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It Was Something Else



The pause did not refresh, it was something else! The past year, 2015, was marked by a total lack of volatility during the first six months, the long awaited first correction to exceed 10% in four years during the third quarter, and the best monthly gain in over four years in October as the S&P 500 rose 8.3%. Looking at the markets, you would never guess that the NASDAQ reached a new high in early December while the S&P did the same in early November. The expected Santa Claus rally was hard to find except for a one day celebration when the Federal Reserve finally increased interest rates for the first time in nine years on December 17th.

Long term secular bull markets are comprised of several shorter term up and down markets. Looks as if we might be experiencing one now.

It was hard to see anything moving much higher or much lower during the year as some fairly deep carnage was hidden by the mega-

cap stocks such as Facebook, Amazon, Netflix, and Google. The S&P 500 managed to overcome its 5.29% loss of the first nine months to eke out a gain of 1.38% including dividends. The Dow Jones made up some ground from the 6.95% loss of September 30th and closed slightly positive at plus .212% including dividends.

Small cap stocks, as represented by the Russell 2000 index, improved from the 7.23% loss as of September 30th to a decline of 4.41% while the NASDAQ index returned .268% including dividends.

The much broader indexes are more indicative of the overall market, such as the Value Line Arithmetic Index, which declined 6.93%. **Damage under the surface was even greater as fully 30% of stocks in the S&P 500 are trading in bear market territory with losses exceeding 20%.** Small cap stocks continue to take it on the chin as 46% of the S&P 600 Small Cap Index are down more than 20%. One important factor in this carnage is the price of crude oil which has fallen 51%, based on the oil related ETF, pulling many oil related equities down with it.

SUMMARY

As discussed, we expect 2016 to be a typical election year with a choppy market early and a rally beginning around the election. The economy is expected to grow at a subdued 2.5%, earnings should rise by 8% to 10%, and the market outlook calls for a gain of about 7% to 2200 on the S&P 500.

The January barometer, publicized by the *Stock Trader's Almanac* states, "As goes the S&P 500 in January, so goes the year. This has been wrong only eight times over the past 65 years for an accuracy rating of 87.7%. So it pays to watch whether the S&P 500 rises or falls in January.

The Leading Economic Indicators (LEI) were discussed later in this Report and showed that they have remained above their moving average for quite some time. Also discussed was the fact that there is an eleven month lead time after the index moves below the moving average before the onset of a recession.

The LEI index closed 2015 on a weak note by declining by 0.2%. While this weakening will not push the index below the moving average, it does show that the economy is showing signs of some weakness. A little worrisome is the fact that five of the ten indicators in the LEI were in negative territory including building permits and ISM manufacturing.

While some weakening does occur along the way it does not mean that we are heading for a recession or that the equity markets will fall into bear territory. But it does bear watching. Remember, the first several months of any election year are historically volatile to down, until a rally usually begins before the election.

Bonds also moved like snails during the year as the Barclays Aggregate Index gained only 0.55%. High yield bonds, heavily involved with the oil patch, recovered from their devastating 8.45% decline during the third quarter and now show a loss of 4.47% for the year as measured by the High Yield Index.

Commodities and basic materials, such as steel, continued their three year bear market by losing another 25.46% on the S&P GSCI Commodity Index. As an indication, U.S. Steel has declined 81% from its peak.

International markets also struggled with the MSCI EAFE Index down slightly and the MSCI Emerging Market Index declining 14.80%. European equities were the standouts as the STOXX Europe 600 rose 6.79%, France's CAC 40 rose 8.53%, Germany's DAX rose 9.56% and Italy's FTSE MIB gained 12.66%. A nascent economic recovery, an easy money policy from the European Central Bank, and attractive valuations helped here and should continue to buoy these countries in 2016.

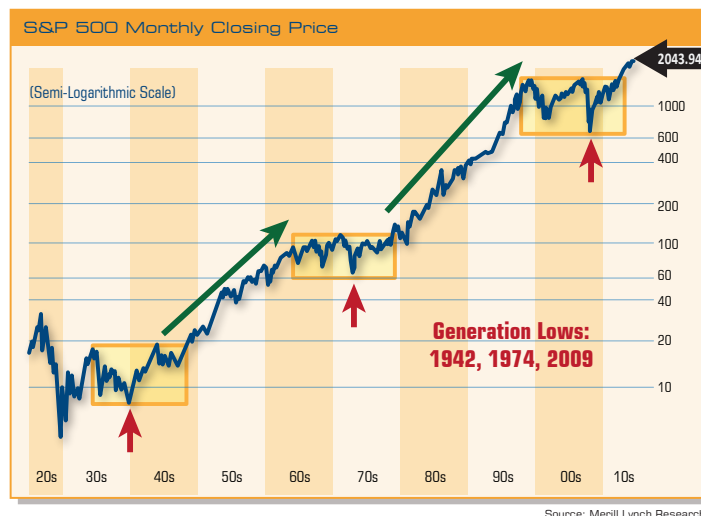
Meanwhile the dollar continues to confound the sceptics and moved higher again. **The Trade Weighted U.S. Dollar Index gained 9.26% during 2015.** The dollar is now higher than it has been in almost 13 years.

