April 2016

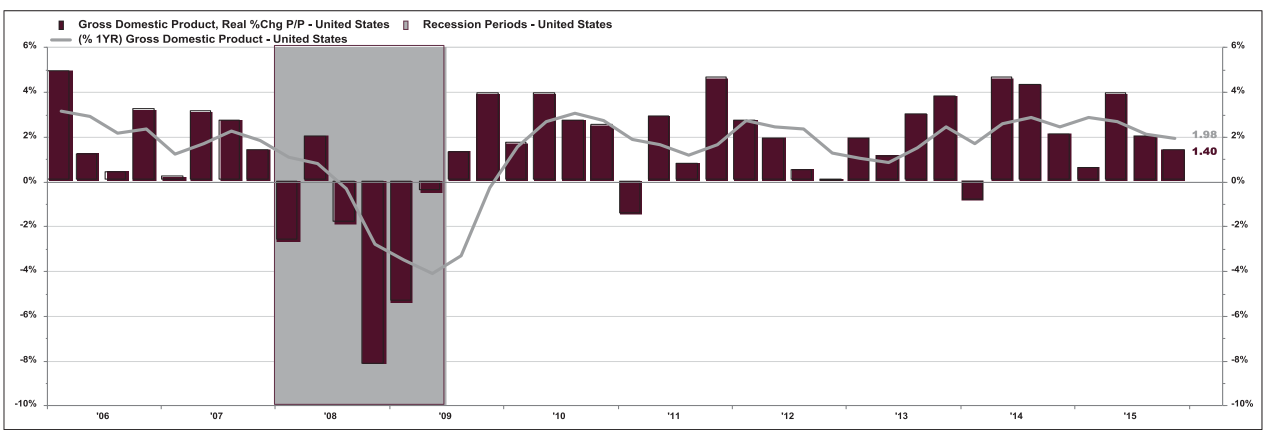
OVERVIEW

A National Geographic program that aired in early February this year was reminiscent of the downward pressure on the market at that time. This particular segment was about the spring thaw in the Arctic and showed how a solidly frozen river mouth was temporarily holding back the high water and flowing ice. As temperatures rose and daylight lengthened, the frozen river mouth slowly weakened and then dramatically broke due to the tremendous pressure of ice build-up and spring high water, unleashing a torrid current. Eventually, the high water receded and the river's current returned to normal.

From the first day of trading this year, risk aversion rose very sharply as investors fled riskier assets, driving down market valuations and significantly elevating risk premiums and volatility. It seemed as though investor's concerns, which had been building up since last August, were unleased in the strong current of uncertainty and fear. This current lasted well into February and then began to subside as evidence continued to mount that moderate U.S. economic growth was sustainable, and not falling off a cliff similar to the 2008 financial crisis, as a few market pundits were suggesting.

THE ECONOMY

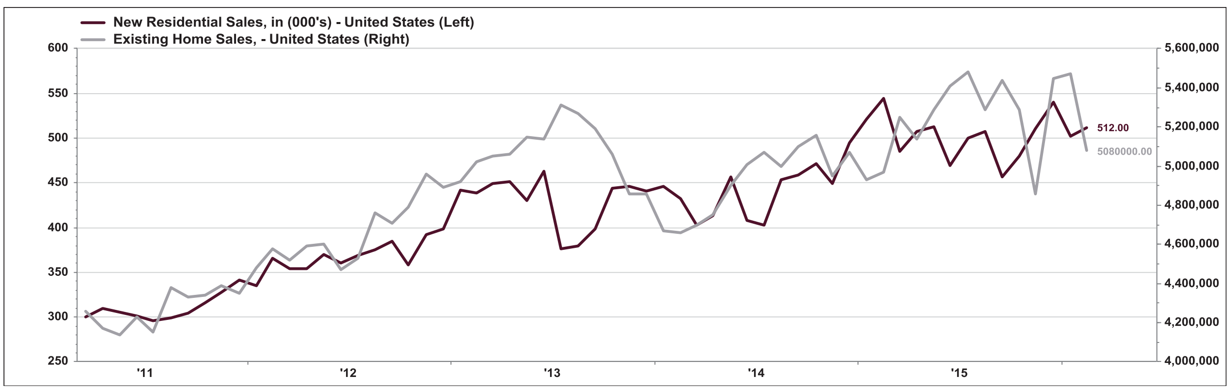
According to the Bureau of Economic Analysis, the pace of economic growth slowed in fourth-quarter 2015 to a 1.4% annualized rate as an increase in consumer spending was countered by lower business investment, inventories and exports. For full-year 2015, the U.S. economy grew 2.4% as increases in consumer spending, housing, building construction and government spending were offset by lower business (mainly energy) investment and a decline in manufacturing exports.



