201 Tower Park Dr, STE 100
Waterloo, IA 50701
319-233-1717
www.HeartwoodInvestments.com

Thoughts

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That Year When Zero Looked Almost Good

Anyone who imagines that all fruits ripen at the same time as strawberries knows nothing of grapes. Paracelsus

2016 started off with a thud, as turbulence in China's stock market triggered selling pressure in most other global exchanges. The U.S. S&P 500 index declined almost 6% in the first week. We have seen such weeks before, as recently as last August, and most often markets take them in stride. Since 2007 there have been 12 weeks that moved 6%. Half were down, the other half up. Half of the weeks that followed also went down, the other half up. Looking at the whole year ahead, 2016 has a lot going for it and bad markets sometimes bring good opportunities.

TABLE 1
Major Asset Classes Full Year 2015
Total Return Including Income Received

Asset Class[1]	Total Return
10-Yr Treasury Note	1.5%
S&P 500 Large U.S. Stocks	1.3%
3-month T-bills	0.1%
Developed Country Stocks	–0.3%
30-Yr Treasury Bond	–2.2%
Low-Rated Corporate Bonds	–6.8%
Emerging Country Stocks	–14.3%
CRB Commodities Index	–22.3%

[1]See Disclosures page 6 for Asset Class information

2015 went into the history books as one of those rare years when investments went sideways—at best. Bloomberg News Service published an article in late December, *The Year Nothing Worked,* showing that neither cash, bonds, nor stocks produced much of a return for investors. Table 1 above tells the tale of this Year of the Big Zero.

Returns faded but volatility roared in 2015. The Dow Jones Industrial Average absorbed its first 1,000-point, one-week loss during August. The most striking example may have been the Shanghai Composite Index of Chinese stocks that rose more than 60 percent through June, tumbled to a loss on the year by August, then rallied to end the year with a gain a bit over 9 percent. The Chinese market lost that entire year's gain on the first day of 2016. Investors gained very little for their trouble in 2015, and broadly diversified portfolios holding international stocks or commodities probably declined somewhat.

Even the two best performers on the list above ended the year actually down a bit in price, before income received lifted the total return to a small positive. Cash equivalent investments, such as Treasury Bills, earned nothing to speak of. Such years are rare. More often than not, some asset class manages to shine.

What might move up in 2016?

We see potential opportunities in two asset classes that performed relatively poorly in 2015: emerging-country stocks and high-yield bonds.

Foreign stocks, particularly those in broad, emerging market indexes, could be the sleeper that wakes up in 2016. These markets underperformed U.S. markets again in 2015. This makes it hard to consider their potential appeal. Yet we are intrigued by this asset class for four reasons.

Why We Find Emerging Country Stock Appealing

1. U.S. investors measure performance in dollar terms. When the dollar appreciates strongly against other currencies, it can make even good performance by foreign assets look bad. This was a big disadvantage for foreign stocks compared to U.S. holdings last year. If the dollar were to stabilize or decline relative to other currencies, foreign investments could see a lift.

2. Emerging country stocks move up and down with commodities to a greater extent compared to U.S. stocks. The commodity sell-off last year is partly to blame for the rough year these shares endured. If commodities were to stabilize in 2016 it could reduce a major headwind in this space.

3. Emerging countries, including China, make up nearly half the world's economic output and continue to grow faster than the rest of the world. More importantly in our view, these countries have very large room to grow internally on the consumer side. The rise of household living standards in developing countries may turn out to be the largest source of investment returns globally over the next two decades.

4. Valuation in foreign stocks is more attractive compared to U.S. companies. In a recent article in the Wall Street Journal Burton Malkiel discussed a measure of value called the cyclically-adjusted P/E ratio, or CAPE. This compares prices to an average of earnings over time rather than only the past year. The CAPE for U.S. stocks is 26 times average earnings. By contrast, European stocks look much cheaper at a CAPE of 15, and emerging country stocks beg for investor attention at a CAPE of 10.