The strong dollar is one of the reasons that corporate profits and forecasts have been consistently lowered over the past year. Almost one-half of corporate revenues of the S&P 500 companies come from overseas and the higher dollar impacts profits on those earnings.

THE BIG QUESTION!

Is the Bull Market over? The answer is dependent on what one defines as a bull market. We believe that a long term Secular Bull Market began in 2009 and we said then that the bottom in 2009 was a "Generational" low and that this generation would never see this low again. Our opinion has not changed. As you can see from the chart of Generational lows, the markets that ensued still had lots of movements up and down. In other words, a secular bull market will be comprised of several shorter, cyclical, movements. Also, notice that the down cycles during the major bull moves upward are far shorter and less severe than those of the long-term bear markets.

We are currently in a cyclical bull market that is getting long in the



tooth at 6.8 years old. It will become the second longest bull market in May. **Can it go on longer?** Definitely! There were two major cyclical bears during the past decade so potentially this bull could make up for that and keep on going. Notice that the trajectory of the current bull from 2009 has been much smoother than those of the prior two generational lows.

Most bull markets end when no one expects them to. **Most bull markets end with a bang not a whimper.** Most bull markets end when the public can't get enough stock; when the cab drivers (or Uber drivers) are touting stocks; when every cocktail party is about the next hot stock. I see none of this today; do you? Of course, this time could be different but history has a very definite way of repeating. Yes! I am a bit upset here with the way 2016 is developing. Let's discuss that later on in this *Report*.

The last two bull markets ended with a bang! The 1982 through 1989 bull ended with a 31.7% gain in year eight. The 90s bull market ended after nine straight years with the last five years all strong. Year nine, 1999, had a gain of 21.0%. Do you remember the crazy tech stocks of that era? The NASDAQ index soared 40% in 1998 and 86% in 1999!!!

The bull is ending with a big bang, not a whimper.

2016

2016 surely began with a bang and not a whimper. The first week was the worst first week of any year ever!! As I said above, a bit upsetting. The S&P 500 is down over 8% from its high in early November while the NASDAQ has declined about 9% from the high in early

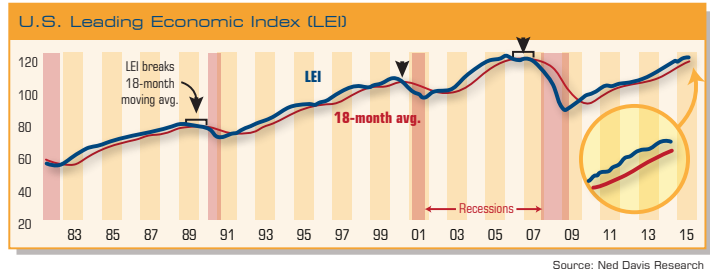
December. The Russell 2000 index of small-cap stocks has fallen 19.3% from its peak in June, already approaching bear market territory. At this rate we will have a cyclical bear by the end of the month!

Is China to blame? We know that China has been one of the engines of world growth for the past decade. Yes! This growth is slowing as China transitions to a more consumer oriented economy. But the Chinese are fairly new to investing in stocks, and their markets are far more volatile than the rest of the world's markets. In an effort to curb speculation, the Chinese government placed circuit breakers on the stock market. The plan was implemented on January 4th and the plan was to halt trading for 15 minutes if the market fell 5%. Then suspend trading when the market reopened and fell another 2%. On that day, the first day the curbs were in effect, the large-cap CSI Index plunged 5% in the first 10 minutes and was closed for 15 minutes. When trading resumed, stocks fell another 2% and trading was closed for the rest of the day. The benchmark Shanghai Composite Index fell 7% that day. The same thing happened the next day and the government pulled the curbs. Instead of instilling a sense of security in the Chinese investor, the curbs instilled panic and fear. Fear that they could not sell so everyone tried to sell.

The trouble in China continues to show how the world markets are interconnected as the massive losses in China triggered massive losses around the globe. The economy in China is contracting. China's Caixin/Markit Purchasing Managers Index dropped to 48.2, below the dividing line of 50, showing that the factory sector is contracting. This is the tenth straight month of decline which does not bode well for the world economy. Capital is fleeing China at a substantial pace and it does not look as if this will stop anytime soon.

OUTLOOK FOR 2016

We expect the U.S. economy to continue to grow at a slow pace. The current economic expansion is now six and a half years old and has grown at 2.2% per year. This could accelerate to 2.5% in 2016. There is talk of a recession but we believe that the fear is not grounded on reality. The Conference Board's Index of Leading Economic Indicators (LEI) continues to rise and is at the highest point since 2006. Over the past 50 years, weakness in the LEI has preceded every recession. Since 1960, the average lead time between a peak in the LEI and a recession beginning has been 11 months. So, at the moment there are no signs of an economic slowdown.

