NOTTINGHAM ADVISORS
ASSET MANAGEMENT

2016: BUCKLE UP, BUT DON'T PANIC

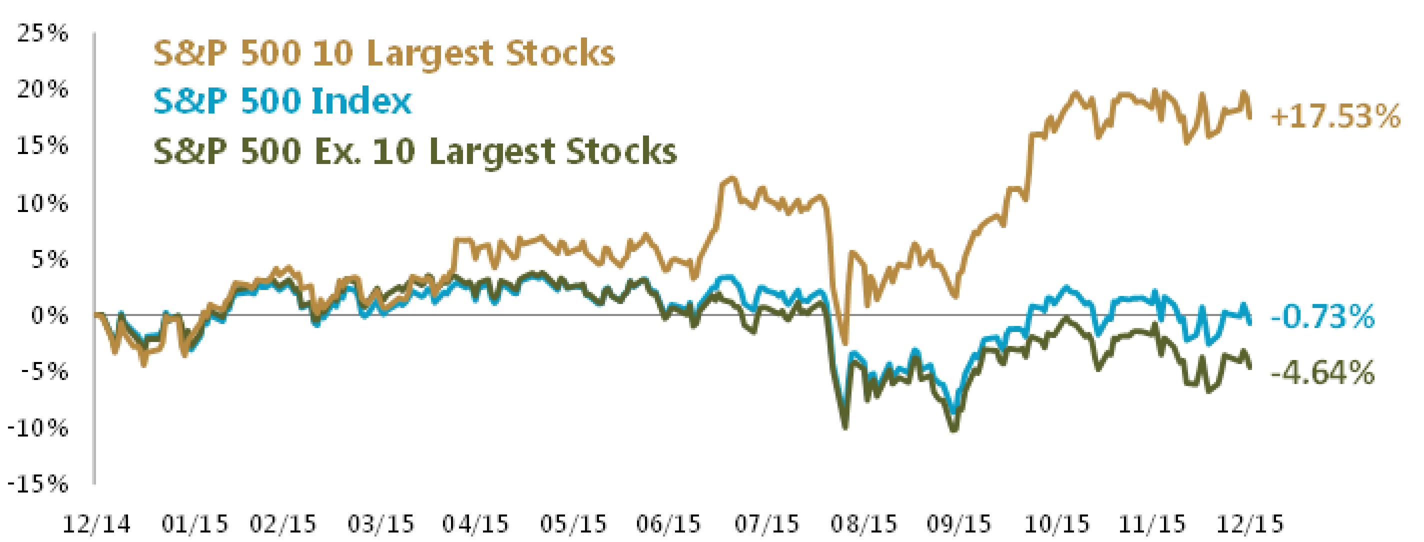
In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497.

-Warren Buffett

So much for "sidewards"! Our thesis for 2015, as outlined in our March CIO letter, called for markets that trended sideways throughout the year, accompanied by a distinct rise in volatility. We were spot on through 12/31 as the S&P 500 closed up roughly 1% while the Barclays Aggregate Index (a broad measure for bonds) finished up a meager +0.55%. 2016, however, has abruptly trashed the sideways thesis, although the rising volatility bet is still on the table. As I pen this note, the S&P has fallen nearly 8% thus far in 2016, its worst start to a year ever. And investors everywhere are getting nervous.

But, much as misery loves company, don't fret – we're nervous too! Then again, we're always nervous. We are, in effect, responsible for things we can't control – like the direction of the stock market. Or interest rates. Or the price of oil. We really do mean it when we say we don't know what direction markets will move in the short term. Likewise, we also really do mean it when we say that it's a really good bet that equities will rise over the long run (see the quote above, coming from a pretty shrewd investor). The price of oil? Honestly, I never thought it would fall to $30! Then again, predicting what OPEC will do in times of crisis isn't our forte.

My original goal in this letter was to rehash a lot of what happened last year, and make some educated guesses about this year. Given the somewhat calamitous start to 2016, however, I'm guessing you would rather I focused on the here and now, with an eye towards the future. As I always prefer to look ahead rather than behind, that's what I'll do. In a minute, though. First I want to focus on my favorite chart from 2015, courtesy of our friends at Strategas Research Partners, which highlights the fact that the vast majority of stocks fared poorly last year.



