Tarheel Advisors Newsletter

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Stock Wars: The Markets Awaken

In a time not very far far away (2015), stock markets across the galaxy were in a deep slumber. A dark energy sapped returns from nearly all asset classes, leaving investors with little to show for their entire year. Now that a new year is upon us, will the markets awaken with the force necessary to forge positive returns in 2016?

Year In Review—Before looking forward, any good Jedi Master takes the time to review the prophecies from the past year. In 2015, Tarheel Advisors foretold of a collapse in commodities prices that could lead to a world recession of the *first order*. While global GDP didn't technically hit recession levels, many countries saw significant slow downs in economic activity making it certainly feel like a global recession.

In 2015 we also predicted a disturbance in the force would lead to a 10% or greater market sell-off. While we expected this pullback in the first half of the year, it didn't materialize until the end of the summer as a bear market gripped China and the fears spread abroad. Thankfully, the pain felt from this sell-off was short lived, and markets fought back to end 2015 mostly flat.

One powerful force, the Darkside...I mean Federal Reserve, which had been slumbering for nearly a decade, did awaken, and in their December meeting, announced a rate increase of 0.25% which was the first since 2006.

2016 Predictions—The opening day of 2016 saw a loss in the DOW of nearly 300 points — the worst opening day in 15 years. Many would expect an auspicious start like this would set a negative tone for the year. But, historically speaking, the first trading day of the year has very little predictive power. According to the data, the indexes end the year in the same direction as the opening trading day only 50.6% of the time. The first month of the year has been way more telling, providing confirmation for the direction that year 72.4% of the time. While we still do believe most domestic indexes will finish the year in positive territory, our expectations are for increased volatility for the entirety of 2016. Perhaps more than any year in recent history there are a lot of clouds of uncertainty shrouding the view of the endpoint.

One of those likely disruptive forces may be in the political future of the United States. As the 2016 presidential race heats up later this year, so will the speculation it will bring to the markets. Look for a stark contrast between the eventual primary winners, much more so than we have seen in decades, and the resulting speculation on policy decisions to cause sector shifts to those areas perceived more favorably under the new regime.

Another source of *resistance* lies with the direction or lack thereof in interest rates. Most pundits prognosticate that the Supreme Leader...I mean Janet Yellen, will orchestrate between one to four quarter point rate increases over the course of 2016. Our prediction is for a much more hawkish Fed that will be painted into a corner by global lack of demand and will raise rates no more than once during 2016. With many central banks around the world dropping their rates into negative territory and engaging in further monetary stimulus, it will be very difficult for the Fed to fight that force as the resulting battle will create its own problem of a further strengthening dollar.

2015 Score Card

World Recession	B
US GDP Growth 1-3%	A
Minimal Interest Rate Changes	A
Stocks End Flat for Year	A
10%+ Sell-off to Start 2015	B

2015 Market Wrap

S&P 500	**1.19%**
DOW	**0.21%**
RUSS 2000	**-4.41%**
MSCI World	**-3.04%**
Bond Index	**+0.55%**
Hi-Yield Debt	**-4. 01%**
GOLD	**-11.78%**

Mortgage Rates

15-Year	**3.14%**
30-Year	**3.94%**
5/1 ARM	**3.40%**

Did You Know?

* We're going digital! We have recently upgraded our internal software to Morningstar Office Suite. This upgrade will allow for the e-delivery of client reports. The enhanced reporting will also allow for deeper insights into portfolio performance and returns. Look for these new reports in April along with instructions for setting up your optional Morningstar client portal.

Finally, we expect that commodities will bottom out and end their multi-year free fall during 2016. Low prices tend to beget higher prices as supply comes offline, and with heightened tensions in the Middle East, commodities like oil may end their nose dive. We expect oil to climb back over $50/barrel before year's end. However, it very well may fall below $30 before that occurs.

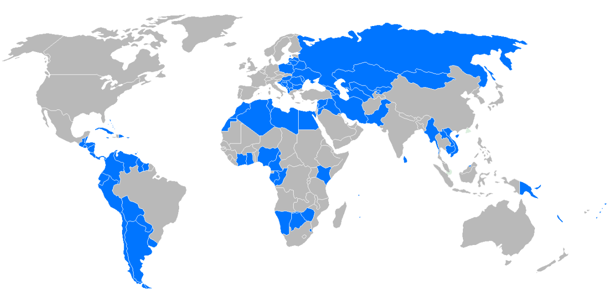
While we wouldn't expect stocks to enter hyperspace, we do feel that once the uncertainty has lifted later in the year, the markets have a strong chance of reaching their historical norms of around a 10% return. In the meantime, the name of the game is diversity and patience until the force awakens. **-Ryan Glover, CFP®**

Emerging Problem?

Emerging Markets (EMs) have been a hot button issue of late in the investment community. With the precipitous fall of the Chinese stock market in September of 2015, we became all too familiar with potential contagion and resulting volatility felt at home. Although we rebounded double digits back to par in October 2016, it once again has brought the lesser known investment sphere back into focus.

