**SCHNIEDERS**
CAPITAL MANAGEMENT, LLC

# 1st Quarter Outlook 2016

In this report, we will review the performance and related factors affecting the financial markets during 2015. We will also discuss factors which we believe might affect the markets in 2016. Finally, we will give our forecast on what to anticipate and expect in 2016.

## 2015 – A Recap

In a word, the financial markets were weak in 2015, with the Dow Jones and S&P both registering losses for the year. The last time that happened was in 2008. Further, the Bond markets were also weak, despite the fact that low interest rates prevailed for most of the year.

Commodities also took a significant beating, losing over 30% on the Goldman Sachs Commodity Index. That decline was led by oil which dropped from $100 per barrel (WTI West Texas Intermediate) to under $30 today. Copper was also down -25%, and other building materials were down, as well.

The chief culprit in much of this was the slowdown in demand from China, which coincided with a sharp drop in the Chinese market in the late summer of 2015, and topped off by the Chinese market welcoming 2016 with an additional 7% drop on each of the first two days of trading this year.

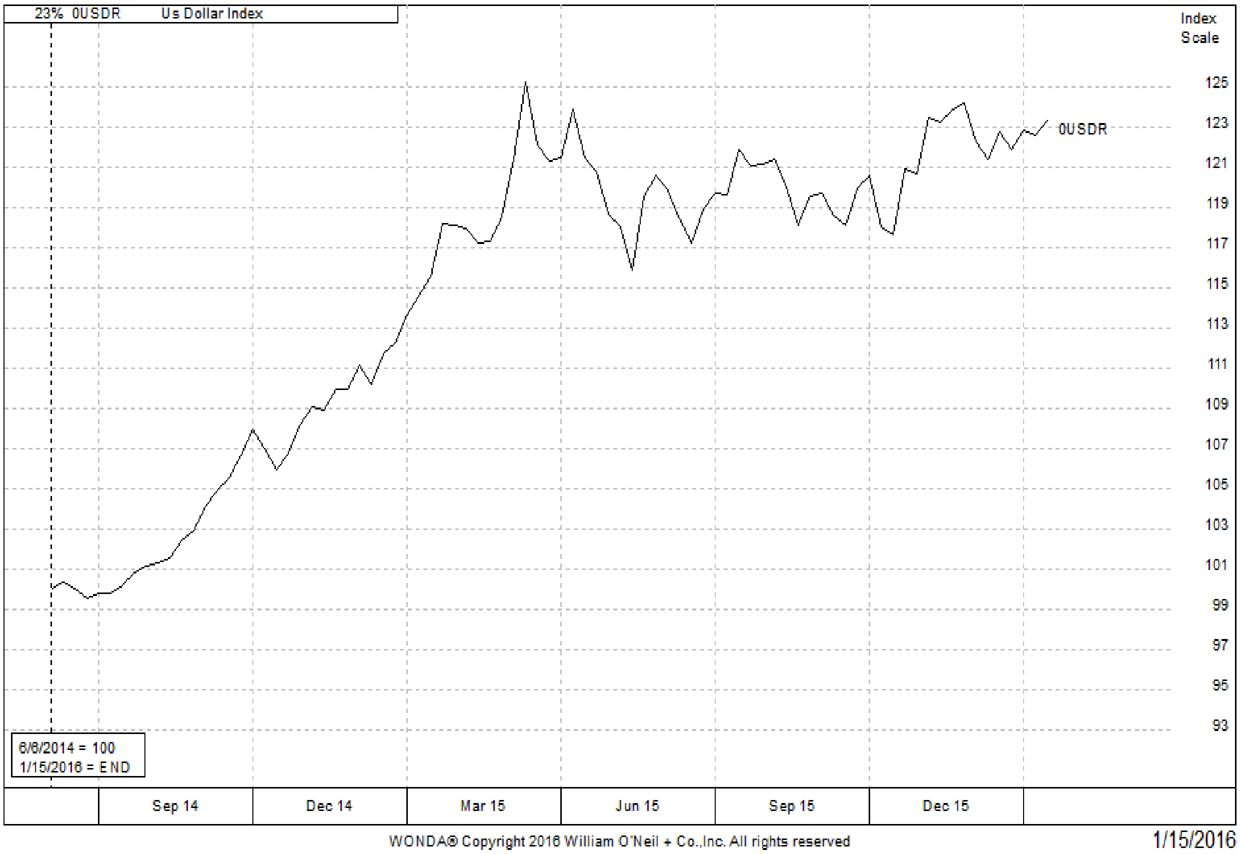
The slowdown in China has been pivotal in causing major slowdowns in the primary natural resource countries supplying China. That would include Canada, Brazil and especially Australia. As such, these major exporting nations to China tightened their belt, and reduced their purchases from other nations, including the U.S.

