

2016 Market & Economic Outlook

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Equity Market Outlook - Jason Ritzenthaler, CFA, CTFA

Mark Twain is credited with saying “History doesn’t repeat itself, but it does rhyme.” If this is true, then 2015 sounded a lot like 2011. Both years ended with annual price declines in the S&P 500 with 2015 ending off .7%. Adding in dividends, both years produced slightly positive total returns with 2015 finishing up 1.37%.

We reached the highs for this year in May and the third quarter was the worst quarterly performance, down 6.44%, since the third quarter of 2011. The fourth quarter saw a significant rally in equity markets coming off the August lows and the re-testing of those lows in September, but equities could not recapture the highs. The S&P 500 was up 8.44% in October and finished the quarter up 7.04%. For the year, the S&P 500 gained 1.37% while Mid Caps lost 2.18% and Small Caps declined 2.01%. International Developed markets lost .21% and Emerging markets were off 14.83%.

Our expectation is for US equity market returns to be below long-term averages for 2016, but better than 2015 with the S&P 500 returning ~5-6%. We expect international markets to do better given easing monetary conditions from the European Central Bank and Bank of Japan. While we believe Quantitative Easing, specifically QE3 from 2012-2014, by the Federal Reserve was the right policy move at the time, a byproduct was the shifting forward of equity market returns we otherwise would have seen in 2015-2017. Annualized S&P 500 returns from 2012-2014 were 20.38%, which was more than double the long-term average. We believe economic data continues to point to the slow growth environment we have seen the past few years. Our expectation is for US GDP growth to come in between 2.4-2.7% in 2016. We are finally seeing signs of some wage growth in the US with year-over-year increases of 2.5% in October and 2.3% in November. These increases together with low energy prices likely will be major tailwinds to consumers. S&P 500 earnings are also expected to get back to year-over-year growth and once again reach record EPS levels in 2016. Maybe as importantly, year-over-year comparisons will be much easier in 2016 which could present some positive earnings headlines.

Internationally, China has been a mainstay in the headlines dating back to the August and September stock market declines. China’s slowing economy, the Yuan devaluation, and their stock market volatility have been the major themes over the last 6 months. Though it is an area we are watching closely, we believe it’s important to put these factors into context, which the headline driven media can tend to overlook. China’s economy is slowing, and it has been since 2010. The financial crisis of 2008 reminded China’s leadership that their manufacturing/export driven economy was largely reliant on the rest of the world to buy their products. Since 2010, their goal has been to increase the consumer/services sector to lessen their dependency on trade partners. In that goal, they have been successful with the services sector now making up the majority of their GDP growth. In order to increase internal consumer demand and spending, wages had to increase. This in turn, slowed growth by increasing their manufacturing costs and making their exports less competitive. From June of 2010 to the start of 2014, their currency appreciated against the dollar by 11.5%. A weaker dollar over that time made their goods relatively more expensive and added to the competitive pressures slowing their manufacturing economy. The talk today is regarding the devaluation of the Yuan, which is true. They have devalued against the Dollar by ~6% in the past year, but given their economic challenges, this seems reasonable when compared to the devaluation of the Brazilian Real by 53%, the Russian Ruble by 22%, the Indian Rupee by 7%, the Canadian Dollar by 19% and even the Euro by 7.5% over the same time period. We also have been hearing a lot about the Chinese stock market and specifically the mainland or A-shares markets like Shanghai. Shanghai has been extremely volatile while declining ~42% since the June high, but it is also true that since 2014 it is still up ~45%. The Chinese mainland markets are very different from the US exchanges structurally and in general are much more volatile. Our Emerging Market exposures have Chinese investments, but only small fractions are the more volatile markets of mainland China that you read about. The vast majority of our holdings are in Hong Kong or are Chinese companies that are listed on US exchanges. China is still the great experiment of

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Communist Capitalism and ultimately we don't know how it will end. I would encourage you to ask yourself, "Could the negative rhetoric that we read and hear be affecting the short-term sentiment of the overall market, and could this, in part, be due to the political climate we are in?" If so, then maybe things aren't as bad as we hear, just ask Apple and Nike. Long story short, China has been willing to give up growth in the short-term to have a more sustainable economy in the long-term.