What this chart highlights, more than anything, is how narrow the advance of the S&P 500 was last year. The 10 largest S&P 500 stocks gained a cumulative 17% last year (think Microsoft, GE, Amazon, Facebook, Wells Fargo). The broad S&P declined (price decline, not including dividends) -1%, while ex-top 10 holdings, the S&P declined -5%. RSP, the Guggenheim S&P 500 Equal Weight ETF fell -4.26% in price terms. So, despite going "unchanged" on the year, the broader market wasn't terribly healthy.

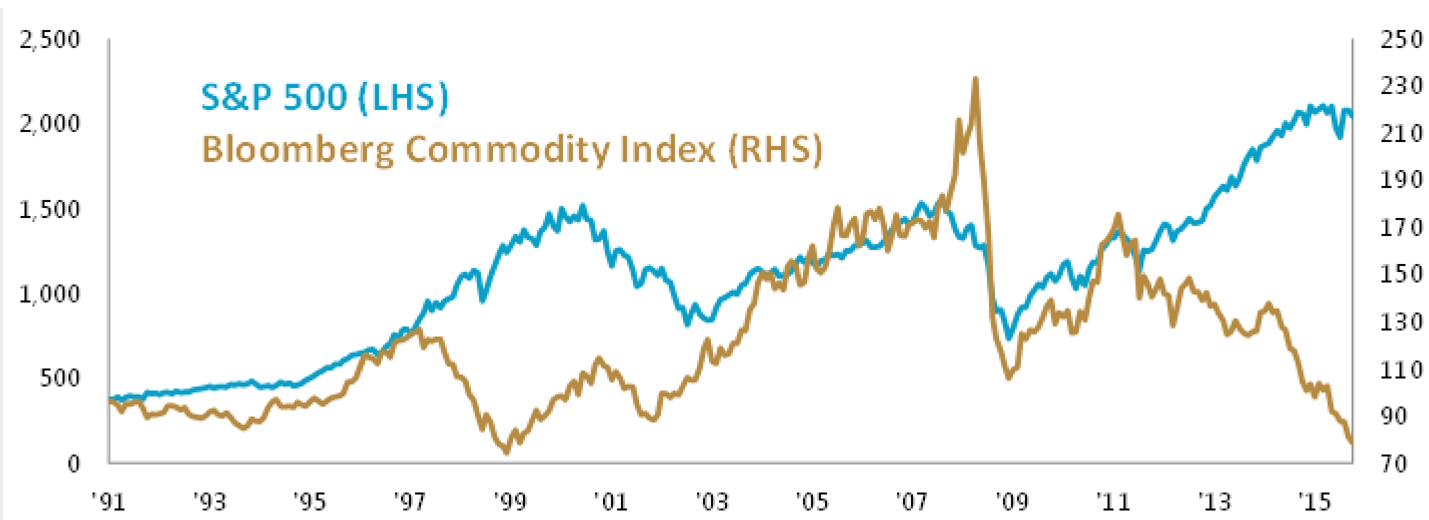
What we're seeing thus far in 2016 has more to do with the collapse in oil prices (and by extension the rising U.S. Dollar) as much as anything else. The price of a barrel of oil has dropped over 15% thus far in 2016, increasing the likelihood of wider scale bankruptcy and default within that space. This prospect has intensified an already burgeoning "risk off" trade, triggered last year by turmoil in China, which then spread to other emerging market countries. Emotional trading appears to be taking hold.