What exactly constitutes an "emerging market"? According to Wikipedia, the term was coined by economist Antoine Van Agtmael at the World Bank in the 1980s and was originally applied to countries that were in a transitional phase between developing and developed status. Apparently in the 1970's these "emerging" countries were referred to as "Less Developed Countries" or (LDCs). That moniker became politically incorrect, and thus the ambiguously vague new title became fashionable.

In the investment community, the EM label typically includes many countries that are experiencing rapid growth and industrialization (see the blue highlighted areas in the map below). These countries possess securities markets that are progressing toward, but have not yet reached the standards of developed nations. Emerging markets typically have fewer and smaller publicly traded companies than developed markets. Securities markets there may have lower liquidity, less regulation, and weaker accounting standards than more mature markets such as the U.S., Japan, and many countries in Europe.



One of the more notable subsets of Emerging Markets is referred to by the acronym BRIC, which stands for Brazil, Russia, India, and China. This term created by Goldman Sach's investment banker Jim O'Neill in 2001 still is in common use today and is meant to represent a group that was deemed to be at a similar stage of newly advanced economic development. Another buzzword that's captured our attention is "Frontier" markets, which is an even smaller and more volatile sub-set of EM countries that are really new to the whole infrastructure game. Now that we know what comprises an emerging market, why should we invest in it? Historically speaking, the simple answer is the potential for high rewards. If you look at the colorful table below produced annually by Callan Associates, you'll notice that the bright orange box representing an index of emerging market stocks has a habit of either being the best or the worst performing asset class in a given year. This volatility in the past has been made somewhat palatable by the great magnitude of the up years (up on average 37.8% from 2003-2007, but down 53.2% in 2008). However, we think that for a number of reasons, perhaps investors should re-consider their allocations towards EM.

The Callan Periodic Table of Investment Returns

Annual Returns for Key Indices Ranked in Order of Performance (1996–2015)

1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
S&P 500 Growth 23.97%	S&P 500 Growth 36.52%	S&P 500 Growth 42.16%	MSCI Emerging Markets 66.42%	Russell 2000 Value 22.83%	Russell 2000 Value 14.02%	Barclays Agg 10.26%	MSCI Emerging Markets 56.28%	MSCI Emerging Markets 25.95%	MSCI Emerging Markets 34.54%
S&P 500 22.96%	S&P 500 33.36%	S&P 500 28.58%	Russell 2000 Growth 43.09%	Barclays Agg 11.63%	Barclays Agg 8.43%	Barclays Corp High Yield -1.41%	Russell 2000 Growth 48.54%	Russell 2000 Value 22.25%	MSCI EAFE 13.54%
S&P 500 Value 22.00%	Russell 2000 Value 31.78%	MSCI EAFE 20.00%	S&P 500 Growth 28.24%	S&P 500 Value 6.08%	Barclays Corp High Yield 5.28%	MSCI Emerging Markets -6.00%	Russell 2000 47.25%	MSCI EAFE 20.25%	S&P 500 Value 5.82%
Russell 2000 Value 21.37%	S&P 500 Value 29.98%	S&P 500 Value 14.69%	MSCI EAFE 26.96%	Russell 2000 -3.02%	Russell 2000 2.49%	Russell 2000 Value -11.43%	Russell 2000 Value 46.03%	Russell 2000 18.33%	S&P 500 4.91%
Russell 2000 16.49%	Russell 2000 22.36%	Barclays Agg 8.70%	Russell 2000 21.26%	Barclays Corp High Yield -5.86%	MSCI Emerging Markets -2.37%	MSCI EAFE -15.94%	MSCI EAFE 38.59%	S&P 500 Value 15.71%	Russell 2000 Value 4.71%
Barclays Corp High Yield 11.35%	Russell 2000 Growth 12.95%	Barclays Corp High Yield 1.87%	S&P 500 21.04%	S&P 500 -9.11%	Russell 2000 Growth -9.23%	Russell 2000 -20.48%	S&P 500 Value 31.79%	Russell 2000 Growth 14.31%	Russell 2000 4.55%
Russell 2000 Growth 11.26%	Barclays Corp High Yield 12.76%	Russell 2000 Growth 1.23%	S&P 500 Value 12.73%	MSCI EAFE -14.17%	S&P 500 Value -11.71%	S&P 500 Value -20.85%	Barclays Corp High Yield 28.97%	Barclays Corp High Yield 11.13%	Russell 2000 Growth 4.15%
MSCI EAFE 6.05%	Barclays Agg 9.64%	Russell 2000 -2.55%	Barclays Corp High Yield 2.39%	S&P 500 Growth -22.08%	S&P 500 -11.89%	S&P 500 -22.10%	S&P 500 28.68%	S&P 500 10.88%	S&P 500 Growth 4.00%
MSCI Emerging Markets 6.03%	MSCI EAFE 1.78%	Russell 2000 Value -6.45%	Barclays Agg -0.82%	Russell 2000 Growth -22.43%	S&P 500 Growth -12.73%	S&P 500 Growth -23.59%	S&P 500 Growth 25.66%	S&P 500 Growth 6.13%	Barclays Corp High Yield 2.74%
Barclays Agg 3.64%	MSCI Emerging Markets -11.59%	MSCI Emerging Markets -25.34%	Russell 2000 Value -1.49%	MSCI Emerging Markets -30.61%	MSCI EAFE -21.44%	Russell 2000 Growth -30.26%	Barclays Agg 4.10%	Barclays Agg 4.34%	Barclays Agg 2.43%

