MarketOutlook 2016

Market Commentary by K. Sean Clark, CFA® Chief Investment Officer

January 2016

K. Sean Clark, CFA
Chief Investment Officer

As Clark Capital's Chief Investment Officer, Sean oversees all of the Firm's investment activities and heads the Firm's portfolio team. Sean joined the Firm in 1993 and is responsible for asset allocation and investment selection for Navigator Investment Solutions as well as directing ongoing market research and contributing to the development of proprietary products. Sean is a member of the Clark Capital Executive Committee and the Board of Directors. He graduated from the University of Delaware, earning a B.S. and an M.A. in Economics. Sean is a Chartered Financial Analyst and a member of the CFA Institute (formerly AIMR) and the Financial Analysts of Philadelphia, Inc. Sean is considered an industry expert and is often asked to appear on CNBC and Bloomberg television to share his views on the market. In addition, Sean was featured in an article in Barron's and has been quoted in a number of articles in nationally distributed business journals and newspapers.

It's No Layup

Entering 2016, we are constructive on the outlook for the U.S. stock market and favor equities over bonds and cash. However, the tape is neutral following a subpar 2015, and valuations and the lack of broad participation in 2015 suggest that risks are skewed to the downside in 2016. So we definitely would not throw caution to the wind, and the fact that the current bull market and economic expansion are long in the tooth has us alert. Before we discuss our outlook for 2016, let's review the major index performance from last year. A good question to ask is whether 2015 was a "consolidation year" or the beginning of a bear market in stocks. Returns in 2015 were surely a disappointment to investors who had become accustomed to handsome returns following three consecutive years of double-digit gains, 2012 to 2014, a feat accomplished only six times in the past 150 years.

The U.S. again was the leader in performance, but that was really only driven by mega large cap stocks, in particular the FANG stocks (Facebook, Amazon, Netflix, and Google). The S&P 500 gained 1.38%, while small cap stocks represented by the Russell 2000 index fell 4.41%. The Value Line Arithmetic Index, a broader more representative index, declined by 6.93%. The damage under the surface was even worse. Thirty percent of the S&P 500 stocks are trading down 20% or more in bear market territory; 37% of the S&P Mid Cap Index stocks, and 46% of the S&P 600 Small Cap Index stocks are trading in bear market

Executive Summary

Economy: We expect the U.S. economy to continue growing in 2016. Even though the expansion is long and remains tenuous, we don't see an economic recession on the horizon. We expect the economy to grow by 2.5%, which is just slightly above its growth trend since the Great Recession ended, and continued job growth should push the unemployment rate to 4.5%. Inflation should remain below the Federal Reserve target.

Equity Market: Long-term view is that we are in a secular bull market in stocks and any correction should be viewed in that context. We have been in a very low volatility environment for years due to central bank manipulation. We are now likely entering a more normal volatility environment which may be a shock to investors because nobody is used to volatility. Continued economic expansion should provide a solid fundamental backdrop for stocks with corporate earnings rebounding. We look for the S&P 500 to advance to 2200 in the back half of the year. Aside from a favorable economic landscape, this year is a presidential election year and those years typically exhibit weakness early and then stage a yearend rally that begins around the election. Risks to outlook include valuations, length of bull market, China slowdown, and geopolitical risks.

Bonds: Now that the Fed has begun hiking rates, the discussion has shifted from "when" to "how fast?" We expect the rate to be gradual and are likely to see two additional rate hikes this year. The interest rate curve is likely to flatten as the Fed hikes rates. High yield bond spreads are wide and look attractive once we see stability in credit markets. Following prior down years for high yield, the asset class has seen a major bounce back in the next year with positive returns every time.

territory. The deteriorating technical underpinnings are a concern as we enter 2016.

