



Artemis

FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Fourth Quarter of 2015

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Executive Summary

- **Global equity markets rebounded in the 4th quarter of 2015 after a severe rout in August and September.** The overall U.S. market increased by +6.3% and international developed markets returns were similar at +4.7%. Emerging market equities failed to rally, posting only a +0.7% increase in the quarter.
- Bonds had a more difficult quarter, largely due to the anticipation of a Fed hike in interest rates and investors rotating back to equities. We also experienced a fierce selloff in high-yield debt.
- **Returns were muted for the year in total. The overall U.S. market returned +0.4%, and this was largely due to the outsized returns of very few companies such as Facebook, Amazon, Netflix and Google.** In investing parlance, the market had very “narrow breadth.” Indeed, small companies severely underperformed larger companies, and value-oriented companies underperformed growth companies.
- **European and Japanese equities had a reasonable year in local currency terms, but due to the dollar’s strength U.S.-based investors saw little gain. Emerging markets had a terrible year, down -14.9%.**
- **2016 is off to a terrible start due to China’s clumsy management of its stock market, low oil returns, and a sinking feeling among investors that global growth is slowing.** With corporate profits declining in the U.S. and valuations fairly rich, the market seemed ripe for a correction, irrespective of news from China.
- **Despite recent volatility, things do look better on the other side of the Atlantic, in part because the European Central Bank is still easing, credit demand is sharply up, and manufacturing growth is robust.** The same cannot be said for emerging market countries which, in our view, are going to have another terrible year.
- **Strategy.** In this issue, we review the strategic moves we made in 2015 and how they played out, and we also discuss our positioning for 2016. We favor Europe and the U.S. over emerging markets, and favor a better balance between credit-sensitive and interest-rate sensitive debt. **We do not believe Treasury yields are going to increase much during the year and that the Fed is going to have a very difficult time increasing interest rates in the current environment.**

Quarter in Review

The 4th quarter of 2015 gave investors some respite as risky assets rallied nicely after August's and September's rout. The catalyst for the rebound was a surprise interest rate cut in China and the U.S. Federal Reserve delaying its own rate hike. Gains were capped, however, by speculation returning that the Fed would raise the Federal Funds rate in December, which it duly did by 25 bps (0.25%) on December 17.

Notwithstanding the Fed's move, the S&P 500 rallied by +7.0% during the quarter, and international developed markets increased by +4.7% in dollar terms. European returns were muted somewhat by disappointment with the European Central Bank's (ECB) tepid moves. Finally, emerging market equities failed to rally commensurately posting only a +0.7% increase over the quarter, in part due to the stronger U.S. dollar. See Figure 1.

Figure 1. 2015 Asset Class Returns in USD (%)

Asset Class	2015		Index
	Q4	Total Year	
Equities			
All Markets - Global*	4.9	(2.2)	MSCI ACWI IMI
U.S. Large Companies	7.0	1.4	S&P 500
U.S. Small Companies	3.6	(4.4)	Russell 2000
Int'l Developed Markets	4.7	(0.8)	MSCI EAFE
Emerging Markets	0.7	(14.9)	MSCI EM
Fixed Income			
All Segments - U.S.*	(0.2)	0.6	Barclay's U.S. Aggregate
U.S. Treasuries	(1.4)	1.6	Merrill Lynch U.S. Treasuries, 7-10 Years
U.S. Municipal Bonds	0.7	2.3	Merrill Lynch Municipal Bonds, 3-7 Years
U.S. Corporate	(0.6)	1.2	Merrill Lynch U.S. Corporate Bond
U.S. High Yield	(2.2)	(4.6)	Merrill Lynch U.S. High Yield Bond
Int'l Bonds	(1.2)	(4.6)	Merrill Lynch World Gov't Bond, Ex-U.S.
EM Bonds	1.4	0.8	J.P. Morgan USD Emerging Market Bonds
Real Assets			
U.S. Tips	(0.6)	(1.4)	Barclays Capital U.S. TIPS
Commodities	(10.5)	(24.7)	iPath Bloomberg Commodity
U.S. Real Estate Income	2.8	4.2	Fidelity Series Real Estate Income Composite
Int'l Real Estate	1.0	(3.8)	iShares Int'l Developed Real Estate

*Used to create Artemis portfolio benchmarks



Bonds had a somewhat difficult quarter, largely due to the anticipation of a hike in interest rates and investors rotating back towards equities. In December, we saw fierce selloff in high-yield bonds amid renewed weakness in oil prices, while U.S government bond yields rose only modestly despite the Federal Reserve raising the benchmark interest rate. In the U.S., only municipal bonds turned in a positive return.

