourself that stocks are volatile assets and will go up and down more often than bonds and cash.

- Continue to invest on a regular monthly basis. As stocks decline, you'll be buying at lower prices.
- Rebalance your portfolio. If the market drops 20% that usually means your allocation to stocks has also dropped 20% and your allocation to bonds or cash has increased 20%. Selling the winners, in this case bonds, and buying the losers, allows you to again take advantage of lower stock prices.
- Keep an eye on international stocks and bonds and ensure proper allocation globally in a portfolio.

Federal Reserve Actions in 2015

The sands began to shift in the global economy in 2015 as the Federal Reserve lifted interest rates off zero for the first time since the Great Recession. The Fed had signaled its intentions to raise interest rates in 2015, but insisted they would only do so if the economic data improved. To the surprise of some, they chose not to raise interest rates during their September meeting. The Fed cited "tightened domestic financial conditions" among other reasons they did not raise rates in September. It was ironic that they chose to raise interest rates in December as "financial conditions" appeared to be tighter since that time. From the September meeting to the December meeting the Goldman Sachs Financial Conditions Index declined along with S&P 500 profit margins, high-yield bonds, inflation and other financial measures. I suspect the Fed raised in December to maintain credibility as they said they would raise rates at some point in 2015.

The Fed is now the only Central Bank in the major advanced economies to begin to tighten monetary policy. The Fed has signaled four additional rate hikes in 2016. The market is pricing in only two rate hikes. The Fed certainly faces challenges as it attempts to normalize monetary policy amidst a weakening global economy. Europe and Japan continue to fight slow growth and deleveraging while China fights lower economic growth, a volatile stock market, and managing its currency, the renminbi.

Clearly, low interest rates forever is not the solution as evidenced by Japan since the late 1980's. The Fed knows that it must raise interest rates. Transitioning interest rates or in this case, the Federal Funds Rate, from zero to 3% or so will be a driving force in markets and the economy for the remainder of the decade.

Global Markets in 2015

It was a very difficult year to be an asset allocator. As shown below, most asset classes registered small to negative returns in 2015.

U.S. stocks rebounded in the fourth quarter to finish the year up 0.5%. Large cap growth stocks outperformed large cap value stocks. Large cap stocks also outperformed mid and small cap stocks.

International developed stocks declined slightly ending down 0.8%. Volatility was felt much more in emerging market stocks as that market fell 15% on the year. Lower commodity prices had an impact on emerging market stocks. Crude oil dropped 45% leading the Bloomberg Commodity Index to a 25% decline on the year. As can be expected with weak commodity prices, the US dollar strengthened on the year, up 7%.

The global bond market retreated 3.2% on the year while U.S. bonds edged up 0.6% on the year. Municipal bonds continued to shine up 3.3% on the year. High-yield corporate bonds declined 4.5% impacted by a large decline in energy prices. Emerging market local currency bonds were impacted by a strong dollar and registered a 10.4% decline on the year.

2015 Global Market Returns		
As of December 31, 2015		
Stocks/Real Assets	Market	YTD
MSCI All Cap World Index	World Stock Market	-2.4%
Russell 3000	U.S. Stock Market	0.5%
S&P 500 Index	U.S. Large Cap	1.4%
Russell Midcap	U.S. Mid Cap	-2.4%
Russell 2000	U.S. Small Cap	-4.4%
MSCI EAFE Index	International Developed	-0.8%
MSCI Emerging Markets	Emerging Market Stocks	-14.9%
Dow Jones Composite REIT	Real Estate	1.8%
Bloomberg Commodity Idx	Commodities	-24.7%
US Dollar Index	US Dollar	7.0%
Bonds	Market	YTD
Barclays US Aggregate	U.S. Bond Market	0.6%
Barclays US Treasury	U.S. Government Bonds	0.8%
Barclays US 1-3 Year Treasury	Short-Term Bonds	0.6%
US Treasury bill 90 days rate	Cash	0.0%
Barclays Municipal	Municipal Bonds	3.3%
Barclays US Corporate Bonds	Inv-Grade Corporate Bonds	-0.7%
Barclays US Corporate High Yield	High Yield Corporate Bonds	-4.5%
Barclays Global Aggregate	Global Bond Market	-3.2%
Barclays Emerging Markets	Emerging Market Bonds USD	1.3%
Barclays EM Local Currency	Emerging Market Bonds LC	-10.4%

Looking Ahead

Valuations in U.S. stock and bond markets have risen over the past 8 years. Predicting market returns is a fool's errand. However, looking at long term historical rates of return and current prices relative to long term returns can give investors some idea of current valuations in markets. Given very strong performance over the past 8 years for markets in the United States, valuations appear stretched. Does this mean investors should run out and sell their domestic stocks and bonds? No! However, investors should remember that we live in a global marketplace and their portfolios should reflect this fact.