Volatility will likely continue in equity markets, and it is important to keep short term declines in context. On average over the long-term, a

"normal" equity market sees 5% or more declines 3 times per year, 10% or more declines each year, and 15% or more declines every 2 years. 20% or more declines happen every three and a half years on average [1]. As long as the goals have not changed, it is important to maintain discipline to the long-term investment strategy while not over-reacting to short term events. In general, we have viewed the recent declines as opportunities to add to equity positions given our focus on downside-risk on the way up over the last 5 years.

[1] – Study presented by Capital Research and Management Co as of 2014

Geo-Political Update —Sheldon Reynolds, CFA

Geopolitics and related risks are factors that we consider as part of our portfolio management process. For 2016, a key geopolitical risk is the possibility of unforeseen consequences related to events in the Middle East and radical Islamic terrorism.

In 2015, we witnessed two terrorist events in France, one of the largest economies in Europe. The Charlie Hebdo and related attacks resulted in the deaths of 17 people. Al-Qaeda in the Arabian Peninsula claimed credit for those attacks. In November, 137 people were killed in multiple coordinated attacks in Paris. ISIS claimed responsibility for those attacks. In the United States, 14 people were killed in the San Bernardino attack. This attack was committed by home grown terrorists, one of whom had pledged allegiance to the ISIS leader via social media. Those events, while horrifying, did not result in significant economic consequences in Europe or the U.S.

The Middle East is currently a complicated chess board, which became even more complex with the active participation of Russian Troops in Syria, attempting to prop up the Assad regime. While Turkey did shoot down a Russian fighter jet when it strayed into Turkish air space, Russia has not yet sought retribution against Turkey. However, if any further Russian-Turkish clashes occur, the result could be very complex, as Turkey is a member of NATO.

The U.N. proposed a diplomatic roadmap for ending the Syrian conflict in December and plans to convene a new round of talks in late January. These talks are not expected to address the areas of Syria controlled by ISIS. While some progress has been made against ISIS by the Iraqi government, with the help of local militias and U.S. Special Forces and air support, the terrorist group still controls significant territory in Iraq

and Syria. ISIS has also been successful in recruiting and indoctrinating followers from throughout the world through social media.

Saudi Arabia and Iran have been fighting proxy wars in the area by supporting various militias. The relationship between the two countries is continuing to decline as diplomatic relations between them have been cut as a result of the execution of a prominent Shiite cleric by the Saudi government.

While the Middle East is our primary area of concern, geo-political risks do exist in other regions of the world:

- The Russian-Ukrainian conflict could heat up again. How would E.U. nations react and what type of support would they provide to Ukraine?
- North Korea likes to saber-rattle. They claim to have both nuclear weapons and long-range missiles and should be considered a potential threat to peace.
- In 2017, the United Kingdom is scheduled to have a referendum on whether or not to remain in the European Union. As that date approaches, if it appears that those wishing to withdraw from the E.U. have the upper hand, there could be consequences throughout Europe.
- The Syrian refugee crisis (primarily in Europe) - More than 1 million Syrians have fled the war in Syria during the past year. It has been the largest immigration flow since World War II. Nearly 4,000 have died during the journey. Questions remain as to the immigration screening process to ensure that ISIS supporters or terrorists do not slip through the cracks. Additionally, questions remain about: the economic im-



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pact of a large inflow of immigrants - many of whom do not speak the language of their destination countries, stress on the social welfare system, challenges putting the immigrants to work so as to be productive members of society and potential issues surrounding assimilation into culture.

We live in an increasingly complex, yet integrated world. This creates tremendous opportuni-

ties for business as well as economic development throughout the world. Events in one country can cause unexpected consequences (both positive and negative) in nearby as well as distant states. We will continue to monitor geopolitical events throughout the world in 2016 and consider the potential consequences of those events in our portfolio management process.

Fixed Income Outlook —Kate Braddock, CFA

U.S. fixed income returned +0.55% in 2015 as measured by the Barclays Aggregate index. Within the sector, returns were led by municipal debt and intermediate bonds. Riskier sectors, notably high yield debt, underperformed this year as many energy borrowers came under financial stress due to the precipitous drop in energy prices. While the ten year ended 2015 basically flat at 2.2%, we saw the yield on the two year

almost double to just under 1%.