On the surface, the United States should not be seriously affected by a slowdown in China, even if it hurts some of our trading partners. We buy Chinese imports, they do not buy much of our exports. Moreover, American exports account for only 13% of our GDP, which is the lowest among the largest economies in the world. For instance, exports account for 50% of Germany's economy (CIA fact book). Not only this, exports from the USA to China represent only 7% of America's total exports, and among the largest items that we export to China include several agricultural commodities like soybeans and corn which are more inelastic in demand. So, in reality, a minimal amount of the total economic activity that takes place within the United States relies on Chinese buyers. Moreover, even if you include the entire Asia Pacific region including Japan, South Korea, and Australia, exports and in country sales only account for 8% of corporate revenue for the S&P 500 companies (Business Insider Magazine). So why is our stock market so affected by a slowdown in China? The answer is currency.

The slowdown in China has caused the Chinese authorities to further devalue their currency, which has also caused other nations to devalue their currencies, as well. This has also caused foreign investors to place their money into the United States since we are doing relatively better than many of our trading partners, and because foreign investors want to preserve their purchasing power by holding appreciating dollars. Indeed, the U.S. Dollar has risen close to 20% since late 2014. The rising dollar is a big deal, and has been a leading reason why our markets have sold off.

So for the S&P 500, which is an index of the largest 500 companies in America, the average company gets about half of its revenue overseas. Therefore when the dollar rises, earnings from their overseas subsidiaries decline by an equal amount when those profits are turned back into dollars. Thus, a rising dollar directly reduces earnings, and since the markets are priced on a multiple of earnings, a rising dollar will therefore lower the prices of our equity markets. However, since most American companies manufacture their products where they are sold, the actual volume of goods sold has not been affected, and profits should bounce back once this storm passes.

# U.S. Dollar Index versus Major Trading Partners




Meanwhile, the European economies have been essentially treading water; and much of the progress that the European markets did make, were driven by the European Central Bank's replicating what was accomplished here i.e. our version of QE (Quantitative Easing). The European printing of money (Quantitative Easing) has likewise caused the Euro to decline in value versus the dollar, which again hurts repatriated earnings from American overseas subsidiaries in Europe.

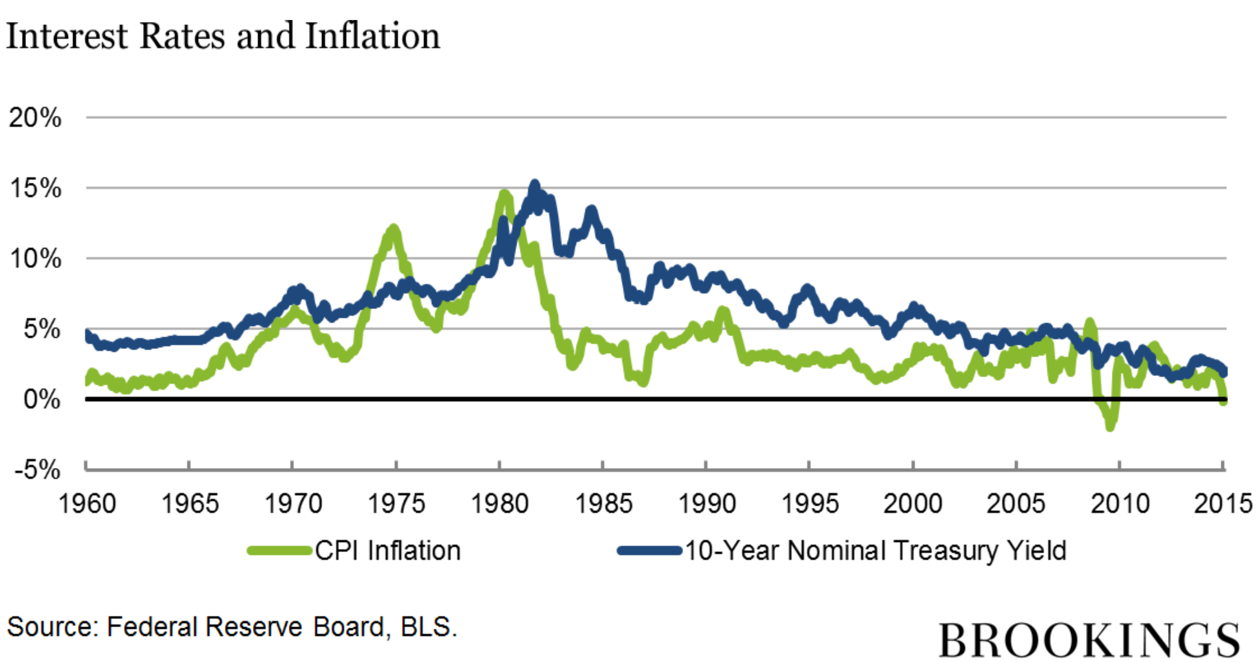
So money creation was a big item in propping up asset prices in Europe; and similar programs were launched in Japan and in China itself. This has produced a world awash in liquidity. Growth, however, is still slow, and underlying demand for goods and services have fallen below historical expectations.