China, Commodities & the U.S. Dollar

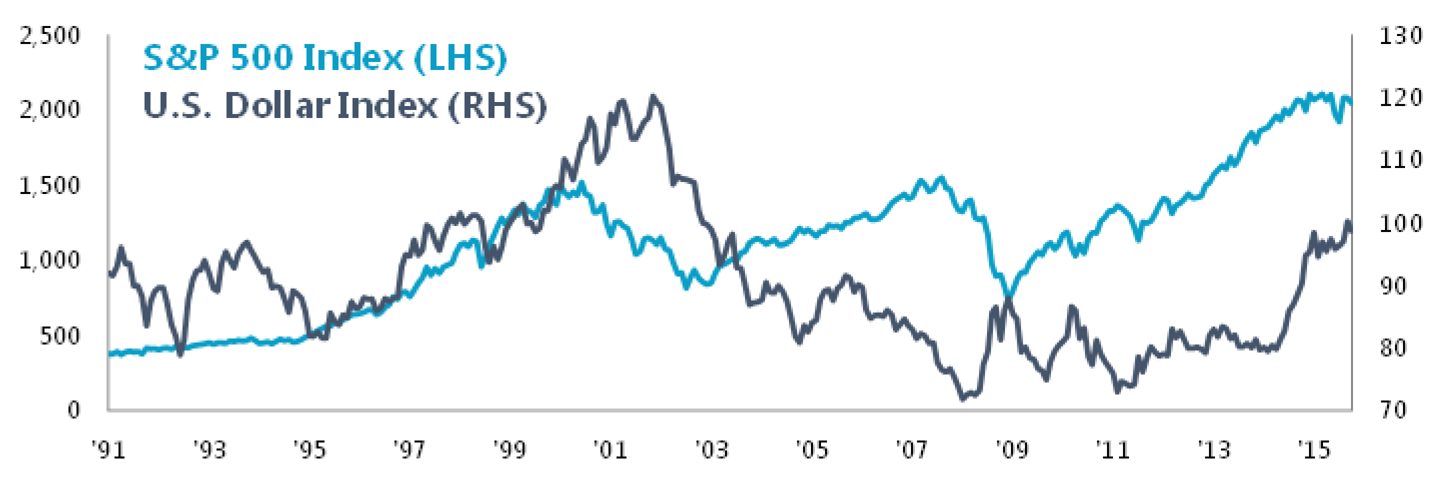
China is probably the biggest single source of global volatility today. I could write an entire novella on the what's, why's and how's of the Chinese economic slowdown, but as I only have a couple pages – and I'd really like you to read all the way through this letter – I'll be succinct. China's economy is slowing from 10%+ growth in past years to…..something north of 1% today? Hard to tell really, because the economy is so tightly controlled; however, most indicators we study point to something in the 3-5% growth range, good but not great (unless compared with virtually every other country on the planet, then it might be considered stellar). Slowing growth means lower demand for commodities (see chart below). Slowing demand for commodities means tougher times for many emerging market economies that are heavily dependent on natural resource exports.

Meanwhile, China's soft peg to the U.S. Dollar means that their currency the Yuan, has appreciated against most other EM currencies, making China less competitive. So, China needs to devalue their currency. A lot. Unfortunately, that may trigger capital flight from China, which might jeopardize that 3-5% growth we discussed. So China's in a bind. Oh, and the Shanghai Composite stock index is down over 15% so far this year.

Softening demand from China has punished commodities across the board and is threatening a number of increasingly levered emerging market economies. The Bloomberg Commodity Index recently hit its lowest level since 1991. Oil is a big part of this collapse; however, it extends to the metals and agricultural sectors as well.



Compounding these problems has been the rise in the U.S. Dollar, now at its highest point in over 10 years. Oil and other commodities are traded in Dollars so a rising Dollar results in weaker demand. And for currencies pegged to the Dollar, it means a loss of competitiveness in international markets and greater difficulty for the countries paying principal and interest on U.S. Dollar based domestic debt.



As the Fed embarks on its normalization process and with both Europe and Japan still in the midst of easing, it's likely the U.S. Dollar will trend higher over the coming year. Despite the negative impact a strong Dollar has on U.S. exports, U.S. equity markets can still advance in the face of currency headwinds.

The Fed and Interest Rates

After nearly 10 years, the Federal Reserve finally raised interest rates in 2015, albeit a measly 25 basis points. There's a grand debate currently taking place amongst the academic and market cognoscenti as to whether this move off the zero-bound will prove a tragic mistake (a la 1937). Some argue the global economy is still threatened with deflation and can't stomach higher rates, while others argue that hyperinflation is just around the corner. While we get and respect both sides of the argument, in our minds the sooner the Fed transitions interest rate policy back to the marketplace, the better off we'll all be.

