SCHNIEDERS
CAPITAL MANAGEMENT, LLC

2nd Quarter 2016 Commentary

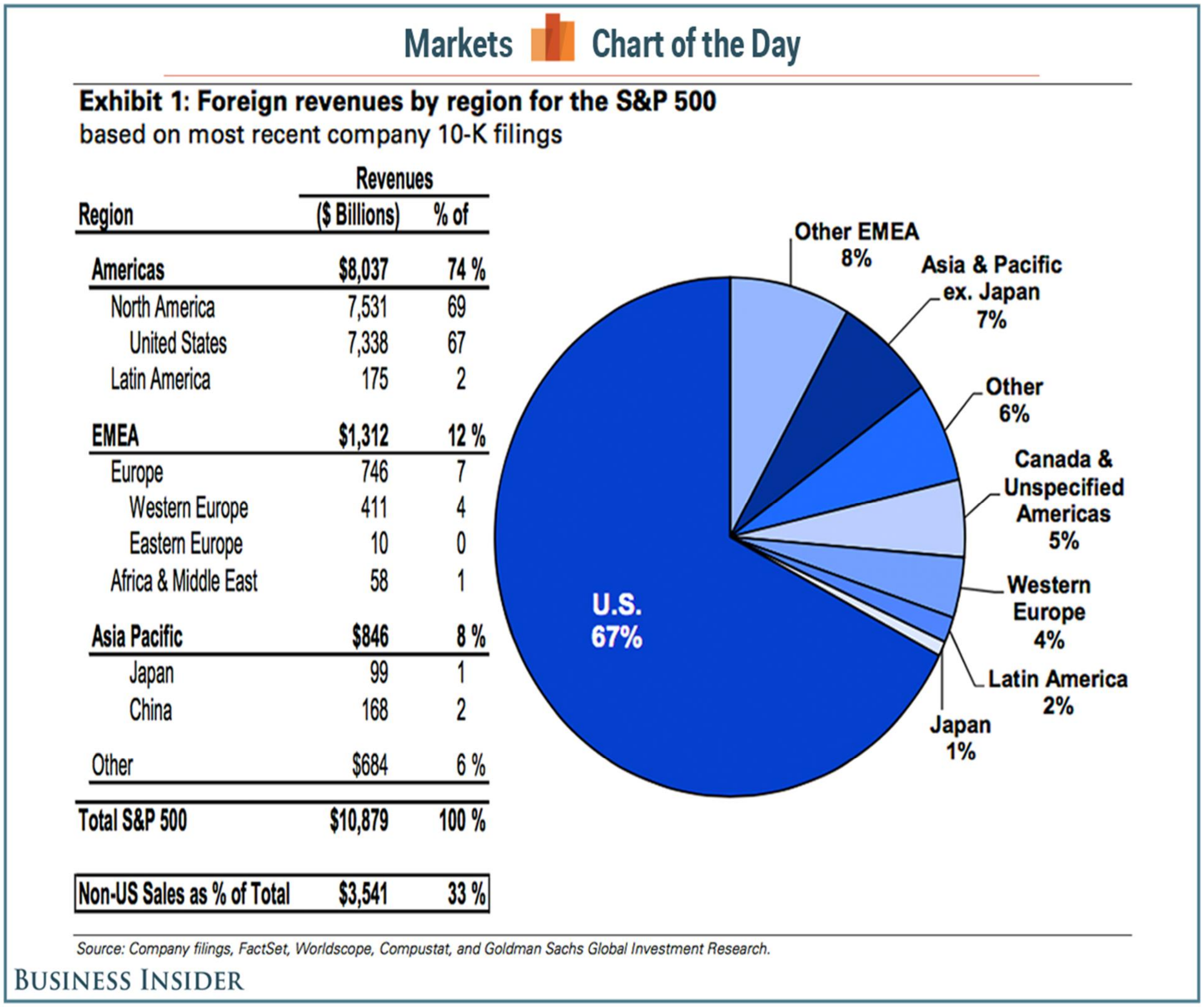
We begin this commentary with a review of the financial markets in light of the increased volatility we have seen over the first three months of this year. According to Gluskin Sheff research, over 42% of the trading days last quarter saw the S&P 500 move at least 1% on the day, equivalent to the Dow Jones moving over 179 points a day. So, we would like to discuss the causes of the market volatility, along with earnings expectations for the S&P 500 this quarter.

