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The Buttonwood—An Informational Newsletter

Fourth Quarter 2015

History of the Buttonwood

On May 17, 1792, twenty-four merchants gathered under a Buttonwood tree at 68 Wall Street. There they signed the Buttonwood Agreement, creating the first investment community, which later evolved into the New York Stock Exchange.

A Year That Required Patience

We mentioned last January that we thought 2015 would be a year that requires patience for investors. That certainly proved to be the case as the US financial markets as measured by the Dow Jones Industrial Average and the Standard & Poor's 500 posted losses of -2.2% and -0.7% respectively for the year.

If you look back at 2015, you cannot help but see why the markets struggled last year. By way of review, we note the following. In February, the 10 year Treasury rate posted a low of 1.67%. It would rise from there throughout the year. The US dollar continued to show unprecedented strength which dented US multinational corporate earnings.

In August, China devalued its currency in order to stimulate its sluggish economy. US markets experienced a 10% plus correction in August on the heels of slow global growth projections led by China. International and domestic terrorism made headlines throughout 2015, especially in Paris and California.

On December 11th, West Texas Intermediate crude oil hit a 6 year low of $33.62, the equivalent of a 33% drop for the year. Gross Domestic Product growth was a tepid 2.5% (Kiplinger estimate); S&P 500 earnings were negative year-over-year. And finally, on December 16th, the Federal Reserve raised interest rates for the first time in almost 10 years. One could argue that the US markets had every opportunity to post larger declines in 2015, given all the headwinds. Yet the US markets (Dow Jones & S&P 500) were only slightly down to flat. This becomes more remarkable when you take a closer look at the aforementioned August stock market correction.

As you may recall, the Dow Jones and S&P made all-time highs in May 2015. From those highs to the intraday market low on August 25th, the Dow Jones fell by 16.07%. In August, it looked like the US markets might be in for a very rough run. Yet the August correction proved to be a "normal" correction (see Q3 2015 Buttonwood) within a secular bull market. The Dow Jones would rally 13.37% from the August lows to the year-end close.

So we'll ring out the old by saying that the 2015 market proved it could take some punches and still avoid larger declines year-over-year. At the same time, we'd point out that the US stock indices that we follow closely, which include the large, mid, small, growth and value segments of the market, were each up mid to high teens at the end of 2014 on an annualized basis over the previous five years. So perhaps we were due for a flat year. While the US economy continues along at a slow pace and last year's performance was flat, the underpinnings of the market suggest that we are on solid, long-term footing.

Ring In the New

2016 is off to a less than auspicious debut. Among the early year negative headlines were continued turmoil in China, which included a slowing economy and a free falling stock market. Stocks dropped 10% in the first week of trading in China and the Chinese Yuan dropped 1.5%. North Korea reported that it had detonated a hydrogen bomb; the health of the global economy came into question, while global commodity prices continued to fall. The first day of trading in New York was the 10th worst opening going back to 1904 and the first week of trading was the worst-ever start to a new year. The Dow Jones and S&P 500 were down over 6% for the week and each is at or near a 10% correction from the 2015 all-time highs. Even a strong domestic employment report on Friday (1/8/16) couldn't stop the selling pressure; the Dow was down 1% on the day.

Five trading days does not a year make, but the scope and breadth of the declines, both domestic and worldwide get your attention. Last week left many asking if the bull market that began in March of 2009 might be ending. Among all the negativity, we still see signs that point to continuation of the bull market. As we have said many times, successful investing requires a long-term time horizon. As we look long-term, we believe it makes good sense to continue to favor good quality stocks until credit tightening makes an economic downturn inevitable. Given today's investment and economic climate, we think that is several years off.

Fairly Valued

After last week's selling, the S&P is now trading at about 16 times consensus 2016 earnings estimates. While that doesn't make stocks inexpensive by historical measures, it compares favorably to Treasuries and investment grade bonds from a valuation perspective. Given current interest rate levels and benign inflation, stocks are fairly valued. If earnings grow and dividends increase in 2016, there is room for price appreciation.

Currently the S&P 500 dividend yield is at 2.3% vs. the 10 year Treasury rate of 2.12%. This is a rare occurrence and is a compelling argument for owning good quality stocks. Tom Lee, founder of Fundstradt Global Advisors, mentioned on 1/8/16 that the last time this occurred was in late 2011. We went back and checked Dow performance from the beginning of October 2011 through the end of December 2011 and saw that the index was up 14.66% during that time.