Risks to Emerging Country Investment

Economic events in China could impact emerging-country investment in the near term. Renewed weakness in the Shanghai stock market in January sent shivers around the world. Chinese manufacturing output slowed again in December. A number of emerging country economies depend significantly on exports to China, and would feel a slowdown. Recent news and economic data from China do not paint a positive picture. However, markets tend to turn positive well before the "all clear" signal reverberates around the world. These thoughts guide us to take measured steps, rather than giant leaps. Mindful of the risks and their poor performance relative to U.S. stocks the past year or two, we still view the case for including foreign and emerging country stocks as strong for diversified, long-term portfolios able to bear the risks of stocks.

High-yield Bonds May Have Become Attractive
Yields on sub-investment-grade bonds sometimes get high enough to view them as a companion to U.S. stocks. We looked unfavorably on this asset class the past few years because the spread, or extra interest they offered over high-investment-grade bonds seemed too low. We were concerned that so-called junk bonds could suffer outsized price drops if too many investors wanted to sell them in a short period of time. During December there was a sell-off in high-yield bonds, to the point that spreads once again look reasonable. We are evaluating a selection of high-yield bond vehicles that could offer returns—up or down—similar to U.S. stocks at this point, with greater income and a different risk profile. It might make sense at some point to replace some of the stocks in a portfolio with a selection of high-yield bonds.

What about other asset classes?
U.S. stocks look expensive compared to the profits they earn. There are two ways stock prices can move higher: 1) earnings growth, and 2) an increase in the price/earnings (P/E) ratio. The P/E can be seen as a measure of investor confidence. Earnings did not grow in 2015, but actually declined. Meanwhile the P/E ratio of the S&P 500 index remains above 21 times reported profits for the past 12 months. That is high compared to long-term average levels closer to 16. We look for profits to grow modestly in 2016 but not by enough to close the gap between present and average P/E measures. A price correction could be in store if profits do not grow soon and strongly enough. U.S. stock prices can move higher in 2016 if economic growth and profits come in more strongly, as many other observers expect. However, the indicators we follow suggest only a mid-single-digit rate of return on stocks in the most favorable scenarios. The popular notion that stocks reliably produce 10% returns is wrong.

Investment-grade bond prices could have difficulty moving higher in 2016 if the Federal Reserve follows through on its announced intentions toward higher interest rates. It's just math. Keeping all else equal a bond's price would decrease whenever the yield it must pay an investor goes up. An investor may hope to earn today's low yield by holding a bond until it comes due and repays principal, yet negative returns remain possible at times during the holding period.

Commodities face ongoing challenges in 2016 due to persistent oversupply. The market price for oil is just one example. It fell because oil producers increased production by about 1.4 million barrels per day in 2015 while oil consumption grew slower, by 1.2 million barrels. The surplus builds up in storage, which also holds the price down. Commodity prices tend to be volatile because events can impact supplies fairly quickly. However, barring some such disruptive event it is hard to see much upside potential for investments tied to commodity prices.

The 23 percent decline in commodity prices last year probably helped to keep inflation rates below the Federal Reserve's target level of 2 percent in 2015. This in turn may have prompted the Fed to delay increasing interest rates until the end of the year. Fed Chair Janet Yellen has described the commodity price decline as "transitory." What if she were right? Think about it. Inflation was mildly positive in a year when commodities fell more than 20 percent. If

commodities had not gone down so much, or were to begin moving upward, how much higher might the inflation rate be? Dr. Yellen has said that interest rates would have to move higher, faster, if inflation runs much above 2%. We would call that something to watch in 2016.

As we always say, past returns do not predict future results. That is why we decided to reach for our crystal ball. Yes, we have one. Here is an actual photo taken as we consulted it recently.

OK, a number of asset classes face challenges in 2016. Important to note, these are the types of challenges that can resolve themselves given a little time. For example household spending did not grow as fast as personal income in 2015. Savings are good but may have contributed to a lull in corporate profits, making P/E ratios look temporarily high. That picture got brighter in the 4th quarter as U.S. employers added a total of 851,000 jobs. Real wages grew 2% in the 12 months through November. Employment and income numbers look set for more growth in 2016. And cheap fuel is giving families more money to spend. If households lift spending in line with income it would go a long way toward returning stock valuations back to attractive levels. The market could begin to move upward in anticipation of more consumer confidence.