What is Behind the Recent Market Volatility?

The selloff earlier this year was actually just a continutation of the sell off that started late last summer, and then accelerated in January before hitting a low in February this year. At their lows, the Dow Jones and S&P 500 were both off double digits. In addition, the more aggressive NASDAQ was down almost 15% from its January start date, and is still down just under one percent as of 4-13-2016.

The market weakness in the first quarter is reflecting weak economic growth in the United States and the rest of the world. Even though the American economy has been growing slowly, it is actually doing better than the rest of the world. Conseqently, the US dollar has risen over 20% from 2014 levels as foreign investors want more of their assets in dollar denominated assets. The rise in the US dollar has hurt the economy and the market because it has made imports less expensive, and exports more expensive, which has hurt our balance of trade numbers. This has also led to a contraction in manufacturing over the last year in the United States. Moreover, since the average company in the S&P 500 receives roughly one third its earnings and revenues overseas, the high dollar has reduced the profitability of overseas operations of US corporations, because when those overseas profits are repatriated back to

America, the currency translations cut the total by 20%. Thus, earnings in the S&P 500 have been weak.

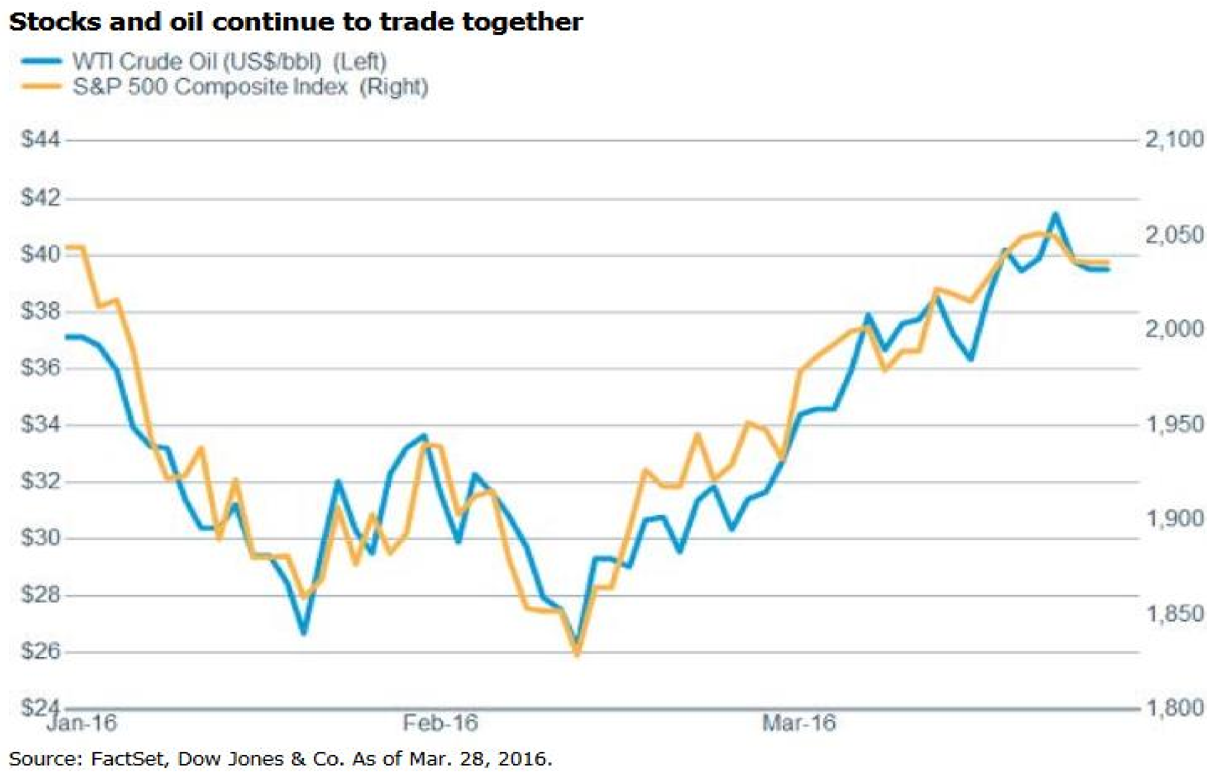


Region	Revenues ($ Billions)	% of
Americas	**$8,037**	**74 %**
North America	7,531	69
United States	7,338	67
Latin America	175	2
EMEA	**$1,312**	**12 %**
Europe	746	7
Western Europe	411	4
Eastern Europe	10	0
Africa & Middle East	58	1
Asia Pacific	**$846**	**8 %**
Japan	99	1
China	168	2
Other	$684	6 %
Total S&P 500	**$10,879**	**100 %**
Non-US Sales as % of Total	**$3,541**	**33 %**

Source: Company filings, FactSet, Worldscope, Compustat, and Goldman Sachs Global Investment Research.

Another big factor contributing to the sell off has been oil. Usually when oil drops, America benefits because we are a huge importer of oil. That is still the case, and American consumers are benefiting from lower oil prices and can use those savings for other purchases. However, the drop in oil prices during this business cycle has been so severe, that the soverign wealth funds of the Middle East, which by some estimates have amassed over 2.2 trillion dollars of wealth over the last 20 years from oil, are now selling assets to meet their shortfall internal budget needs. Indeed, the Bank of Japan estimated that up to 8% of all securities traded in

Japan were owned by these wealth funds, and that a large reason for the sell off in their market was due to soverign wealth fund liquidations.



