Market Review

First Quarter 2016

The first quarter of 2016 was reminiscent of a roller coaster ride at an amusement park with stocks down almost 10% in the first six weeks of the year only to finish the quarter with slightly positive returns (*See chart: S&P 500® Performance*). For the quarter, the S&P 500 Index eked out a small gain of 1.35%, but the Russell 2000 Index and the NASDAQ Composite declined 1.52% and 2.43%, respectively. Higher yielding stocks performed extremely well with the S&P 500 utilities and telecommunications sectors up over 15% for the quarter. Emerging market stocks also were particularly strong after a difficult 2015 with the MSCI Emerging Markets Index up 5.71%.

S&P 500® Performance

Source: Strategas
Data as of March 31, 2016. Data is assumed to be reliable.
Past performance is no guarantee of future results.

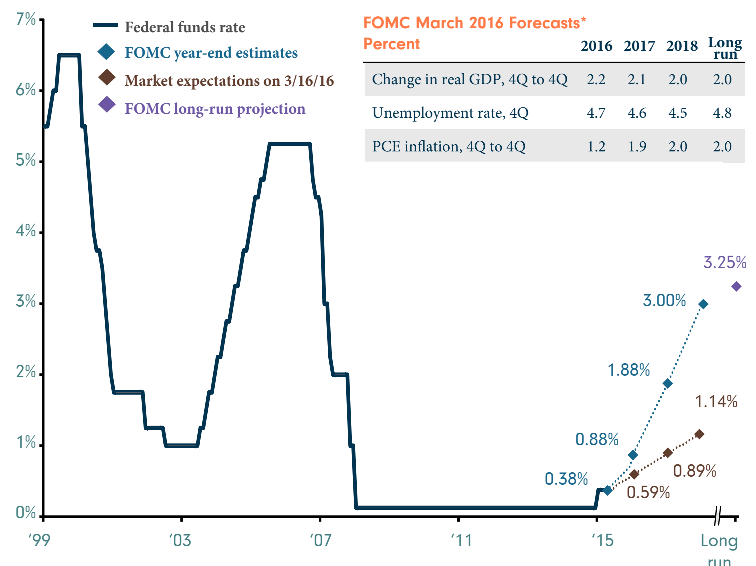
Bonds had a very strong quarter, returning 3.03% (as measured by the Barclays U.S. Aggregate Index). Credit-sensitive areas did particularly well with emerging-market debt up 5.22% (as measured by the JP Morgan Emerging Markets Bond Index Global) and high yield returning 3.25% (as measured by the Bank of America Merrill Lynch U.S. High Yield Index). California municipal bonds also generated a positive return with the Barclays California Municipal Bond Index returning 1.60% for the quarter. And, once again, the 10-year U.S. Treasury yield fell during the quarter from 2.27% to 1.77%.

We believe the major causes of the market decline early in the quarter were driven by the continued declines in the price of oil below $30 a barrel and concerns about the potential depreciation of the Chinese currency. Coming into the year, many economists and investors had overly optimistic forecasts of U.S. economic growth in the 2.5% to 3.5% range and the Federal Reserve raising rates four times this year. Many believed this upward interest-rate pressure in the U.S. (particularly with many foreign central banks doing the opposite) would lead to continued strength in the U.S. dollar and could potentially spark global currency wars. However, by the end of the quarter, it became clear that the domestic economy is growing slower than anticipated in the 1.5% to 2.25% range, and a recession is not imminent.

In response to this slower growth and turbulence overseas, the Federal Reserve has made it very clear that they are not trying to engineer a recession and it is likely to raise rates only once or twice in 2016 (See chart: *The Fed and Interest Rates*). The Fed is not oblivious to weakness in Europe, Japan, and many emerging markets, such as Brazil and Russia, so this new interest-rate outlook has relieved upward pressure on the U.S. dollar. Despite significant improvement in the labor market, Janet Yellen prefers to err on the side of too much inflation, which is still below the Fed's long-term target. We agree that choking off inflation if and when it occurs is less of a policy risk than facing serious deflation. This change in future interest-rate expectations is the key reason higher yielding stocks did so well during the quarter.

The Fed and Interest Rates

FOMC and Market Expectations for the Fed Funds Rate



	2016	2017	2018	Long run
Change in real GDP, 4Q to 4Q	2.2	2.1	2.0	2.0
Unemployment rate, 4Q	4.7	4.6	4.5	4.8
PCE inflation, 4Q to 4Q	1.2	1.9	2.0	2.0

Source: FactSet, Rederal Reserve, and J.P. Morgan Asset Management
Market expectations are the federal funds rates priced into the fed futures market as of the date of the March 2016 Federal Open Market Committee (FOMC) meeting.
**Forecasts of 17 FOMC participants, midpoints of central tendency except for federal funds rate, which is a median estimate.*
Data as of March 31, 2016. Data is assumed to be reliable.
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Our forecast for 2016 remains unchanged. We believe the domestic economy will grow at a modest rate in the range of 1.5% to 2.5% and corporate earnings will grow in the mid-single digit range. We believe oil has finally bottomed out because domestic shale producers and major international oil companies have announced dramatic reductions in capital spending on the order of 40% to 70%. These supply reductions combined with natural depletion rates will ultimately reduce excess supply. Importantly, stability in the price of oil and the U.S. dollar will help stabilize reported profits for companies in the S&P 500, which have been sliding downward over the last two years due to the impact of weak oil and a strong U.S. dollar (See chart: *S&P 500® Annual Earnings Estimates*). Stability in the price of oil is needed in order for equity markets to generate returns in line with earnings growth.