Here are some elements of our base-case scenario. We call it "muddling through."

- U.S., international and emerging market economies continue to grow.
- Consumer spending tracks closer to ongoing growth in personal income.
- Employment remains robust and real wage growth tracks real productivity.
- U.S. election campaigning stabilizes in a conventional, two-party Presidential contest.
- The Federal Reserve stays on a gradual path toward a Fed funds rate at or above 1% by year-end.

- Commodity prices stabilize or rise modestly. The U.S. dollar stabilizes or declines slightly relative to major foreign currencies. We note the year is not starting out that way, but moving in the opposite direction for these two indicators. Give it time.
- Corporate earnings grow at low double-digit rates. This would better support current share price levels and could reduce P/E ratios back closer to normal in the mid-teens.

In our scenario, we would expect 2016 to be another year of modest returns.

- Interest rates on cash and short term assets appear likely to follow the Fed upward, as they did soon after the Fed hiked its short-dated target rate in December.
- Stocks may perform better than bonds or cash, if only through growth of dividends. Payouts to shareholders may rise in response higher to interest rates. Index price levels might fluctuate quite a lot within a trading range that tops out near last year's highs.
- Bonds seem set to earn near-zero or negative returns as yield level increases translate into price declines that could offset low interest payouts. We plan to watch for opportunities in credit spreads and the shape of the yield curve.

For the sake of balance, here are some bad events that we can imagine happening for a while in 2016, but think are unlikely to have a lasting effect. In other words, we think the world would find a way to shake off headlines such as the following:

- Current troubles in China intensify, causing disruption not only in emerging market stocks, but also in US and developed international companies
- Commodity prices weaken a lot farther down – bad because it could provoke concerns about economic slowdown or deflation
- Commodity prices rebound rapidly and strongly upward – bad because it could raise fears of accelerating inflation prompting central banks to tighten policy against an otherwise still-modest recovery
- Geopolitical event disrupts the global flow of goods and services for a while
- Financial event such as a major sovereign default or currency devaluation large enough to disrupt the global payments system for a time

Times like these remind us that not all fruit ripens at the same time as strawberries. Investment returns tend to come in spurts, rather than at a steady pace. To us this means staying invested with a consistent process rather than jumping out and in. Even if 2016 proves to be both volatile and disappointing at times, the approach that we believe works best has two parts: 1) make sure that money you need to spend in the foreseeable future is safe from market risk, and 2) diversify long-term assets very broadly. As we build portfolios in this challenging year we will consider reducing exposure to U.S. stocks, maintaining exposure to international stocks, and looking for opportunities where interest rates or valuation levels may have become attractive.

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[1]Asset Class returns shown in Table 1 were calculated by Heartwood Investments as follows.

- 10-Yr Treasury Note: Total return on purchasing on December 31, 2014 the 2.25% Treasury Note due 11/15/2024 and holding it through December 31, 2015. Data source: Wall Street Journal
- S&P 500 Large U.S. Stocks: Based on the price change adjusted for dividends of the iShares S&P 500 Index ETF (IVV). Data source: Yahoo! Finance
- 3-month T-bills: Cumulative total return based on compounding the yield of a 3-month T-bill at the start of each quarter. Data source: U.S. Treasury Daily Yield Curves
- Developed Country Stocks: Based on the price change adjusted for dividends of the iShares EAFE Index ETF (EFA). Data source: Yahoo! Finance
- 30-Yr Treasury Bond: Total return on purchasing on December 31, 2014 the 3.0% Treasury Bond due 11/15/2044 and holding it through December 31, 2015. Data source: Wall Street Journal
- Low-Rated Corporate Bonds: Based on the price change adjusted for dividends of the SPDR Barclays High Yield Bond Index ETF (JNK). Data source: Yahoo! Finance
- Emerging Country Stocks: Based on the price change adjusted for dividends of the iShares Core MSCI Emerging Markets Index ETF). Data source: Yahoo! Finance
- CRB Commodities Index: One-year return on the Thomson Reuters CoreCommodity CRB Commodity Index (CRY:IND). Data source: Bloomberg.com