As it pertains to stocks, earnings growth has historically been the key driver for rising prices. The bad news here is that earnings growth in 2015 for the S&P 500 was close to zero percent. The good news is that oil was largely responsible for much of the weakness, and if one were to remove oil from the equation, earnings would have been up 5% (CNBC). This is good news because it's unlikely that oil will have a repeat performance in 2016, and the current low price for oil appears to be baked into most analysts estimates.

**Interest Rates**

Another key factor in the financial markets was the low level of interest rates. The low level of interest rates have helped to encourage economic growth, as it was intended to stimulate borrowing. In addition, low interest rates help to prop up the stock market, since dividend returns on many quality companies exceeded what an investor could expect from Treasury securities, or even Bonds for that matter.

Interest rates were low for the entire year in the four largest trading blocs i.e. the U.S., Europe, Japan and China. This despite the Feds rate hike in December of ¼ of 1%. Year-end rates were 2% on 10 year U.S. Treasuries, and 3% on 30 year Treasuries.



## 2016

## How We View the Markets Currently

So last year, it was all about earnings, the dollar, and interest rates; and what kind of returns competing asset classes generated. Further, as mentioned previously, nominally low interest rate numbers made stocks look pretty good by comparison, as dividend yields were over 3% on a good many high quality stocks, whereas 10 year Treasury yields varied close to (and generally below) 2% all year. The bond market also was flat to weak, trading predominantly on both the reality of low rates, and the angst of when and how high the Fed would take them.

All the factors described above are still pertinent for 2016. The dollar is still about 20% above an index of interest rates on government securities of our major trading partners, and interest rates, while just having been increased in December, are still at historically low levels (1/4 of 1% on short term bills, and 2.1% on 10 year Treasury).

Moreover, given the results stated above for 2015, expectations for a robust 2016 are low, and the decline in the Standard & Poors and Dow Jones Industrial Averages mentioned above was the first annual decline since the financial debacle in 2007 and 2008. While most analysts look for a rebound this year, the confidence of their optimism is more constrained than in previous years. Nevertheless, for 2016, analysts expect S&P 500 profits to expand by 7.6%, according to the investment research firm FactSet.

Continued volatility in both the oil and commodity markets, however, may tamper those numbers downward as the year progresses. International tensions are also a major factor, especially since recent events in the Middle East have put that whole area on high alert.

These tensions include the fact that oil production continues to be high, and there is a surplus of oil that could keep the price contained for a while. The Iranian deal exacerbates this problem as incremental oil production from that country is expected to increase by 500 thousand barrels per day in 2016. So the outlook for oil, plus Iran's new production leaves us with worldwide overproduction with not a lot of surplus capacity to store it. Until that point where demand catches up with supply, oil prices will continue to be problematic. Oil companies make up roughly 10% of the S&P 500, and account for an even larger percentage of capital spending in this country. So what happens in the oil patch does affect the overall market. Moreover, Middle Eastern Sovereign wealth funds, which own large amounts of US stocks, control over two trillion in assets (UAE – 773 billion, Saudi Arabia 668 billion, and Kuwait – 592 billion, source: Sovereign wealth Fund Institute) and have been rumored to be selling assets to plug their budget deficits. The International Monetary Fund predicts that the Saudi Arabia alone will run a budget deficit of over 100 billion this year.