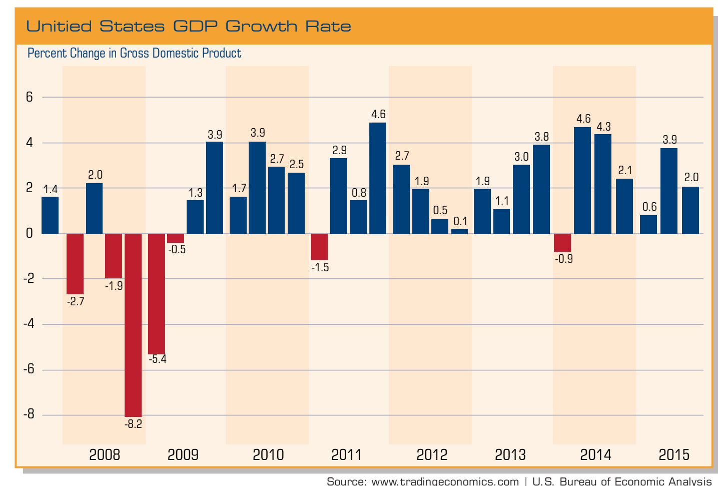
International markets didn't fare any better. The MSCI EAFE index was down marginally and emerging markets were hit hard by the decline in commodities and falling currencies, ending down 14.8%. One would think that given poor performance in stocks, bonds would fare well. However, given the low interest rate environment, risks of rate hikes, and the influence of the energy decline on credit, fixed income didn't provide much of a safe haven. The Barclays Aggregate Bond Index gained just 0.55% while the High Yield Index was down 4.47%. Commodities are in a secular bear market and the S&P GSCI Commodity Index was down 25.46% in 2016, now having declined three years in a row. Meanwhile, the U.S. dollar has benefitted from weak commodities and divergent monetary policy from the rest of the world and gained 9.26%.

We have been in a very low volatility environment for years due to central bank manipulation. We are now likely to be entering an environment of more normal volatility which may be a shock to investors because nobody is used to volatility. Investors have become accustomed to low volatility, but that is not the norm for the markets. Historically the market has three 5% corrections a year, one 10% correction a year, one 15% correction every two years, and a 20% or greater bear market every three years. If we are now entering a more normal environment, as is our expectation, it is not reason to be alarmed, but it does point up the importance of proper asset allocation in line with client's risk tolerances, goals, and objectives.

Our long-term view is that we are in a secular bull market in stocks, and any correction should be viewed in that context. We expect the U.S. economy to continue growing at a sub-optimal pace of 2.5% in 2016, and we don't see risks of a recession on the horizon. With that economic view, we expect a favorable fundamental backdrop for stocks, with corporate earnings rebounding, and look for the S&P 500 to advance to 2200, a 7.5% increase excluding dividends. Aside from a favorable economic landscape, this year is a presidential election year and those years typically exhibit weakness early on and then stage a year-end rally that begins around the time of the election. We just looked at returns for last year and, from an historical standpoint, good years normally follow flat years for the market. Since WWII, there have been 10 times that the S&P 500 rose or fell by less than 3% in any calendar year. In the subsequent year, the S&P 500 gained an average 12.8% and rose in price 80% of the time. Only in 1947-48 was one flat year followed by another flat year. The Fed has finally hiked rates, and history shows that the market has a tendency to be resilient after the first rate hike, especially if the rate hike cycle is slow. We expect the Fed will hike two or three times, which should be a pace that the market can handle. We expect the yield to flatten as the Fed hikes rates and look for credit to outperform. High yield historically has had major rebounds following negative years such as 2015.

Now there are plenty of risks including a deterioration of the market's technical underpinnings, valuations, China, and geopolitical concerns to mention a few. These will all need to be monitored closely.

The U.S. economy has expanded for six and a half years now, but only at a 2.2% pace. In fact, the economy has grown at a below a 3% rate in every calendar year since the Great Recession ended in 2009. Economic growth has surely been a disappointment, but the subpar growth is likely one reason, in addition to the extreme monetary policy measures enacted by the Fed, that has kept the economy growing for the past six and a half years. The subpar growth has kept skepticism about economic prospects high, which has kept the economy from overheating, thus keeping monetary policy very accommodative.