In the chart below, I have listed recent performance for major asset classes along with a projected 10-year average annual nominal return for each market. The projected returns come courtesy of Research Affiliates. Investors that keep a domestic focus have the potential for lower projected returns. A balanced portfolio of 60% U.S. stocks and 40% U.S. bonds is projected to provide investors with only a 3.5% average annual return over the next 10 years. To put 3.5% into context, for the past 50 years, this same allocation has returned roughly 8% per year on average. Taking a 2.5% inflation projection into account, a 3.5% number drops to 1% real return.

It's only natural that the asset classes that have performed poorly over the past 10 years may be poised to provide better returns for the next 10 years. Emerging market stocks and bonds along with international developed stocks and high-yield corporate bonds are at the top of that list. The point of this exercise should remind investors to stay diversified and rebalance portfolios on a regular basis. U.S. markets may be in for a bear market in the near future, but don't forget that there are many other opportunities globally for long-term oriented investors.

Average Annual Total Returns					
As of December 31, 2015					
Market	YTD	3 Yr	5 Yr	10 Y	Projected
U.S. Large Cap Stocks	1.4%	15.1%	12.6%	7.3%	3.6%
U.S. Small Cap Stocks	-4.4%	11.7%	9.2%	6.8%	3.0%
International Developed Stocks	-0.8%	5.0%	3.6%	3.0%	7.8%
Emerging Market Stocks	-14.9%	-6.8%	-4.8%	3.6%	10.4%
Real Estate	1.8%	9.9%	11.0%	6.5%	4.7%
Commodities	-24.7%	-17.3%	-13.5%	-7.5%	5.1%
U.S. Bond Market	0.6%	1.4%	3.3%	4.5%	3.7%
U.S. Government Bonds	0.8%	1.0%	2.9%	4.2%	3.3%
Short-Term Bonds	0.6%	0.5%	0.7%	2.4%	2.8%
Cash	0.0%	0.0%	0.1%	1.1%	2.2%
High Yield Corporate Bonds	-4.5%	1.7%	5.0%	7.0%	5.6%
Global Bond Market	-3.2%	-1.7%	0.9%	3.7%	3.5%
Emerging Market Bonds USD	1.3%	0.6%	5.1%	6.7%	5.9%
Emerging Market Bonds LC	-10.4%	-5.6%	3.6%		7.9%

References

A Wealth of Common Sense – Ben Carlson.

Research Affiliates Expected Returns as of 12/31/2015.

DISCLOSURES & INDEX DESCRIPTIONS

Relative to the chart listing expected returns. As of 12/31/2015. Source: These expected returns are calculated by Research Affiliates LLC using data provided by MSCI Inc., Bloomberg, and Barclays. These forecasts are forward-looking statements based upon the reasonable beliefs of RA and are not a guarantee of future performance. This content is not investment or tax advice or an offer, sale or any solicitation of any offer to buy any security, derivative or any other financial instrument. The use of the content is subject to important disclosures, disclaimers and provisions found at www.researchaffiliates.com/Pages/Legal.aspx.

All indexes are unmanaged and an individual cannot invest directly in an index. Index returns do not reflect fees or expenses.

The MSCI ACWI (All Country World Index) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. As of June 2009 the MSCI ACWI consisted of 45 country indices comprising 23 developed and 22 emerging market country indices.

The S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. An investor cannot invest directly in an index.

The Russell 3000 Index[®] measures the performance of the 3,000 largest U.S. companies based on total market capitalization.

The Russell Midcap Index[®] measures the performance of the 800 smallest companies in the Russell 1000 Index.