Nevertheless, we see a number of positive factors emerging:

- Employment numbers are improving. While we regard the official 5% unemployment rate as an illusion, the Bureau of Labor's U6 report, which adds those out of work for two years, plus part-time workers seeking full time employment, change adjusted unemployment numbers to a more realistic 9.8%[1]. Nonetheless, this is significantly better than 14%, where it was two years ago.

- While the Federal government debt has now ballooned to $19 trillion, the good news is that household balance sheets are in better shape than in the last cycle, with new consumption being financed primarily out of incomes.[2]

- Interest rates are still low, which allows consumers greater buying power. The after tax percent of disposable income going to debt service (because of low interest rates), is the lowest in years. This gives consumers the ability to spend more if they choose.

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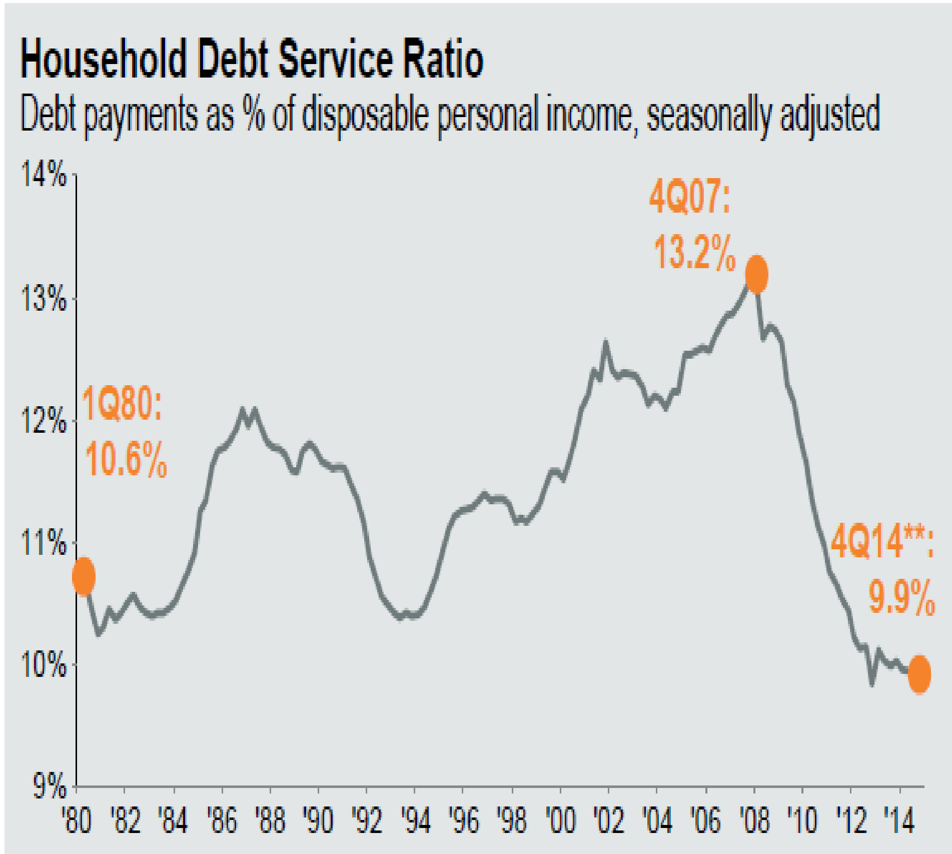
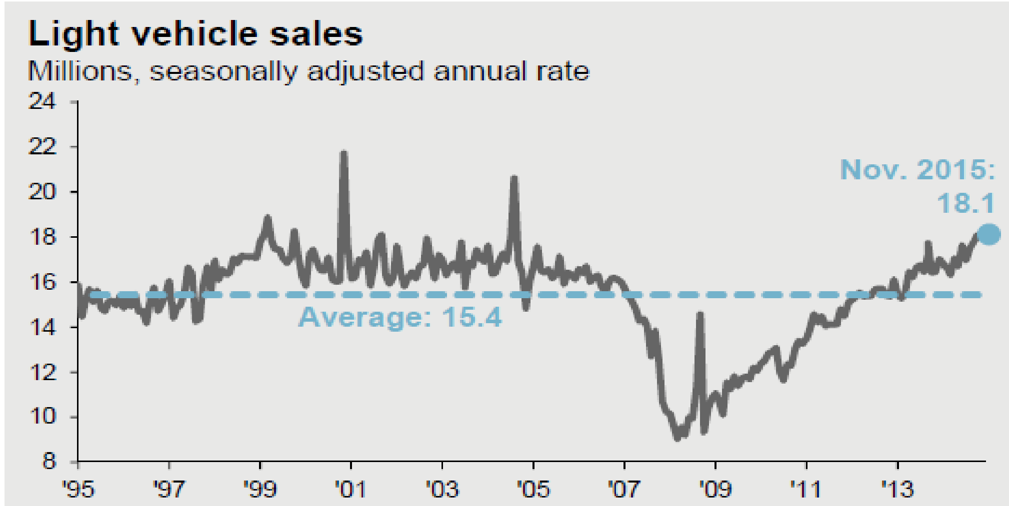
[1] U.S. Department of Labor
[2] Investor's Business Daily – December 30, 2015