Source: www.tradingeconomics.com | U.S. Bureau of Economic Analysis

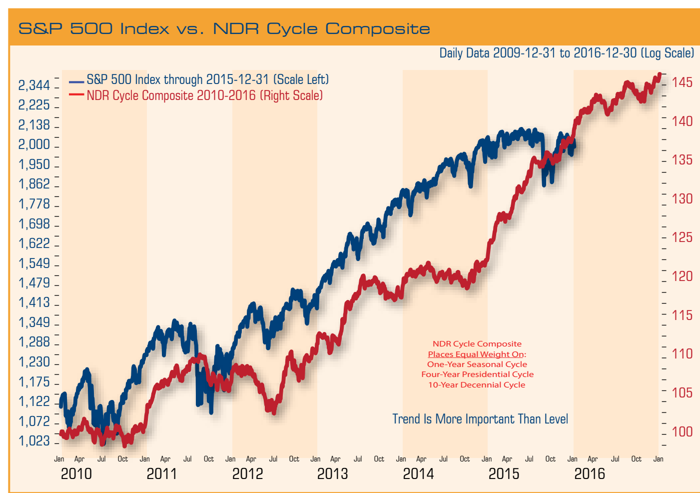
We expect the U.S. economy to continue growing in 2016. Even though the expansion is long and remains tenuous, we don't see an economic recession on the horizon. We expect the economy to grow by 2.5%, which is just slightly above its growth trend since the Great Recession ended.

We have a high degree of confidence that the U.S. economy has further growth potential. The Conference Board's Index of Leading Economic Indicators (LEI) has risen to its highest level since early 2006 and is almost out to a new all-time high. On a year-over-year basis leading indicators are up 3.4%, suggesting continued growth

but lacking strong momentum, remaining in a subpar economic growth environment. Over the past 50 plus years, early weakness in the LEI has preceded recessions and provided an early warning sign for investors. As the table shows, the typical lead time between the peak in the LEI and the start of recession is at least four months. Since 1960, the average lead time has exceeded 11 months. We are not seeing any weakness currently in the LEI. So if history is any guide, the U.S. economy should continue its expansion through 2016.

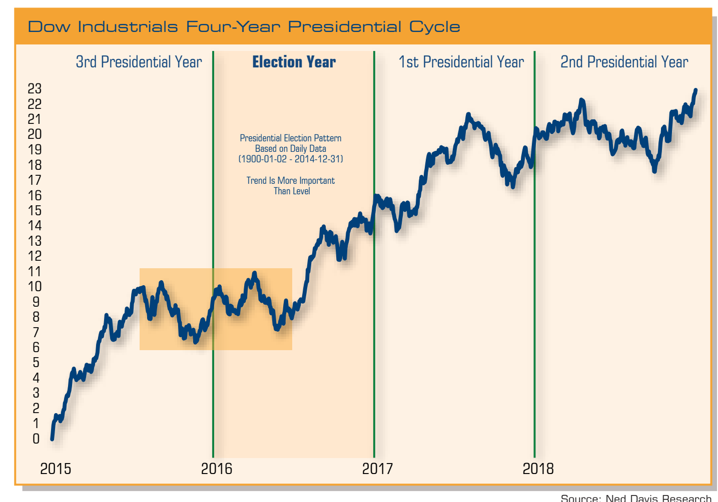
Additionally, jobless claims continue to hit new post-recession lows, and our research shows, in fact, that it sits at its lowest level since the 1970s. Our research shows that an upturn from jobless claim lows typically occurs six to 12 months prior to a recession. This will bear watching, but for now we don't think a recession is on the immediate horizon. The labor market is tight with the unemployment rate at 5.0%, and we are beginning to see wage pressures with average hourly earnings up 2.2% year-over-year, having just broken out of a long period of stagnation. We are likely to see the unemployment rate continue to come down. Employment growth has been solid with the economy adding jobs for over 60 consecutive months. Over the past year and a half, the economy has created an average of 240,000 jobs per month. We expect that trend to continue and to push the unemployment rate lower toward 4.6%.