Year in Review

2015 was dominated by central bank activity, mixed economic signals, and sudden bouts of volatility with little to show for it. For the first time since the financial crisis, U.S. corporate profitability declined during the entire year due to tepid global growth, a strong dollar, and low oil prices. The latter mainly affected the U.S. energy sector, especially the higher-cost oil and gas fracking producers.

With the U.S. market fairly richly valued at the onset of the year, the decline in earnings weighed heavily on market returns. While the S&P 500 managed to eke out a +1.4% return for the year, it was largely due to the outsized performance of very few companies such as Facebook, Amazon, Netflix, and Google (now call the “Fangs”). Many other sectors posted negative returns. Smaller companies (represented by the Russell 2000) also struggled, declining by -4.4% overall for the year. See Figure 1.

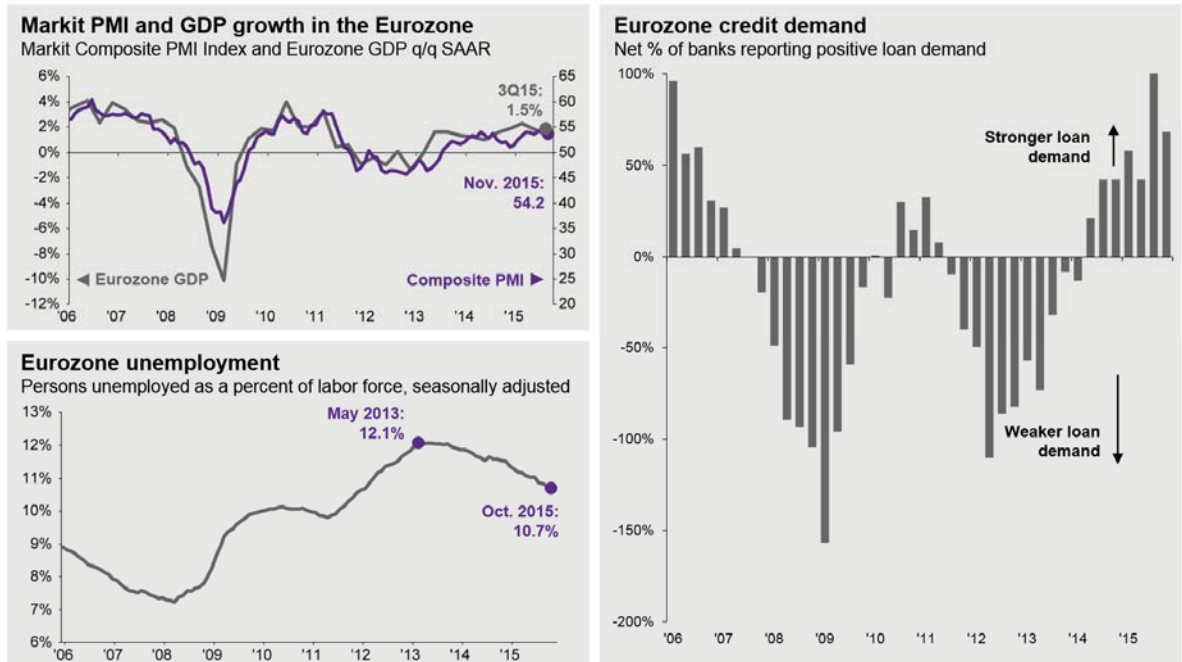
Europe had a better year. Euro-based investors (except U.K) saw the local market increase by +9.0% for the year, but due to the U.S. dollar’s strength, returns from Europe were only +0.1% for USD investors. Europe fared relatively well due to the ECB’s decision in early 2015 to implement its own quantitative easing program. This, plus a sharp easing in bank lending standards and pent-up demand, helped Europe to achieve modestly positive growth for the year. See Figure 2 (next page).