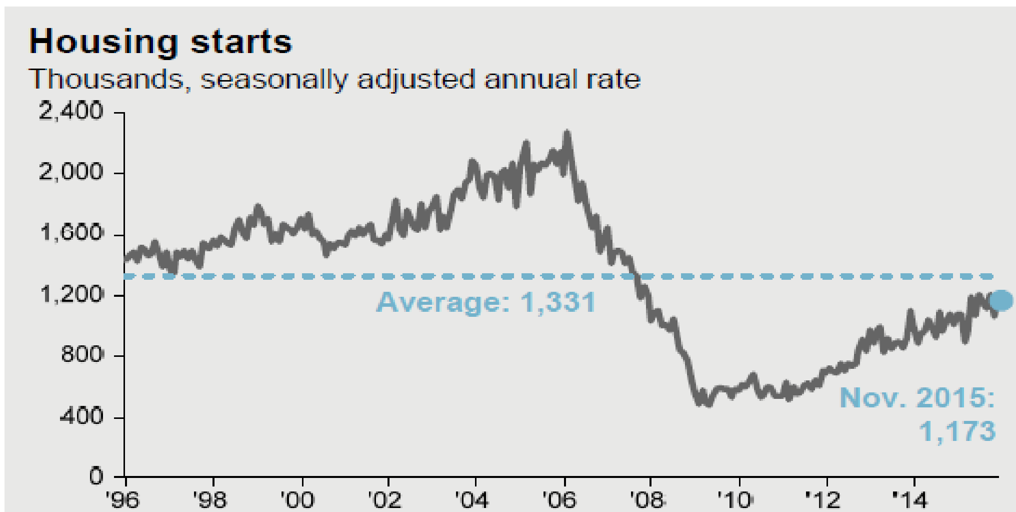



Source: JP Morgan, Census Bureau

- The drop in the price of oil has caused gasoline prices to fall significantly below previous years, even in California where refining costs are higher. A number of Wall Street analysts have pegged the dollar savings for an average working family to be in the vicinity of $700 per year. To date, these savings appear to have been used primarily to pay down debt and strengthen household balance sheets. (source: Business Insights)

- Auto sales are at multi-year highs due to improving employment and pent -up demand. Auto manufacturing is still the largest manufacturing sector in the country and has offset weakness in oil, and general manufacturing weakness. Housing starts also continue to improve.