There are several key themes and indicators that help shape our outlook. One of them is our longstanding belief that we are in a secular bull market in stocks. We went on record in early 2009 and stated that we were in a new secular bull market in stocks and the low made in March 2009 would be the low of our generation. That secular bias helps shape our analysis of potential upside and downside risks and helps keep the short-term noise of the market and economy in their proper perspective. The other is the Ned Davis Research Cycle Composite. The Cycle Composite is a combination of the market's historical one-, four-, and ten-year cycles combined into a single composite and serves to provide a framework or possible roadmap of how the market may trade. In the past, it has served us well in formulating our outlooks and by this chart you can see that the market (in blue) has tracked the cycle composite (in red) very closely since 2009. It not only forecast the broad trends correctly, it also called many of the important turning points over the past couple of years. This year the Cycle Composite shows the market continuing its advance that began at the secular low in 2009. However, it does call for several corrections in 2016 so we expect to see an increase in market volatility.



Source: Ned Davis Research

It is often said that the market dislikes uncertainty, and the market will have to deal with political uncertainty in 2016. This chart of the four year Presidential Cycle suggests a trading range into mid-2016. In addition, it shows that the market has been positive in the election year, but the market is typically weaker in the first half and then rallies strongly in the second half of the year. The timing of an election rally may depend on when the winner of the presidency is well known, regardless of party. From an historical perspective, there have been 17 post WWII elections and the median gain for the S&P 500 in the election year is 10.4%, the average gain is 6.6%. However, the market has fared better in the election year when there was a Democrat in office. There have been eight such cases, and the S&P 500 has gained 11.7% in those election years. Breaking it down even further, it didn't seem to matter much if the Democratic incumbent won or lost. In the years in which the incumbent won, the market gained 11.5% and when they lost it gained 8.8%.



Source: Ned Davis Research

We enter 2016 with the equity markets having made no progress in almost 18 months, with many indices and the broader market having suffered losses over that time. Those negative returns, subpar economic growth, geopolitical concerns, and a host of other factors have definitely weighed on investor sentiment and pushed investor sentiment to a point of pessimism. Investors are driven by two very powerful emotions, greed and fear. One of Warren Buffett's famous quotes is: "Be fearful when others are greedy and greedy when others are fearful." It does feel as if sentiment is approaching one of those points where it will become a tailwind for stocks.

Now that the Fed has begun hiking rates, the discussion has shifted from "when" to "how fast?" Even though policy has shifted, the Fed still remains very accommodative. What stands out to us is that Chairman Yellen has emphasized that once hikes begin, they should be done at a slow pace. In addition, the Committee's admission that the reinvestment process will persist until the "normalization of Fed funds is well under way" is a major dovish concession. We think that the paring of the central bank's balance sheet presents the greatest secular threat to stocks. However, Yellen's recent remarks indicate that is not a topic of discussion for the Fed yet. Implicitly pushing this inflection point further into the future keeps monetary policy both transparent and certain to maintain a favorable fundamental environment for share price appreciation.