2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
MSCI Emerging Markets 32.59%	MSCI Emerging Markets 39.78%	Barclays Agg 5.24%	MSCI Emerging Markets 79.02%	Russell 2000 Growth 29.09%	Barclays Agg 7.84%	MSCI Emerging Markets 18.63%	Russell 2000 Growth 43.30%	S&P 500 Growth 14.89%	S&P 500 Growth 5.52%
MSCI EAFE 26.34%	MSCI EAFE 11.17%	Barclays Corp High Yield -26.16%	Barclays Corp High Yield 58.21%	Russell 2000 26.85%	Barclays Corp High Yield 4.98%	Russell 2000 Value 18.05%	Russell 2000 38.82%	S&P 500 13.69%	S&P 500 1.38%
Russell 2000 Value 23.48%	S&P 500 Growth 9.13%	Russell 2000 Value -28.92%	Russell 2000 Growth 34.47%	Russell 2000 Value 24.50%	S&P 500 Growth 4.65%	S&P 500 Value 17.68%	Russell 2000 Value 34.52%	S&P 500 Value 12.36%	Barclays Agg 0.55%
S&P 500 Value 20.81%	Russell 2000 Growth 7.05%	Russell 2000 -33.79%	MSCI EAFE 31.78%	MSCI Emerging Markets 19.20%	S&P 500 2.11%	MSCI EAFE 17.32%	S&P 500 Growth 32.75%	Barclays Agg 5.97%	MSCI EAFE -0.81%
Russell 2000 18.37%	Barclays Agg 6.97%	S&P 500 Growth -34.92%	S&P 500 Growth 31.57%	Barclays Corp High Yield 15.12%	S&P 500 Value -0.48%	Russell 2000 16.35%	S&P 500 32.39%	Russell 2000 Growth 5.60%	Russell 2000 Growth -1.38%
S&P 500 15.79%	S&P 500 5.49%	S&P 500 -37.00%	Russell 2000 27.17%	S&P 500 Value 15.10%	Russell 2000 Growth -2.91%	S&P 500 16.00%	S&P 500 Value 31.99%	Russell 2000 4.89%	S&P 500 Value -3.13%
Russell 2000 Growth 13.35%	S&P 500 Value 1.99%	Russell 2000 Growth -38.54%	S&P 500 26.47%	S&P 500 15.06%	Russell 2000 -4.18%	Barclays Corp High Yield 15.81%	MSCI EAFE 22.78%	Russell 2000 Value 4.22%	Russell 2000 -4.41%
Barclays Corp High Yield 11.85%	Barclays Corp High Yield 1.87%	S&P 500 Value -39.22%	S&P 500 Value 21.17%	S&P 500 Growth 15.05%	Russell 2000 Value -5.50%	S&P 500 Growth 14.61%	Barclays Corp High Yield 7.44%	Barclays Corp High Yield 2.45%	Barclays Corp High Yield -4.47%
S&P 500 Growth 11.01%	Russell 2000 -1.57%	MSCI EAFE -43.38%	Russell 2000 Value 20.58%	MSCI EAFE 7.75%	MSCI EAFE -12.14%	Russell 2000 Growth 14.59%	Barclays Agg -2.02%	MSCI Emerging Markets -1.82%	Russell 2000 Value -7.47%
Barclays Agg 4.33%	Russell 2000 Value -9.78%	MSCI Emerging Markets -53.18%	Barclays Agg 5.93%	Barclays Agg 6.54%	MSCI Emerging Markets -18.17%	Barclays Agg 4.21%	MSCI Emerging Markets -2.27%	MSCI EAFE -4.90%	MSCI Emerging Markets -14.60%

As I mentioned before, the securities exchanges in these countries are often way less sophisticated than here in the U.S., thus, making an investment in one of their local exchanges can have several drawbacks. The main one as of late has been the currency conversion. The U.S. Dollar has rocketed higher much faster than nearly all of the EM currencies and when your returns are translated back into dollars, a lot of the performance is forfeited. Second, the liquidity of EM publicly traded companies is much less than their developed counterparts. Sure you could invest in the largest EM domiciled maker of consumer products, but why is that inherently better than purchasing shares in a company like Coca-Cola that does 50% + of its sales in the EM geography? It seems to us that the risk/reward dynamic has shifted, and gaining exposure to EM growth and profit without as many pitfalls is more logical. **–Walter Hinson, CFP®**

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