The same thing is happening here. American stock exchanges account for almost half the world's equity capitalization, and those same wealth funds described above own a lot of American stocks as well. With oil prices at very low levels, those funds are also selling American securities. Because of this, the correlation between oil price movement and the stock market is now almost 1 to 1 (see chart above). If oil goes up, then our markets rally because traders reason that the Middle Eastern funds will need to sell less securities to cover their budget short fall. The recent price decline in oil has been so severe, that if oil goes down, our markets have been going down because oil dependent soverign wealth funds need to raise more money in financial markets to fund their own needs.

That being said, the stock markets have now rallied off of their lows due to an estimated improving supply/demand balance for oil going forward. Oil and gas supply/demand balance is improving because capital expenditures for new oil discovery and production has declined sharply, which could lead to higher prices in the future. EPD (Enterprise Products Partners), which is a 50 billion dollar energy transportation and storage company, estimates that one third of current oil production must be replaced by 2020 due to incremental growth of worldwide demand and existing field decline from depletion of reserves as they are used up. Moreover, global oil and gas investments are expected to fall to their lowest level in 6 years in 2016, following a 22% decline in new investments in 2015, this according to Oslo, Norway based energy consultancy Rystad Energy. As a consequence of these numbers, we are looking for oil to bottom within the next 18 months, it if has not already done so. As of this writing, the current price of oil has rebounded to the low 40's from the high 20's.

"THE SUPPLY TREADMILL"

Industry needs to replace declines ***and*** satisfy demand growth

MMBPD of Oil	**2016**	**2017**	**2018**	**2019**	**2020**
Declines of Existing Fields	5.0	5.0	5.0	5.0	5.0
Annual Demand Growth	1.4	1.4	1.4	1.4	1.4
Annual Additions to Supply	6.4	6.4	6.4	6.4	6.4
Cumulative Additions to Supply	**6.4**	**12.8**	**19.2**	**25.6**	**32**

One-third of Global oil production (≈32 MMBbls) must be replaced by 2020

- Globally, Industry needs to replace 5–6% decline rates in existing fields ***in addition*** to meeting demand growth:
  - **Supply:** average annual decline of 5% on 95 MMBPD of production is ≈5 MMBPD of brown field decline
  - **Demand:** just 1.5% annual demand growth requires another 1.4 MMBPD of new production
- Note: the decline rate for shale is much steeper, especially in the early periods
- Billions of CapEx dollars are dedicated yearly to expanding and maintaining existing fields; lesser amounts are dedicated to new fields and exploratory drilling (riskier, longer lead time investments)