The interesting thing to note now is the divergence between what the Fed says they're going to do (hike 3 or 4 times in 2016 implying a 1.00-1.25% Fed Funds rate at year-end) and what the market is betting they will do (hike 1 to 2 times, implying a .50-1.00% funds rate). Despite overtly telegraphing their intentions, market participants don't believe growth will be strong enough in the U.S. to support significant interest rate hikes. In fact, since peaking on December 29th at 1.09%, the yield on the 2 year Treasury has fallen to .87% today. U.S. growth remains stuck around 2% while inflation registers barely north of 1%. And, a strong US Dollar and weakening Chinese Yuan are both deflationary forces working against the U.S. economy.

I think Nottingham's "lower for longer" thesis will remain intact another year. We've long felt that there just isn't enough economic growth or inflationary pressure to drive rates up significantly higher. We're likely to see continued curve flattening though, and wouldn't be surprised to see the 2/10 spread below 100 by year-end. Quality should outperform in 2016, including munis, hi-grade corporates and Treasuries.

Government

As we've said in the past, buy some earplugs and hide the babies, its election time! With a spending deal finalized and little but jawboning and electioneering to take place over the coming months, we don't expect too much volatility from Washington. Further, after having been a fiscal drag on the economy the past few years, government spending is poised to add roughly .5% to 1.00% to U.S. GDP in 2016 – and it's sorely needed! Fiscal drag becomes fiscal stimulus, but is it enough? To be candid, I have no idea who the next president will be but she'll have her hands full working with a Republican dominated Congress.

State and local governments are also picking up the slack, increasing hiring and promoting a plethora of infrastructure related spending projects. The timing couldn't be better, as we've reached the limits of what monetary policy can do in addressing the '08 crisis and its high time fiscal policy carried some of the load. With corporate earnings slowing, government spending will be critical to economic growth in 2016.

Equity Markets

It's earnings season, but too early to make any assumptions yet. We anticipate S&P 500 earnings coming in around $120 per share in 2016, which at a 17x multiple implies a year-end index level around 2,050, or up 6.3% from here. Given that we're already off 8%, we're looking for another year of flat to +/- 1% returns on the S&P 500. I would suggest that I think we're more likely to see an upside surprise in earnings, rather than downside, as I think expectations have been ratcheted down low enough to allow room for both revenue and eps beats.

International equities began last year with a bang, and quickly flamed out as once again the ECB overpromised and under delivered. We're not as optimistic this year, but maintain exposure, nonetheless, as the ECB clearly needs to step up its QE efforts, which would obviously benefit shareholders. Japan remains a compelling story, while broader Asia's fate will be tied into China. If China can manage a soft landing after years of staggering growth, we would expect the broader EM space to benefit. If China tumbles badly, all bets are off and we'll work to minimize our exposures to that region.

Equities have historically returned more than bonds for a reason: they involve greater risk and carry far more unpredictable return patterns and have far greater drawdowns. They test investor patience, faith and sanity repeatedly. Yet, as Mr. Buffett so astutely observed, the stock market has endured a lot and still managed to trend upward over time, delivering incredible returns to those brave and patient enough to withstand the periodic pullbacks. This time should be no different.

Conclusion

Although it wouldn't surprise us after 7 years to have the bear come out of hibernation, we're not convinced he's ready yet. The equal-weighted S&P 500 is now down nearly 16% from its May '15 high (a bear market is typically called when down 20%). This could very well turn into a bear market soon. We don't know. Or, like the market did in September/October, things could turn around tomorrow and we could march towards 2,200 on SPX. We just don't know. I do know, though, if we remain invested, diversified and patient, the odds of us achieving our financial goals rises measurably. There really is no better mousetrap, no matter how often they are advertised. Investing isn't for the faint of heart. We've had a really nice run the past number of years (thank you Fed!). We will have nice runs again. This year might be tough, as could 2017. Then again, they might not. We don't know. Stay the course. Call us when you're nervous, or your circumstances have changed. If the data point to something more ominous on the horizon, rest assured we'll take action. But for now, let us do the worrying, and keep your fingers crossed that the Fed doesn't get too aggressive, China has a soft landing, geopolitical risks lessen and oil doesn't fall below $25. Other than that, it's all good.

Happy New Year,

Lawrence Whistler, CFA
President/Chief Investment Officer
January 2016