Despite the global stock market sell-off earlier this year, it appears the U.S. economy held on to a modest growth trend during first-quarter 2016 as the labor market strengthened, the housing market continued its slow and steady upward progress, and business and consumer sentiment indicators held steady.

The labor market remained resilient during the first quarter as the unemployment rate held steady at 5.0%, monthly job gains averaged 209,000, weekly initial jobless claims remained near 43-year lows, and more workers re-entered the labor force as the labor participation rose to 63.0% — a twelve-month high. Unfortunately, lingering structural issues such as the number of workers considered long-term unemployed or employed part-time for economic reasons remains historically elevated at 2.2 million and 6.1 million, respectively.

As shown in the graph below, housing market sales have continued to trend higher, although the climb has been choppy. Housing fundamentals remain solid as builder sentiment stays optimistic, monthly job gains continue, and mortgage rates remain attractive. Last year, according to the Federal Housing Finance Agency, housing prices increased 5.6% on average and the median home sale price rose to $229,500. Consensus expectation is for home prices to increase 4–5% in 2016. Headwinds against existing home sales are low inventory levels and home affordability, while for new housing it is a shortage of available workers to complete construction.



Even with the market turmoil, monthly business and consumer sentiment remained upbeat. The Conference Board's Consumer Confidence Index rose in January to 97.8, fell in February to 94.0, and rose in March to 96.2. The Conference Board's Leading Economic Index, which measures 10 components, softened slightly in January to 123.1, only to rise slightly in February to a level of 123.2. The Institute of Supply Management surveys both manufacturing and non-manufacturing (service). While the service survey has had expansionary (above 50) readings for quite some time, including this quarter, the manufacturing survey has been under pressure of late due to the strength of the dollar and low oil prices. However, manufacturing may be turning the corner as readings have begun to trend higher, with January, February and March posting levels of 48.2, 49.5 and 51.8, respectively. Also, recent regional Federal Reserve manufacturing surveys from Richmond and Philadelphia showed strengthening data as well.

The latest Federal Reserve economic forecast issued in March projects the U.S. economy to grow 2.2% in 2016, which is slightly lower than the 2.4% projected back in December. The Fed cited global softness and tighter financial conditions for the lower revision. FactSet's 2016 consensus estimate, which include estimates from 74 economists, forecasts economic growth of 2.2%.

CAPITAL MARKETS

The markets experienced quite a roller coaster ride this past quarter. Early on the morning of January 4, the first trading day of 2016, it was evident that market participants in China were eager to test their newly imposed trading circuit breakers as Chinese markets declined very sharply. Other markets throughout the globe followed suit that day, including in the U.S., and the rout was on.

As alluded to earlier, it was as if the pent-up fear and uncertainty was released all at once. Entering the year, the usual concerns were in play: slowing growth in China, Fed policy, and lack of revenue and earnings growth. But the one concern that seemed to take center stage was oil. Oil fundamentals — high production/supply, low demand — continued to weaken and prices plunged. The severity and velocity in the decline of oil prices, and its potential financial and economic impact, unnerved investors. At one point during the first-quarter, oil prices were down 29.2% from year-end. (2/11 - $26.21 vs. 12/31 - $37.04).

As market turmoil gained steam, talk of an imminent economic recession grew louder, and dollars flowed out of riskier equity and high-yield assets and into the traditional safe havens of Treasury bonds and gold. The yield on the 10-year Treasury bond fell 64 basis points, and reached a low of 1.66% on February 11, which was also the quarterly closing low for the S&P 500 at 1,829.08 (-10.3%). Lower yields drove bond returns higher as the Barclays Aggregate Index finished the quarter up +3.03%. The elevated uncertainty also affected capital market liquidity. Compared to the same period last year, corporate bond issuance, IPOs, and M&A activity were all down sharply due to market conditions. Corporate credit concerns also rose as investment-grade and high-yield credit spreads reached multi-year highs.