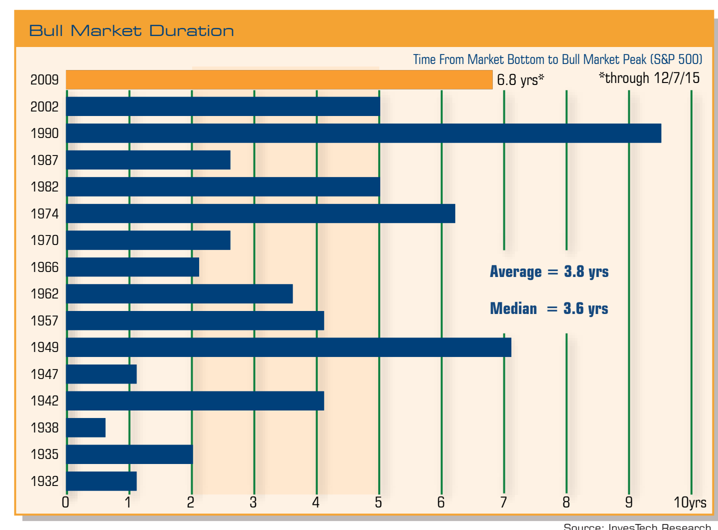
A slow pace of rate hikes would be in stark contrast to the 2004 to 2006 tightening cycle, in which the Fed raised rates at 17 consecutive meetings. In fact, all tightening cycles since Greenspan have been faster than what the Fed is implying for the next cycle. The S&P 500 Index has performed better during the first year of slow cycles than during fast cycles. The average gain one year later was 10.8% for slow cycles versus -2.7% for fast cycles. The concept that a slower pace would be less of a burden on the market also makes intuitive sense with the geopolitical challenges facing the market today.

Let's turn to some of the risks we see. There are definitely reasons to be cautious including valuations, length of the expansion and bull market, record margin debt, the possibility the Fed will hike faster than expected, the China slowdown, geopolitical risks in the Mid-East, tension between Saudi Arabia and Iran, the European immigration crisis, and now add North Korea to the list after they detonated a hydrogen bomb.

All of this heightens concerns about valuations. In last year's *Market Outlook* we said "Our single biggest concern continues to be stretched valuations." Well here we are exactly one year later and we have to say the same thing. The correction we had in the summer did very little to ease the valuation concerns. The median P/E ratio for the S&P 500 is 22, up slightly from where it was at this time last year. What concerns us most is that excluding the period from the late 1990s/early 2000s, the market has been unwilling to push valuations much higher, suggesting that there is not much room for multiple expansion. Valuations can remain stretched for extended periods so they are not to be used as a timing tool but as more of a measure to assess potential risks. Valuations have also restrained market growth. Our conclusion is the same as a year ago: stretched valuations do not necessarily mean that a bear market is imminent, but they place increased importance on earnings growth.

Fortunately we do think we will see an uptick in earnings growth. Year-over-year earnings fell by 3.2% in the second quarter of 2015 and that should mark the bottom of the recent earnings recession. Higher earnings should help support high multiples, but given the still subdued economic growth, a strong U.S. dollar, weak commodity prices, higher interest rates, and fewer corporate buybacks, it seems that the consensus is wildly optimistic with forecast earnings growth of nearly 19% in 2016,. We do think it is reasonable to expect an earnings rebound given our forecast that the economy should grow by about 2.5%. Energy and materials are not likely to be the big detractors they were in 2015, and comparisons are easy. Looking at our expected real GDP of 2.5%, inflation approaching 2%, and a positive contribution from energy, we think S&P 500 earnings have the potential to grow about 8% in 2016.

Bull markets don't typically die of old age, but at the same time, a long-lived bull market can be a risk when investors become wary and more selective. And this bull market is no exception as it is the third longest with a duration of almost seven years. If it lasts through May, it will become the second longest bull market in Wall Street history. By historical comparison, this long running



Source: InvesTech Research

bull market has yielded extraordinary profits with gains that have outpaced 12 of the last 15 bull markets since 1930. Only the 1949, 1982, and 1990 bull market gains exceeded the current gains.

In addition, the amount of margin debt in the system is a great concern. Margin debt is a reflection of speculative excesses that often develop late in a bull market. It measures money borrowed to buy stocks on margin and consequently also measures psychological extremes. Past peaks in margin debt have led or coincided with the start of past bear markets. If margin debt falls decisively from here to a two year low, we would need to reassess whether a bear market is near.