Low energy and commodity prices, declining growth in trade (and a few corruption scandals thrown in) took their toll on emerging markets, which collectively fell -14.9%. Brazil, South Africa, Russia and other commodity exporters in particular, had a terrible year. Basically, they were stuck between a rock and a hard spot of having to increase interest rates to stem the decline in their currencies, while needing to stimulate to keep growth from collapsing.

China didn’t help matters either when it intervened to stop the popping of the local market equity bubble and staged a “mini-devaluation” in the early fall, leading investors to believe that China was headed for a hard landing.



Figure 2. Indicators of European Recovery



Source: JP Morgan. Data as of 12/31/2015

The bond market was equally volatile and tripped up a lot of investors in 2015. The U.S. bond market barely budged over the year even as labor markets strengthened and the Federal Reserve raised interest rates for the first time in nearly a decade. The only real bright spot was municipal income due to favorable technical factors.

2016 Outlook

Needless to say, it has been a very rough start to 2016. While the proximate cause of this latest rout is the rapid decline in oil prices and China's clumsy moves to manage its stock market, the more fundamental cause is that the market simply does not believe the U.S. domestic and global economy is sufficiently strong to justify the direction the Federal Reserve is taking.

It's easy to see why this pessimism has developed. Very recent indicators are suggesting that the U.S. economy may have only grown by 0.5% in the fourth quarter, and inflation



readings are coming in very low. In addition, retail sales for December were flat, despite the fact that consumers have more money in their pockets due to job growth and low oil prices. Finally, the ISM[®] U.S. Manufacturing Index fell to 48.2 in December, its worst showing since 2009.¹ And if that is not enough, the high-yield debt market is strongly indicating that corporate health is deteriorating due to falling profit margins.

Things look a bit better on the other side of the Atlantic. Industrial production is on the rise, leading economic indicators are rising, profits are accelerating, and lending standards are easing. Moreover, the ECB's easing relative to the U.S. suggests that the euro is unlikely to increase any time soon. While Europe faces some very difficult longer-term issues such as poor demographics and high debt levels, which will constrain growth over the longer run, the region appears likely to have a decent 2016.

Europe also looks better from a valuation standpoint. European equities are relatively cheap, currently trading at a Shiller P/E (price-earnings ratio) of just 14, whereas U.S. stocks now trade at a Shiller P/E of 24. While P/E ratios are poor predictors of share prices in the short-run, they do suggest that European stocks are poised to outperform their U.S. peers in the next few years. The same can be said for Japanese stocks, although conditions are not as favorable as in Europe.

In contrast, emerging markets are highly likely to continue to be a trouble spot for investors in 2016 (and they are off to a terrible start so far this year). One big concern is the amount of debt taken on by companies in emerging markets. As a percentage of emerging market GDP, private sector debt is approaching 140% of GDP. As one analyst points out, reducing debt in a smooth and orderly manner is hard enough in advanced economies -- so imagine what might happen when emerging market countries need to get off the juice. (This is a key topic at the Davos conference that is underway as I write.)

And, of course, China is a wildcard. As has been well-publicized, Chinese policymakers are in the midst of transitioning the country to a new economic model, one that is less reliant on industry-led export growth and more reliant on services and domestic consumption. It's a tall order for any country to pull this off, and there are bound to be missteps along the way.

Quite honestly, nobody knows how long it is going to take for China to adjust and what the shorter-term effects will be on the global economy. What we do know is that industry-led

¹ The ISM is an index based on survey of more than 300 manufacturing firms by the Institute of Supply Management. It monitors employment, production inventories, new orders and supplier deliveries.



growth has reached rapidly diminishing returns in China as evidenced by the large-scale financing of very unproductive projects and the terrible impact rapid industrial growth has had on the environment.² As such, it is unlikely that China will do an about-face and massively stimulate its economy via rapid credit growth like they did in 2009. In brief, we cannot look to China to bail the rest of the world out of its slow growth slump. This is another reason why we think the slump in emerging markets is not going to turn in the short run.

The outlook for fixed income is changing rapidly. Credit spreads have widened considerably as rising leverage and declining profitability have damaged corporate balance sheets, especially in the energy sector³. The slump in profitability is particularly worrisome for corporate spreads, given the strong correlation between declining profit growth and rising default rates. All of this suggests that high-yield corporate and floating rate bonds are likely to have a tough 2016.

It is tough to argue at this juncture that U.S. interest rates are going to increase much in 2016. Deflationary pressures are building with the decline in oil prices and the strong US dollar, and wage pressures in the U.S. have yet to exert themselves. Interest rates are also subdued in large part because growth is so slow.