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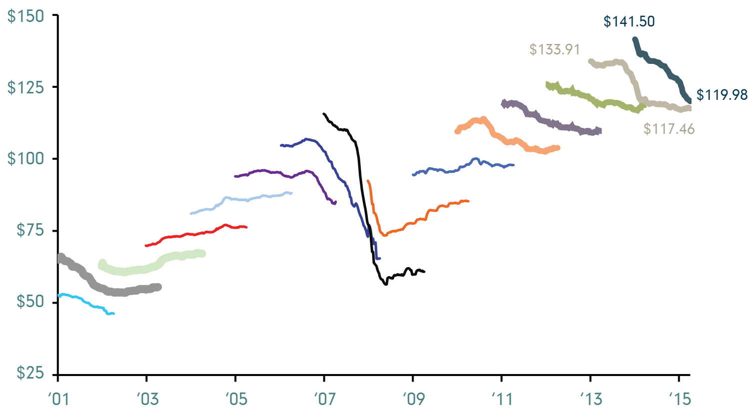
S&P 500® Annual Earnings Estimates
Weekly Progression



Source: Strategas
Data as of March 31, 2016. Data is assumed to be reliable.
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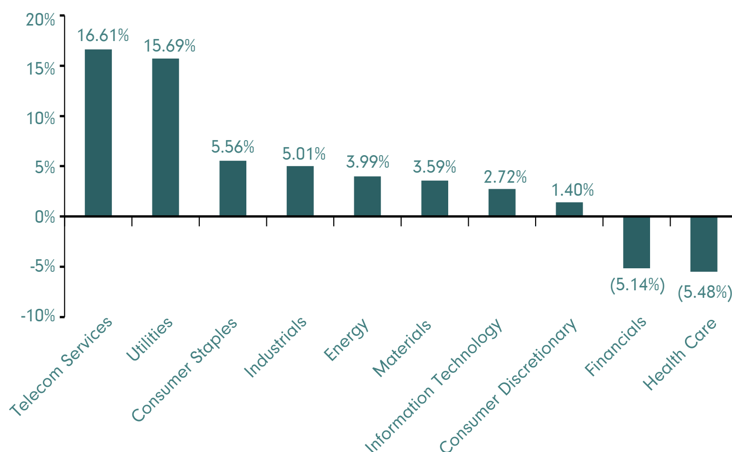
There continues to be significant dispersion in performance among sectors despite fairly benign overall equity index returns. Higher yielding sectors, such as telecom, utilities, and REITs, were standout performers. Industries, such as oil and gas, manufacturing exporters, industrial companies, railroads, and emerging markets, that have been in or close to a recession over the last 18 months have finally started to show some stability this quarter. Health care, which has been very strong over the last several years, got hit hard due to concerns about the sustainability of drug and biotech pricing. Banks continued to struggle with continued pressure on their net interest margins (*See chart: S&P 500® Sector Performance*). We would argue that these rolling recessions/corrections in various industry groups over the last two years help mitigate the risk of a more broad and serious market problem. They also provide more opportunity for shrewd stock pickers to add value relative to an index strategy. Several of our funds

S&P 500® Sector Performance
First Quarter 2016



Source: FactSet
Data as of March 31, 2016. Data is assumed to be reliable.
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(Small Cap Core, Small Cap Sustainable Growth, Small Cap Quality Value, and Mid Cap Core) were honored to be top 10 performers within their peer groups based upon trailing 12-month returns. Stock selection has become very important over the last two years unlike the 2009 to early 2014 time period when almost all stocks and sectors were increasing in value.

As we have seen over the last year, cross currents in the equity market are likely to continue with a possible Brexit in June, Fed watchers guessing at which meeting rates will get hiked, and a contentious presidential election. A disciplined investment approach combined with a long-term quality orientation should continue to pay off. As we have done for over three decades, we will continue to purchase high-quality businesses that we believe can perform well in both good and bad times. We thank you for your continued trust and confidence and we welcome any questions you may have.

Douglas S. Foreman, CFA
Chief Investment Officer
Douglas S. Foreman, CFA is Chief Investment Officer, Portfolio Manager, and a member of the Executive Management Committee. He has approximately 30 years of investment experience.

The S&P 500® Index is a market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. The Russell 2000® Index is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The NASDAQ Composite Index is the market capitalization-weighted index of the more than 3,000 common equities listed on the Nasdaq stock exchange. The MSCI® Emerging Markets (EM) Index is a free-float adjusted market capitalization index tracking the equity performance of global emerging markets. The Barclays U.S. Aggregate Bond Index is a market value weighted index that tracks the daily price, coupon, pay downs, and total return performance of fixed-rate, publicly placed, dollar-denominated, and non-convertible investment grade debt issues with at least $250 million par amount outstanding with at least one year to final maturity. Performance is calculated on a total return basis with dividends reinvested. The JP Morgan Emerging Markets Bond Index Global is a benchmark index for measuring the total return performance of international government bonds issued by emerging market countries that are considered sovereign (issued in something other than local currency) and that meet specific liquidity and structural requirements. The Bank of America Merrill Lynch U.S. High Yield Index tracks the performance of U.S. dollar denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. The Barclays California Municipal Bond Index is a market capitalization-weighted index of California investment-grade municipal bonds with maturities of one year or more.

This report is based on the assumptions and analysis made and believed to be reasonable by Advisor. However, no assurance can be given that Advisor's opinions or expectations will be correct. This report is intended for informational purposes only and should not be considered a recommendation or solicitation to purchase securities. Past performance is no guarantee of future results.