December saw the much anticipated first increase in the Federal Reserve Rate to 0.25%. This move signaled the market that the Federal Reserve felt the economy was showing strength, but inflation remained an issue. Now that we have “lift-off”, what should we expect? Here’s what has happened in past rate hike environments:

Fed Rate Hikes After Pauses of At Least a Year: 1994 - 2016

Date	Change	Rate	Days Between Changes	S&P 500 Performance (%)		
				During Pause	Peak to Trough Decline at First Hike	One Year After First Hike
2/4/94	0.25	3.25	518	12.64	-8.94	1.88
3/25/97	0.25	5.50	419	24.06	-9.63	39.65
6/30/04	0.25	1.25	371	16.97	-8.16	4.43
12/16/15			2556	127.02	-9.80	
Average (Ex Current Period)				17.9	-8.91	15.32

Source: Bespoke

One clear trend in the data above is that initially when the Fed first hiked rates, the market sold off. For all three periods, the S&P 500 saw a peak to trough pullback of between 8% and 10% in the months surrounding the first hike in rates. Longer term, the results are mixed, but still showing positive returns in all three time periods. We have experienced a similar pull back in these first few weeks of 2016. If history were to repeat, we could see the market rally back to end the year with a positive return.

High Yield bonds have been featured

prominently in recent headlines. We saw multiple funds close or merge in the deeply distressed sector. This combined with the Federal Reserve rate hike and yearend tax loss selling resulted in a triple whammy to high yield bonds. Yields in this sector are now close to 9%, back to 2011 levels. We believe that at these levels, the sector will begin to lure buyers back in. The yield spread over treasuries is now approximately 7%, up from lows of 3% in June of 2014. The historical average for this sector is around 5.2%. Most of the carnage has been in the lower rated (CCC) sector where the energy and mining companies were already



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CFA**

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facing liquidity challenges in the face of plummeting oil prices. Default rates at 2.8% are up a bit, but still well below the twenty year average of 4.3%. To put this in perspective, in 2002 and again in 2009, the default rate jumped to 11-12%.

As we move forward, we would expect to see the following. With regards to the Federal Reserve, we see it as extremely unlikely that they will raise rates at the January meeting. We will be watching global and economic trends closely as we head into the March meeting. Although the yield curve has started to shift upward, we would expect further shifts to be con-

strained due the relative attractiveness of US bonds on the international stage. Not only can investors earn more investing in US bonds, but they have the potential to benefit from a strengthening dollar and the safety of the US market. We would expect to see rates stay lower for longer with a medium term estimate on the Federal Funds Rate at 2%. Globally, we would expect slower growth will also contain rates as continued global divergence by the central banks (US tightening while Europe, Japan and South America need to stimulate their economies) will continue to make US fixed income attractive to foreign buyers.

2016 Forecast — John Largent, CFA, CFP®, CAP



John Largent
CFA, CFP®, CAP

“Although 2016 is starting out historically weak, we believe that the stock market will come back and close up 5%.”

2015 was a flat year regarding the US stock market and fixed income markets and disappointed most forecasts. Although 2016 is starting out historically weak, we believe that the stock market will come back and close up 5%.

Members Trust Company's Investment Team Forecast for 2016 is as follows: an increase of 5.28% for the Dow Jones Industrial Average, which is slightly less than 2015's forecast, the S&P 500 up 5.03%, NASDAQ up 5.00%, developed international markets up 6.25%, and emerging markets at up 6.25%. We forecast fixed income as the 10 year treasury increasing to a 2.76% yield from the current 2.00%. We're forecasting that the Fed Funds Rate

will increase to an average of about 1.21%. Fed Chair Janet Yellen and the rest of the FOMC will again have the market's attention as they watch economic conditions and respond accordingly. MTC expects the year-over-year growth of the United States economy as measured by Gross Domestic Product (GDP) to be 2.40%. Regarding inflation, many have been concerned about a substantial increase because of the great amount of quantitative easing. This concern has been overstated for now and deflation is now moving up to be greater concern. MTC expects inflation as measured by CPI of 1.95%, still slightly below the FED's target of 2%. Oil prices are a wild card. We see oil stabilizing around \$48.63, up substantially from the current \$30.00.

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