Let's turn to fixed income. There wasn't a whole lot of movement in yields in 2015, with the 10-year range between 1.67% and 2.48%. The 10-year yield closed last year at 2.27%, up only 10 bps for the year. The short end of the curve is a different story. The two year yield moved from 0.66% to 1.05%, up 30 basis points, with the entire move higher in yields occurring in November and December as the market adjusted to the Fed rate hike. The Fed is likely to hike rates two or three times in 2016 and we think the yield curve will continue to flatten as the Fed hikes rates.

The front end of the yield curve should rise with Fed rate hikes. The longer end of the yield curve, which is more responsive to real growth and inflation than short-term policy rates, is likely to remain more anchored. We have a 10-year Treasury yield target of 2.75%. For longterm rates to move up notably, the market will need to be convinced that the current low inflation environment driven by the strong dollar and weak oil is temporary.

Now that the Fed has finally hiked rates, let's look at historical precedent regarding bond sector performance around first rate hikes. This table from Ned Davis Research summarizes bond sector performance around the seven first rate hikes the Fed has made since 1980. From the data, it's clear that bonds historically tend to decline leading up to the first rate hike, but then they typically advance following the hike. In the past, the clear winners around the first rate hike were high yield and emerging market debt, which was likely due to their lower correlation to Treasuries and leverage to the economic cycle. High-yield and emerging-market debt posted the strongest gains six, nine and 12 months later following the rate hike.

MEDIAN PERFORMANCE OF SELECTED BOND SECTORS BEFORE AND AFTER INITIAL FED RATE HIKES SINCE 1980

	% Gain X-Months Before				% Gain X-Months After			
Sector Index	12	9	6	3	3	6	9	12
U.S. Aggregate	2.25	1.32	0.15	–1.82	2.54	4.18	3.68	6.80
Treasuries	3.12	3.72	–0.20	–1.13	2.62	3.74	3.73	7.06
Agencies	3.25	3.25	0.01	–1.06	2.11	3.33	3.44	5.72
MBS	2.73	1.71	1.28	–1.13	2.37	3.90	3.78	6.14
Investment Grade	0.30	0.32	–0.26	–3.32	2.90	5.66	4.47	8.16
High Yield	10.33	6.27	1.78	–0.31	0.95	7.99	9.02	11.49
Emerging Markets	15.16	15.09	5.93	–0.17	4.56	12.75	11.93	18.07
CMBS	0.90	–0.81	–0.91	–2.38	3.81	4.48	3.61	7.00
ABS	4.70	2.33	0.81	–0.03	1.64	1.97	2.56	4.48
Municipals	2.22	2.51	1.05	–1.76	1.08	3.94	5.16	8.24
				All Negative	All Positive			

Fed Funds Target Rate used since 1989, Discount Rate used prior. Data Source: Barclays

Source: Ned Davis Research

High yield spreads have risen to 650 bps and currently stand at about the 75th percentile for all periods but are still not dramatically higher than their long-term average. A huge amount of the backup in credit spreads is being driven by specific sectors such as commodities, paper, steel, chemicals, and railroads. Most consumer sectors, financials, tech, and media are all trading at normal spread levels that reflect the overall health of the consumer and the domestic economy. For the year, the Barclays High Yield Index declined by 4.47%, and most of the decline was concentrated in the worst credit ratings. For example, BB credit was only down 1.0%, B -4.72%, CCC -12.11% and CC and below was down 56.15%. Meanwhile, according to Moody's and Barclays Research, default rates have risen to 3.0% on a trailing 12-month basis. That is still very low given the stress in the energy sector and the fact defaults bottomed at 1.1% in 2007 and peaked at 14.7% in 2008.