Interest Rates and Jobs

Other variables in the stock market equation that support a continuation of the bull market include interest rates, jobs, and GDP growth. The most important thing to remember about credit tightening (rising interest rates) is that we are returning to a normalization of Federal Reserve interest rate policy. That is a process that will very likely take some time. For context, it helps if you look at the current 10 year Treasury rate of 2.12% and compare it to the average 10 year rate since 1871, which is 4.61%. It seems obvious to us that it could take some time for rates to return to that 144 year average. Supporting this contention is rhetoric by Federal Reserve Chair Janet Yellen that suggests that the Fed will be very cautious with respect to rate increases.

Healthy job gains were reported in November reflecting strength across many sectors of the economy.

These included food service, health care, construction, and retail. Many times a positive report is followed by a revision or disappointing report in subsequent months. That did not occur in December, as the most recent jobs report showed a nonfarm payroll increase of 292,000. For all of 2015, the US added 221,000 jobs per month, the second best since 1999.

Unemployment held steady at 5% and consensus estimates peg the rate at 4.6% in 2016. Wage growth improved slightly with average hourly earnings rising 2.4% in December. The Wall Street Journal reported that wage gains were stronger in 2015 than any of the previous five years. Kiplinger suggests that wage growth could rise to 2.5% by the end of 2016.

GDP Growth

Ever since the economy bottomed in 2009, it seems that Gross Domestic Product growth has been labeled as slow or tepid. We have long maintained that slow growth seems logical given the depth of the 2008-2009 recession. That has been the case and, in part, has kept interest rates low. Going forward we see more of the same; slow, non-inflationary growth. Estimates for 2016 GDP growth are around 2.7%, up slightly from 2015. Strong consumer spending which is over 60% of US GDP should continue. A strong housing market will help also. International trade will continue to weigh on US growth. The strong US dollar makes our exports expensive and Kiplinger says that the drag from trade is expected to subtract half a percentage point from GDP growth in 2016.

Don't Panic

Recent market selling is quite similar to the sell offs in 2011 and 2015. We went back and looked at 2011 and found that the Dow Jones fell by 15.75% from 7/21/11 to 8/10/11. As we mentioned above, the market would rebound off those 2011 lows by 14.66% at 2011 year end. A similar scenario played out last year. From the intraday low on 8/25/15, the market would rally by 13.37% by year end. Markets never go up in the short run in a gradual consistent fashion. Corrections and choppiness are a part of the successful long-term investment process. We cannot predict when things will return to a more normal scenario, but we can guarantee that no one ever made a dime by panicking – in fact a substantial sum of money has been lost by doing so. We predict that 2016 will be a year when investors will have no choice but to ***Get Rich Slow***!

In closing we'd like to take this opportunity to thank you for entrusting us with your investments. We value the relationship and encourage you to call or email us with any questions or comments. We would like to extend to you and your family our sincere best wishes for a happy, healthy, and prosperous New Year!

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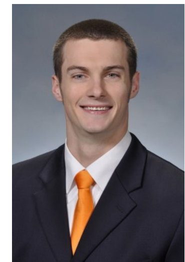

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7 Key Tenets to Successful Long-Term Investing

At its core, successful investing requires a consistent investment philosophy and discipline. We believe that buying and holding quality investments over a long period of time is the foundation for a successful investment program. Below are our 7 Key Tenets to Successful Long Term Investing.

Get Rich Slow

Belief in Capitalism, Free Enterprise, & America

A Disciplined Investment Philosophy is Critical

Don't Overpay For Underperformance

Compare Performance Correctly

Taxes Are Important

Managers Manage

For more information about our investment philosophy and approach, please visit our website at

www.armorycm.com

Patient Investing. Steady Returns.

Successful investing is an elusive realty for many people. It should not be that way.

Investors who are willing to embrace a long-term time horizon, adhere to a conservative investment philosophy, and seek proper guidance will be rewarded. In the short run, the markets may seem volatile, in the long run, the trend is favorable for those willing to hold quality investments over time.

At ACM we believe that the underlying principles of sound investment should not alter from decade to decade. The likelihood for success is overwhelmingly in your favor if you have the required patience and proper guidance.

Please call us, we'd like to help you **Get Rich Slow**.

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