The Russell 2000 Index[®] measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

The MSCI[®] **EAFE** (Europe, Australia, Far East) Net Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises 21 MSCI country indexes, representing the developed markets outside of North America.

The MSCI Emerging Markets Index SM is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of June 2007, the MSCI Emerging Markets Index consisted of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

The Dow Jones Composite REIT Index measures the performance of Real Estate Investment Trusts (REIT) and other companies that invest directly or indirectly through development, management or ownership, including properties.

The Barclays Commodity Index is composed of futures contracts on physical commodities and represents twenty two separate commodities traded on U.S. exchanges, with the exception of aluminum, nickel, and zinc.

The US Dollar Index is an index (or measure) of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of US trade partners' currencies.

The Barclays Capital U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indexes that are calculated and reported on a regular basis.

The Barclays U.S. Treasury Index is U.S. Treasury component of the U.S. Government index. Public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Treasury bills are excluded (because of the maturity constraint). Certain special issues, such as flower bonds, targeted investor notes (TINs), and state and local government series (SLGs) bonds are excluded. Coupon issues that have been stripped are reflected in the index based on the underlying coupon issue rather than in stripped form. Thus STRIPS are excluded from the index because their inclusion would result in double counting. However, for investors with significant holdings of STRIPS, customized benchmarks are available that include STRIPS and a corresponding decreased weighting of coupon issues. Treasuries not included in the Aggregate Index, such as bills, coupons, and bellwethers, can be found in the index group Other Government on the Index Map. As of December 31, 1997, Treasury Inflation-Protection Securities (Tips) have been removed from the Aggregate Index. The Tips index is now a component of the Global Real index group.

The Barclays U.S. Treasury: 1-3 Year includes securities in the Treasury Index (i.e., public obligations of the U.S. Treasury) with a maturity from 1 up to (but not including) 3 years.

U.S. Treasury Bill 90 Days Rate is an index comprised of short-term obligations issued by the United States government.

The Barclays Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least \$7 million and be issued as part of a transaction of at least \$75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.

The Barclays U.S. Corporate Investment Grade Index is the Corporate component of the U.S. Credit index. Publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

The Barclays U.S. Corporate High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

The Barclays Global Aggregate Bond Index provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and

the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian government, agency and corporate securities, and USD investment grade 144A securities.

The Barclays Emerging Markets USD Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes USD denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The index is broad-based in its coverage by sector and by country, and reflects the evolution of EM benchmarking from traditional sovereign bond indices to Aggregate-style benchmarks that are more representative of the EM investment choice set. Country eligibility and classification as an Emerging Market is rules-based and reviewed on an annual basis using World Bank income group and International Monetary Fund (IMF) country classifications. This index was previously called the Barclays US EM Index and history is available back to 1993.

The Barclays EM Local Currency Government

The flagship Emerging Markets Local Currency Government Index is designed to provide a broad measure of the performance of local currency emerging markets (EM) debt. Classification as an Emerging Market is rules-based and reviewed on an annual basis using World Bank income group and International Monetary Fund (IMF) country classifications. Not every country classified as EM will be eligible for this benchmark as additional evaluations of market size and investability are also used to determine country eligibility for this index. Some local currency EM debt markets excluded from this index due to investability (China, offshore and onshore, India, and Taiwan) are eligible for the broader EM Local Currency Government Index. Historical index returns are available from July 1, 2008.

Index Date Sources: MSCI, Russell, Standard & Poors, Morningstar, Kwanti, Barclays, Hatteras

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International investing involves additional risks, including currency fluctuations, political or economic conditions affecting the foreign country, and differences in accounting standards and foreign regulations. These risks are magnified in emerging markets. Small and mid-cap stocks carry greater risks than investments in larger, more established companies. Fixed-income securities are subject to interest-rate risk. Investing in high-income securities may carry a greater risk of nonpayment of interest or principal than higher-rated bonds. Investing in commodities is generally considered speculative because of the significant potential for investment loss due to cyclical economic conditions, sudden political events, and adverse international monetary policies. There are several risks associated with alternative or non-traditional investments above and beyond the typical risks associated with traditional investments including higher fees, more complex/less transparent investment strategies, less liquid investments and potentially less tax-friendly. Some strategies may disappoint in strong up markets and may not diversify risk in extreme down markets.

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