Sources: EPD Fundamentals, IEA, EIA and Various Company Announcements

Market Volatility- The Presidential Election Year Cycle and the Federal Reserve

Oil and earnings are not the only sources of volatility in the market; the upcoming presidential election is also weighing on investors. Much research has been performed on how the Dow Jones reacts to the four year presidential cycle. Since we are in the heat of the primary elections, we thought it would be a good time to revisit these findings. The logic behind the presidential election year cycle is simple. Namely, incumbent administrations try to make themselves look better before an election, and so they increase spending and borrowing in hopes that the economy is humming by the time that voters vote, and then they pull back on spending after an election in order to reign in deficits. According to Dimitri Speck, an economist who has studied over a 100 years of election cycles, in an actual election year the Dow Jones tends to sell off in the first six months of an election year. This is because voters do not know who is going to win the election, and what policies might then be changed. So investors raise cash by selling stocks. Then, after the conventions are held and the parties pick their candidates, the Dow Jones traditionally begins a second half of the year rally. The idea here is that investors have a better idea of who will win the election, and begin to put money back to work into areas they think may benefit from the new administration. While we do not let such theories interfere with our investment decisions, we thought you might be interested in this historical backdrop as the year progresses.

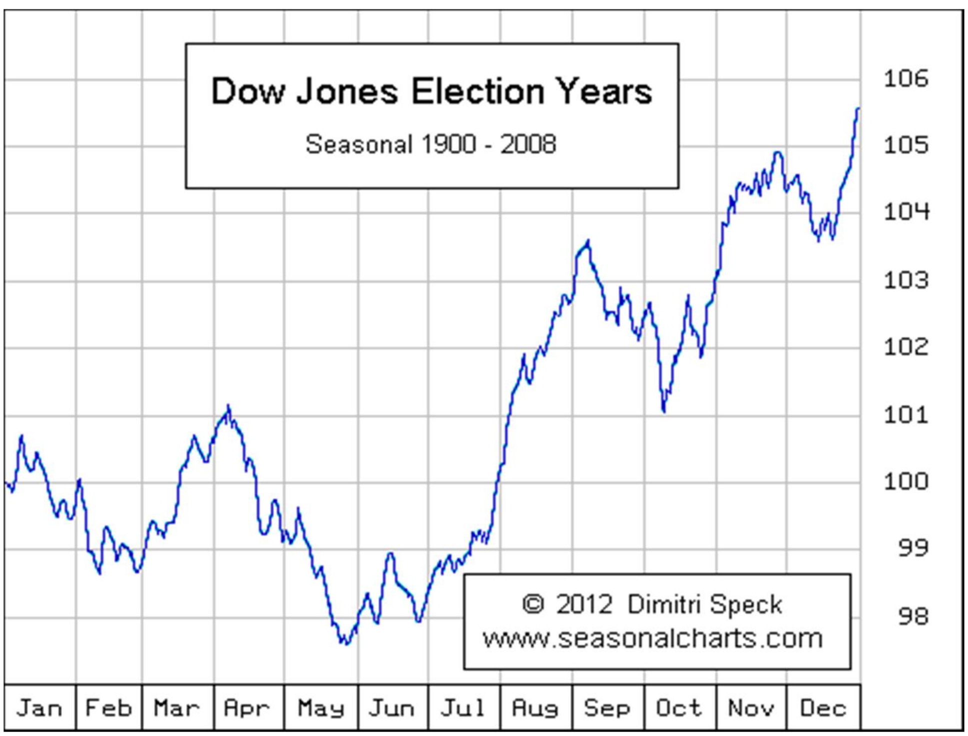


Chart shows performance change of the Dow Jones in an election year.

The Federal Reserve Interest Rate Policy and Volatility

Besides the potential market volatility caused by an election year, the Federal Reserve has also not helped the recent volatility with their conflicting back and forth interest rate hike announcements. In the past, the Fed chairperson would give testimony to Congress on interest rate expectations and that was it. This year, Janet Yellen has given testimony to Congress and almost immediately after her comments, her staff gave interviews that were contradicting her official report. This is significant in that the Federal Reserve controls the level of short term interest rates. Interest rates are very important for the stock market because if the risk free rate of returns are high (as defined by interest rates) then investors would be inclined to just put their money into CD's or bonds. If investors believe that interest rates will stay low for a long time, they become inclined to take more risk and buy dividend paying stocks in order to get a return on their capital. Thus, it is not helpful, and in fact creates stock market volatility if and as Federal Reserve officials give different outlooks on interest rate expectations that vary widely from the official report. Hundreds of billions of dollars are invested and sold based on interest rate expectations, so conflicting Fed reports move markets both up and down.

