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Market Update

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May 2016

Volatility in May that Went Away

Several factors converged in May to raise doubts about the strength of the market. Fortunately, investors pushed through this wall of worry once more to resume buying stocks, guiding the market to a stronger finish after the initial selloff. Among the broad concerns that emerged, we consider three areas:

- ***Federal Reserve Suggests Higher Rates.*** Fed officials hinted at a series of small interest rate increases later this year into next. Jeffrey Lacker, president of the Federal Reserve of Richmond, acknowledged that "the downside risks [to raising rates] have dissipated and we're very far away from the benchmarks that we have to guide where rates ought to be." In reaction, the bears suggested that higher rates make equities less attractive by reducing the risk premium, while the bulls maintained that higher rates signal "good news" when the Fed declares growth and employment strong enough to remove the training wheels having simultaneously tamed deflation concerns.

  If the Fed raises rates, *banks and financial company stocks* are poised to do well as net interest margin—the money charged on loans—expands. That is provided we do not see a "flat yield curve" where longer-term rates sit closely to the level of shorter-term rates. Since banks borrow on a short-term basis and lend out longer-term, some steepness to the curve is needed to allow banks to profit. Similarly, in an inflationary or rising rate environment, *dividend paying stocks* have a strong record as a hedge relative to the general market because of their ability to raise payouts alongside increased earnings.

Dividend-Growing Stocks Outperform in Inflationary Periods (1972-2015)

Inflationary Environment	Y/Y% Change in CPI*	Total Return Non-Dividend Payers (%)	Total Return Dividend Payers (%)	Total Return Dividend Growers (%)
Low to Moderate	0%-2%	2.40	1.10	5.80
Elevated	2%-4%	5.81	11.17	12.09
High	4%-6%	(20.15)	(5.16)	(2.62)

Source: Ned Davis Research, Inc.

- ***Downbeat Tone to Consumer Discretionary.*** Spending remains flat and unevenly dispersed across different stores and brands, even with a strong dollar. In May, investors witnessed a "retail bloodbath" in the sector including bad earnings and bankruptcy developments (Aeropostale, Sports Authority, and others). Investors reacted by pulling capital from many areas, suggesting the following: shopping malls

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and department stores are out of fashion; growth-oriented retailers with slowing sales are to be avoided; and several areas have the resilience to buck these trends, including “cheap fashion,” bargain stores, and the mighty Amazon.

- ***Energy and Emerging Markets Still Drive Sentiment.*** April’s rebound in global risk assets that bolstered emerging markets pulled back in May as investors recalibrated and worried that we may have gotten ahead of ourselves. In China, for example, monthly economic figures showed an ongoing slump in demand with exports down 2% and imports falling 11%, joining the year-on-year declines to both. Further, we continued to see a link between oil prices and equity markets. Crude oil prices, which rose sharply in April, tumbled close to 10% in the first week of May only to end up at 5% by month-end.

Domestic Equities Kept Footing While Many International Markets Lost Ground

Major U.S. benchmarks produced positive returns in May, although the Dow Industrials underperformed slightly relative to others. Performance among sectors in the Standard & Poor’s 500 Index varied widely, with technology surging over 5%, health care and financials performing nicely, and energy shares falling roughly 1%. Growth stocks handily outpaced value stocks by around 1.5% for the month (measured by the differential in the S&P growth and value indexes), while the smaller-cap benchmarks outpaced large-cap counterparts.

Developed International stocks measured by the EAFE index posted slight losses in May, putting the rally that began in late February on pause and with most international markets remaining down overall for the year. The upcoming vote by Britain’s citizenry for whether the United Kingdom exits or “Brexits” the European Economic Union kept European shares away from the party, although the Japanese market was up over 3% for the month in dollar terms measured by the Nikkei 225 index. Emerging markets stocks dropped in May after the Federal Reserve’s rate signals reduced demand for riskier non-dollar assets, with the MSCI Emerging Markets index down -3.7% in total return.

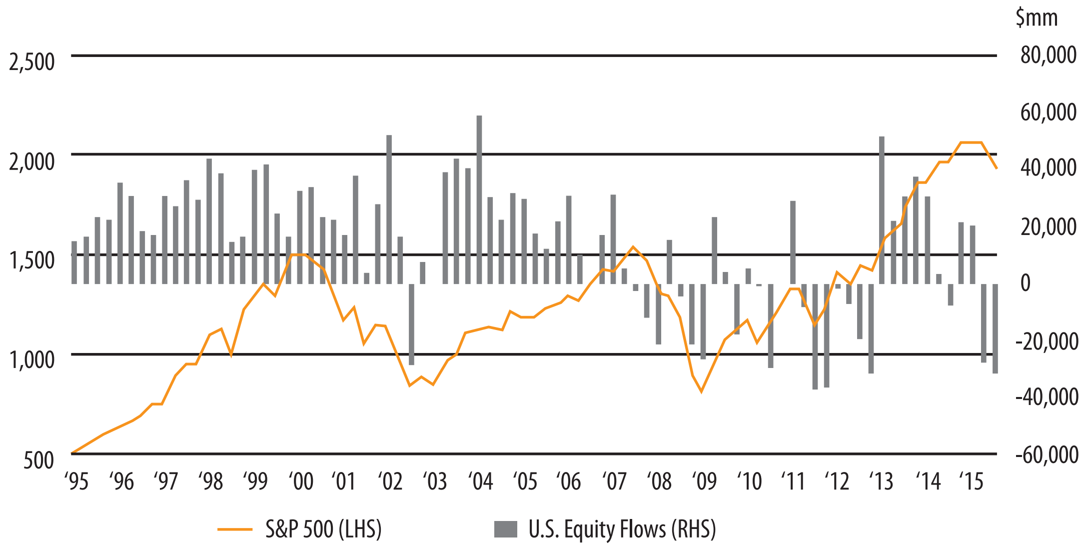
A Final Thought on Market Timing

Professional and individual investors have poor track records at picking the exact right times to invest. The team at FMA agrees with this, and yet we can comfortably say that professional advice on *where* to invest and re-invest (instead of exactly *when* to invest) is the valuable aspect of an advisory service together with help on financial planning.

Looking at a measure of market timing, by tracking dollar inflows and outflows into equity funds we see that investors tend to shift in and out of the market at precisely the wrong time, perpetually buying high and selling low. During the depths of the financial crisis, investors pulled substantial assets out of equity funds. Of course, after the market restored most of its lost value, investors plowed back into equity funds just as the indexes were approaching old highs.

> Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves. – **PETER LYNCH**

Buying Low and Selling High: Human Nature Overrules Rationality



Source: Neuberger Berman

As famed investor Peter Lynch deftly pointed out: "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

We hope this update finds you well, and we welcome an opportunity to meet with you or to review your investments with our team.

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