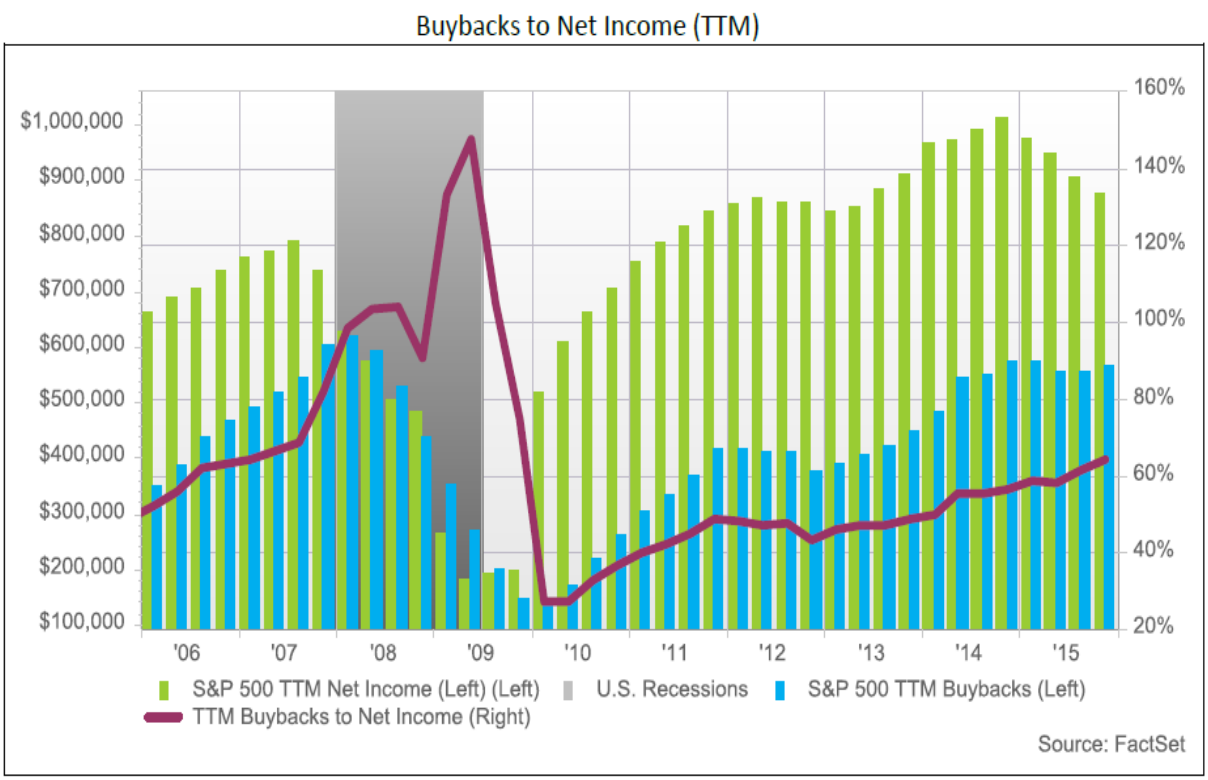



Census Bureau, FactSet

- Cheap oil and natural gas is stimulative for consumer spending, but detrimental to sustaining energy production levels in 2015. As a consequence, capital expenditures for new oil discovery and production declined sharply in 2015. This could lead to shortages in the future. Enterprise Products (EPD), a major factor in all areas of oil production, transportation, and storage, notes that approximately one third of current oil production must be replaced by 2020 due to longevity and field decline. So going forward that should ultimately provide some stimulus.

- Share Buy Backs - A slow growth economy, in conjunction with facilities that are adequate to meet current demand, have caused companies to invest surplus capital into buying back their own stock instead of investing in new office buildings, stores, or factories. This is favorable to investors, because as the number of shares in a company is reduced, the same level of earnings will produce earnings growth on a per share basis. For many companies this has seemed like a safer way to grow earnings than investing in risky new ventures or adding capacity that is not needed. Companies in the S&P 500 spent $156 billion on share buybacks during the third quarter of 2015. This represented a 16% boost in spending from the second quarter and a 6.4% increase from the year ago quarter, according to Factset Research. The total dollar-value share repurchases in Q3 marked the 2nd highest post-recession total. The number of companies in the Standard and Poor's 500 largest companies in America participating in such buybacks during the third quarter increased to 383 from 380 in the second quarter.



## Conclusion

In conclusion, we see another mixed and volatile market for 2016. As stated above, we think a case can be made for 6-8% returns in the stock market this year, based on projected earnings growth of 6% and dividend yields of 2%[3].

Then, however, we still have the question of what kind of multiple will the market place on these earnings? The valuation of the S&P 500 is still in line with historical averages of 16 times forward earnings, so the market is not historically expensive, but it is not cheap either. Bottom line is that if earnings can grow, the stock market should grow as well, but selectivity of both sector and asset classes will be even more important.

Meanwhile, international tensions are high, and there will be continued jockeying for position among presidential candidates on both sides of the aisle, making for a very political year. In addition, investors are worried about a deeper slowdown in growth, and/or another slide in oil, as well as weakness in China and its subsequent effect on worldwide currencies. Further gains in the dollar could curb earnings also, so our conclusion is to stay conservative, invest in high quality brand name companies, with recurring revenue streams, and which are returning cash to investors through dividends, share repurchases and growing earnings.

As always, we thank you for your continued support. Please call with any questions you might have.

Sincerely,

Bill

William H. Schnieders
Principal

Jim

James F. Schnieders, CFA
Principal

John

John C. Schnieders, CFA, CFP®
Principal

[3] FactSet