For example, the president of the Federal Reserve Bank of St. Louis, stated on March 18th that he felt the conditions had been met for the Federal Reserve to raise interest rates, because the Fed's unemployment target of 5% had been met and that the Fed's 2% inflation target was close to being met. This Fed official changed his earlier forecast from only a month earlier from a speech on February 17th when he said it would be unwise to continue a Federal Reserve rate hiking strategy while inflation and growth expectations were declining. Further, this testimony is at odds with Federal Reserve Chairwomen Janet Yellen's remarks just a week earlier. Yellen caused a market rally by specifically down playing interest rate hike expectations of what was to be four hikes this year, to no more than maybe two hikes this year.

The president of the Federal Reserve Bank of St. Louis, was also joined a few days later by fellow Federal Reserve Governor of the Bank of San Francisco. That Governor confirmed the Federal Reserve Bank of St. Louis hawkish rate hike views and likely contributed to a 120 point market sell off on March 22nd by calling for more interest rate hikes. Yellen then issued prepared remarks to Congress on March 29th that affirmed her original dovish March 16th comments and that caused the market to rally almost a 100 points.

We know that the Federal Reserve officials above are hoping to add insight and color to their deliberations by making their respective statements. However, it is our belief that the market would be better served and volatility reduced if the Federal Reserve clarified their own thinking and issued a more unified statement that informed the market of their intentions instead of unintentionally confusing investors with lots of different opinions.

Earnings Expectations Still Low for this Quarter- More Volatility

We expect a continuation of increased volatility going forward because Wall Street lowered its earnings expectations for the first quarter of this year. In fact, according to Thomson Reuters I/B/E/S, earnings growth ex energy companies for the S&P 500 (500 largest companies in America) is expected to decline -2.3% this quarter. Moreover, in the S&P 500, there have been 103 negative EPS (Earnings Per Share) preannouncements issued by corporations for Q1 2016 compared to 27 positive EPS preannouncements last year at this time. By dividing 103 by 27 one arrives at an N/P (Negative to Positive) ratio of 3.8 for the S&P 500 Index. This is above the long term average (since 1997) of 2.7 but below the trailing four quarter average of 4.0.

As we mentioned last quarter, the decline in earnings is almost completely being caused by the high dollar which is reducing the level of overseas income for US corporations and at the same time suppressing exports. If the dollar were to become less expensive (more competitive) with other currencies, the earnings situation could turnaround quickly.

On the other side of the equation, low interest rates will act as support for the market because there is not a lot of investing options for investors to invest their capital. There are 70 million American baby boomers who represent one of the largest demographics in US history, they are starting to retire and they need income. Low interest rates are forcing these people into dividend paying stocks to supplement their retirement income needs.

In conclusion, we believe that extremely weak oil prices which caused forced selling from overseas national oil funds that needed money to fund their budgets, currency fluctuations, and whipsawing comments from Federal Reserve officials on the direction of interest rate policies helped to usher in the New Year with an abnormal amount of market volatility. Going forward, if the estimated weak earnings growth forecasted for the S&P 500 comes to pass, that could trigger future sell offs in the market as investors worry about growth. However, we also think that any declines in the market will be met with subsequent buying as income investors, and retirees swoop in to pick up income opportunities in dividend paying stocks. One of the largest and richest demographic in US history is the baby boomers and they need income and they need safety. With interest rates on CD and bank savings accounts paying almost nothing, conservative, blue chip dividend paying stocks look attractive on any market weakness.

Thus, we continue to believe that investments in large capitalization, brand name companies with strong balance sheets, inelastic demand profiles, and who are returning cash back to investors through dividends and stock buybacks offer the best risk adjusted returns in an uncertain world. If you have any questions on your individual portfolios, please do not hesitate to call or email. As always, we thank you for your continued support.

Sincerely,

Bill

William H. Schnieders
Principal

Jim

James F. Schnieders, CFA
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John

John C. Schnieders, CFA, CFP®
Principal