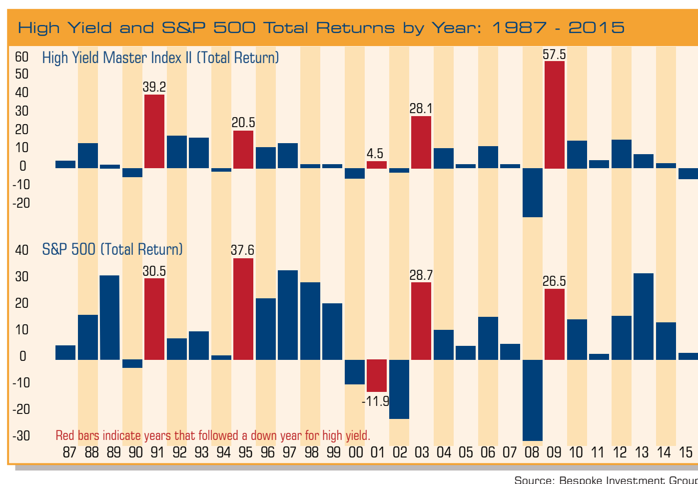
We reiterate our view that spreads can resist higher rates, as they did in the last three hiking cycles. In our view, to the extent rising rates are a response to stronger growth, risk appetite should remain firm and thus drive spreads tighter. At the same time, we expect the normalization to be gradual. In addition, current spread levels are much wider relative to the last three hiking cycles, and the 8.74% yield on the Barclays High Yield Index leaves plenty of room to absorb the pressure from rising rates on total returns.

We think the combination of continued economic growth, moderate inflation and gradual monetary policy normalization in the U.S. remains supportive for credit. This leaves us with a constructive outlook for high yield but cognizant of the fact that the recovery in risk appetite will likely be highly dependent on what happens

in commodity sectors. There are risks that need to be monitored closely, such as a spillover effect from stress in commodity related sectors to other sectors and a lack of access to issue new debt by lower credit issuers. At this point, we think these risks are minimal but they bear watching for signs of potential deterioration.

Staying on credit, let's compare the performance of high yield debt in 2015, which had one of its worst years on record, to the performance of the S&P 500, which ended the year with a total return gain of just a percent. Historically speaking, both asset classes have been closely correlated making 2015's performance divergence notable. In fact, going back to 1987 there has only been one other year where high yield debt was down and the S&P 500 was up; that was 1994.

Using historical precedent and looking ahead to 2016, the table shows the annual performance of high yield and the S&P 500 since 1987. The red bars indicate returns following a down year for high yield and illustrates that following prior down years for high yield, the asset class has seen a major bounce back in the next year with positive returns every time, with an average gain of 30% in those bounce back years. On top of that, the four best years for high yield all followed down years. We don't expect to see the same kind of gains this time around, but historical precedent is a factor favoring high yield in 2016, and we think high yield has one of the best risk-adjusted return profiles.

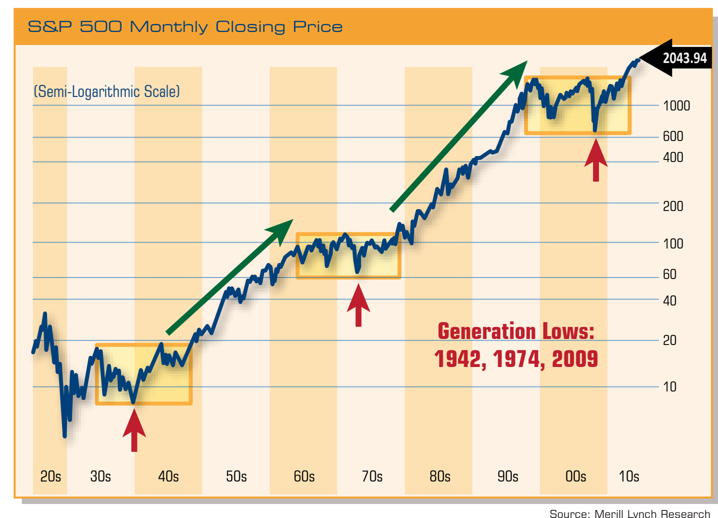


Source: Bespoke Investment Group

Equities have also seen nice returns following a down year for high yield. Following the five prior years where high yield declined, the S&P 500 was up an average of 22.3% in the next year with positive returns four times. If prior history is any guide, high yield and equities, could bounce back nicely in 2016.