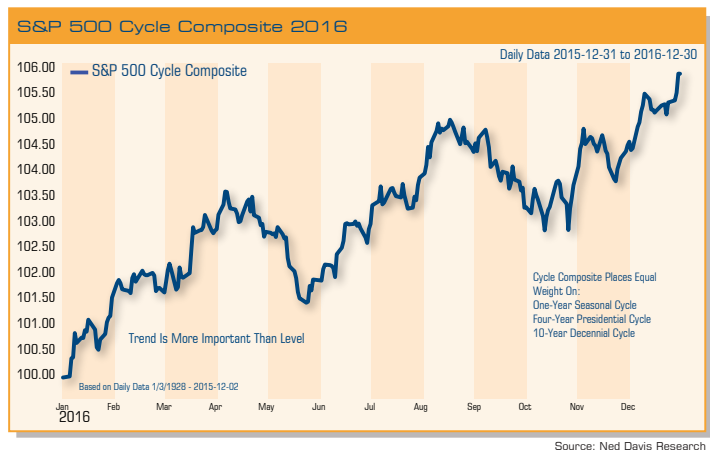


Corporate earnings are one of the main driving forces behind the equity markets.

Corporate earnings fell 3.2% in the second quarter and are expected to have fallen again in the fourth quarter. This is what most likely precipitated the 12.8% correction we saw in August/September. We believe that earnings will now recover through 2016 and should move higher by 8% to 10%.

PRESIDENTIAL CYCLE

The Ned Davis Research Cycle Composite, shown below, is a combination of the market's one, four, and ten year cycles and serves as a potential roadmap for the year ahead. The market has tracked this composite fairly closely since 2009 by forecasting the broad trends and showing many of the turning points over the years.



This composite predicts a trading range early in the year with a rally beginning near the elections. There have been 17 post WWII elections and the median gain for the S&P 500 has been 10.4% with the average gain of 6.6%.

BONDS

There was not much movement in bonds during 2015 as the 10-year closed at a yield of 2.27%, up only 10 basis points for the year.

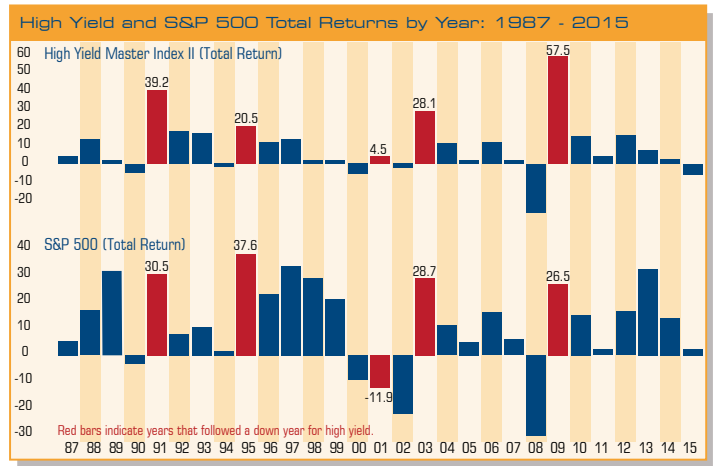
Speculation is that the Fed will raise rates two or three more times in 2016. We believe that they may raise rates once and be done with it. Rate changes either way in election years are not the norm. The biggest bond story of 2015 was in the high yield area. These bonds were absolutely hammered in the third quarter and declined by 8.45%. This decline was mostly due to the decline in the price of crude oil because so many high yield bonds are attached to the oil patch. The recovery took the index back to down 4.47% for the year. The great bulk of the decline was concentrated in the lowest quality bonds with ratings of CC and lower which declined by 56.15%. For our clients that own our Fixed Income Total Return program of high yield bonds; we sold to Treasuries on July 28th, bought back high yield on October 21st, and again sold to Treasury bonds on December 9th. Our results for the year were basically flat before any advisory fees as we avoided most of the decline.

The good news is, that since 1987, every time high yield has experienced a down year, the bounce back the following year produced nice gains. Since 1987, high yield has experienced declines five prior times and the following years **were up every time with an average gain of 30%.** We do not expect to see that kind

of return this time but historical precedent is a factor favoring high yield this year and we believe that this asset class has one of the best risk-adjusted return potentials of 2016.

Equities have also seen nice returns following a down year for high yield bonds. Following the five times when they declined, the S&P 500 was up four of the five times with an average gain of 22.3%

If history is any guide, high yield and equities should bounce back nicely in 2016.



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The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

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

The S&P Small Cap 600® measures the small-cap segment of the U.S. equity market being designed to track companies that meet criteria showing that they are liquid and financially viable.

The Value Line Arithmetic Composite Index uses the arithmetic mean change in the index reflects change if a portfolio of stocks in equal amounts were held.

The Barclays U.S. Aggregate Bond Index covers the U.S. investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities and commercial mortgage-based securities. To qualify for inclusion, a bond or security must have at least one year to final maturity and be rated investment grade Baa3 or better, dollar denominated, non-convertible, fixed rate and publicly issued.

The S&P GSCI represents an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities to provide a picture of realizable returns in the commodities markets.

The MSCI Emerging Markets Index is a free float adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The Barclays U.S. Corporate High-Yield Bond Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market.

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