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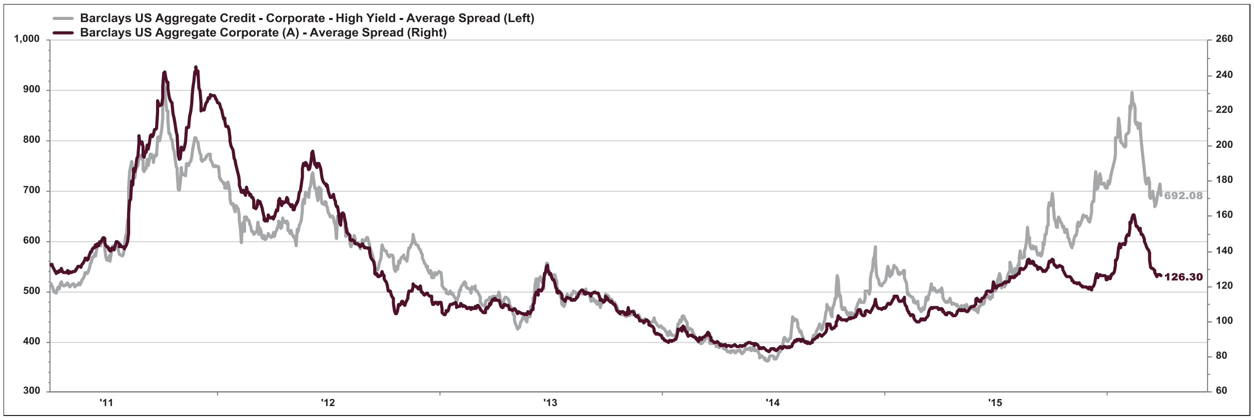

In the first half of the quarter, investors were risk-adverse and the risk trade was off. In the second half, as reasonable housing, retail and auto sales, employment, etc. numbers trickled in, the talk of a recession dissipated and the S&P 500 gradually recovered to finish slightly higher for the quarter at +1.35%. Investors ignored the fact that U.S. economic data was still on a firm footing and that global economic data was stabilizing. This is classic market behavior, where a market is moving sharply in a particular direction — in this case, down — and underlying fundamental economic data is either completely discounted or misconstrued.

Table 1 – Index Total Returns as of March 31, 2016

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
MSCI Emerging	13.23	5.71	5.71	-12.03	-4.43	-4.13	3.02
S&P 400	8.52	3.78	3.78	-3.60	9.46	9.52	7.78
Dow Jones Industrial	7.22	2.20	2.20	2.08	9.29	10.27	7.54
S&P 500	6.78	1.35	1.35	1.78	11.82	11.58	7.01
Russell 2000	7.98	-1.52	-1.52	-9.76	6.84	7.20	5.26
NASDAQ	6.94	-2.43	-2.43	0.55	15.63	13.22	8.71
MSCI Developed	6.51	-3.01	-3.01	-8.27	2.23	2.29	1.80
Fixed Income	**1-Month**	**3-Month**	**YTD**	**1-Year**	**3-Year**	**5-Year**	**10-Year**
Barclays High Yield	4.44	3.35	3.35	-3.69	1.84	4.93	7.01
Barclays Aggregate	0.92	3.03	3.03	1.96	2.50	3.78	4.90
Barclays Inter Gov't/Credit	0.72	2.45	2.45	2.06	1.83	3.01	4.34
Barclays Municipal	0.32	1.67	1.67	3.98	3.63	5.59	4.86
Barclays Michigan Muni	0.37	1.56	1.56	4.27	3.85	5.94	
Barclays Municipal 5-Year	-0.38	1.15	1.15	2.82	2.24	3.36	4.24
Commodity	**1-Month**	**3-Month**	**YTD**	**1-Year**	**3-Year**	**5-Year**	**10-Year**
Bloomberg Commodity	3.82	0.42	0.42	-19.56	-16.87	-14.15	-6.16

For the markets, the primary focus for the remainder of the year will likely be on employment trends, how well consumer spending holds up, overall global growth, the quirky presidential race and, most importantly, the direction of revenue and earnings growth. According to FactSet, first-quarter 2016 earnings are projected to decline -9.1%, which would mark the first instance of four consecutive quarterly earnings declines since 2008. A big difference between now and then is that the weakness is currently concentrated in a couple of sectors — energy and materials (mining, commodities). Back then, most every sector was under pressure.

From a tactical asset-allocation perspective, we remain neutral-weighted on stock and bonds. On the stock side, we continue to favor domestic large-cap over mid- and small-cap stocks. On the international front, we favor developed over emerging markets. On the bond side, we remain slightly defensive on interest-rate risk and favor credit over government, as credit spreads remain above historical averages.

Prepared by Perry Adams, Senior Vice President/Director of Investments

Sources: FactSet, Federal Reserve, Department of Commerce, Department of Labor, The Conference Board, The Institute of Supply Management and the Federal Housing Finance Agency