As we mentioned at the outset, our long-term view is that we are in a secular bull market in stocks. While stocks may be expensive in absolute terms, based on P/E multiples, on a relative valuation basis, stocks look cheap compared to bonds. Comparing the relative valuation of stocks to bonds using the S&P 500 earnings yields and the 10-year Treasury yield, stocks are firmly in the undervalued camp, still coming off their most undervalued level relative to bonds since 1974. They have a long way to go before they are fairly valued or expensive relative to bonds.

Let's take a step back and look at the long-term view of the market and past secular trends. Just after the March 2009 low we stated that that low would end up being a generational low and we weren't likely to see it challenged again. That statement was based on studying prior generational lows. The three boxes in red highlight the last three secular bear markets. Of note is that once the market eclipsed its prior secular peak, it continued higher for many years. The prior secular bull runs lasted 22 and 18 years. We think that is the environment we live in today. Of course, there will be cyclical bull and bear markets as always, but the primary secular trend appears to be higher and, if history is any guide, it has the potential to have some staying power.



Source: Merill Lynch Research

In conclusion, we do think we are still in a secular bull and have a tempered but positive outlook for stocks in 2016. According to election year trends we should see any weakness early in the year give way to a presidential election yearend rally. We look for 2200 on the S&P 500 as a target. The economy should grow by 2.5% and we don't see any signs of recession on the horizon. The Fed has started to hike rates and is likely to hike an additional two to three more times this year in an effort to reload. Based on historical precedent, high yield bonds should have a strong year having suffered losses last year.

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Barclays 7-10 Year Treasury Index tracks the investment results of an index composed of U.S. Treasury bonds with remaining maturities between seven to ten years.

Barclays 20+ Year Treasury Index tracks the investment results of an index composed of U.S. Treasury bonds with remaining maturities greater than 20 years.

S&P GSCI Index is an unmanaged world production-weighted index composed of the principal physical commodities that are the subject of active, liquid futures markets.

S&P GSCI Industrial Metals Index is considered representative of investment performance in the industrial metals market.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performers of developed markets outside the U.S. and Canada.

The MSCI World Index is a freefloat-adjusted market capitalization index that is designed to measure global developed market equity performance.

The MSCI World Index ex. U.S. is a freefloat-adjusted market capitalization index that is designed to measure global developed market equity performance excluding the U.S.

The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

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

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 S&P MidCap 400 Index measures the performance of mid-sized companies, reflecting the distinctive risk and return characteristics of that market.

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 VIX Index is a forward looking index of market risk which shows expectation of volatility over the coming 30 days.

Barclays U.S. Government/Credit Bond Index measures the performance of U.S. dollar denominated U.S. Treasuries and government-related & investment grade U.S. Corporate securities that have a remaining maturity of greater than one year.

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 Barclays U.S. Corporate High-Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

The iPath® S&P 500 Dynamic VIX ETN is designed to provide investors with exposure to the S&P 500® Dynamic VIX Futures™ Total Return Index.

The S&P 500® Dynamic VIX Futures™ Total Return Index (the "Index") is designed to dynamically allocate between the S&P 500® VIX Short-Term Futures™ Index Excess Return and the S&P 500® VIX Mid-Term Futures™ Index Excess Return by monitoring the steepness of the implied volatility curve. The Index seeks to react positively to overall increases in market volatility and aims to lower the roll cost of investments linked to future implied volatility.

Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

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