We believe the U.S. economy will struggle to grow above trend in 2016, limiting the Fed's ability to raise the Federal funds rate in a sustainably aggressive fashion and capping the upside risk for Treasury yields. In an interesting twist, should the Federal Reserve persist in driving up short-term interest rates, the dollar is going to continue to strengthen, which will increase global demand for Treasuries. On the other hand, if the Fed slows or even reverses its current strategy, it will be because global growth is too tepid to increase interest rates without fear of engineering a recession. If this happens, Treasuries are likely to continue their role as a "safe-haven" asset, with demand increasing commensurately. In short, either way, Treasury yields are likely to remain low.

² The PBS Newshour recently aired a segment on China in which they noted that between 2011-2013, China used more cement than the U.S. used in all of the 20th century.

³ The term credit spread refers to the difference between what corporations have to pay to borrow money and what the U.S. government has to pay. When spreads widen, investors are demanding a higher rate of interest to lend to companies as they perceive the risk of companies defaulting is on the rise.



Much more could be written about the outlook for 2016, but there is enough context here to shift gears and focus on the investment implications of how we think the global economy is going to unfold over the next year.

Artemis Portfolio Strategy

2015 Retrospective

It is always helpful and healthy to begin such a discussion by looking back at how our strategy played out in 2015. The year was a mixed one for Artemis portfolios. All portfolios continued to benefit from the absence of holding any commodities and energy-related investments such as Master Limited Partnerships, and we were fortunate not to have been swayed to buy gold as many started doing in the summer and fall as a hedge against equity risk. Our portfolios also continued to benefit from their strong reliance on municipal debt as their core fixed income holding.

The best change we made during the year was to aggressively reduce our (already underweight) exposure to emerging market equities and bonds. The former we reduced in stages during the year and the latter we exited completely in one swoop in the fall. While dollar-denominated emerging market debt did not have a terrible year in 2015, the asset class is taking a hard beating so far in 2016, so at worst we were a bit early with our exit.

I strongly believe the end of the debt supercycle for emerging market countries is approaching very fast and that it is going to get uglier before it gets better. Emerging market countries and companies have taken out an enormous amount of debt over the past decade -- but with little growth to show for it. The day of reckoning is approaching.

So what didn't go so well? By far the biggest detractor to portfolio returns was the stark underperformance of value-oriented U.S. stocks versus growth-oriented stocks, and the same sharp underperformance of smaller companies vs. larger companies. See Figure 3 (next page). Value-based investing seeks to invest in companies whose stock prices don't necessarily reflect their fundamental worth for a variety of reasons. Research has shown that over the long-run, the returns from value-oriented companies are higher on a risk-adjusted basis than those of growth-oriented companies. Hence, Artemis employs this so-called "factor tilt" (i.e., it tends to overweight value vs. growth versus a market-weighted benchmark) when constructing portfolios.

For similar reasons, Artemis also employs a small-company factor tilt in its portfolios. Investing in smaller companies is generally believed to be riskier than investing in large

companies as fewer survive, but over time, the returns from investing in this asset class have more than compensated for the risk taken.

This does not mean that in each and every year small companies are going to return more than large companies, or that value-oriented company returns will beat growth company returns. What it does mean is that on average, over time, they have and are expected to do so.

Figure 3. U.S. Equity Returns by Style, 2015

	Value	Blend	Growth
Large	-3.8%	1.4%	5.7%
Mid	-4.8%	-2.4%	-0.2%
Small	-7.5%	-4.4%	-1.4%

The other principal detractor to 2015 portfolio returns was our tilt towards credit-sensitive debt (e.g., high-yield and floating rate debt). As the name implies, high-yield debt pays the borrower a higher rate of interest to compensate him or her for lending to less-established, lower creditworthy companies. We felt this was a better place for some of our fixed-income exposure because the Federal Reserve was getting ready to start on the path of increasing interest rates, which would put downward pressure on interest-rate sensitive debt prices. This strategy did not play out as hoped in 2015; instead, credit-sensitive debt was negatively affected by the decline in oil prices and declining credit conditions overall. Interest-rate sensitive debt didn't have a great year either but came out better than high-yield. See Figure 1 again.

2016 Positioning

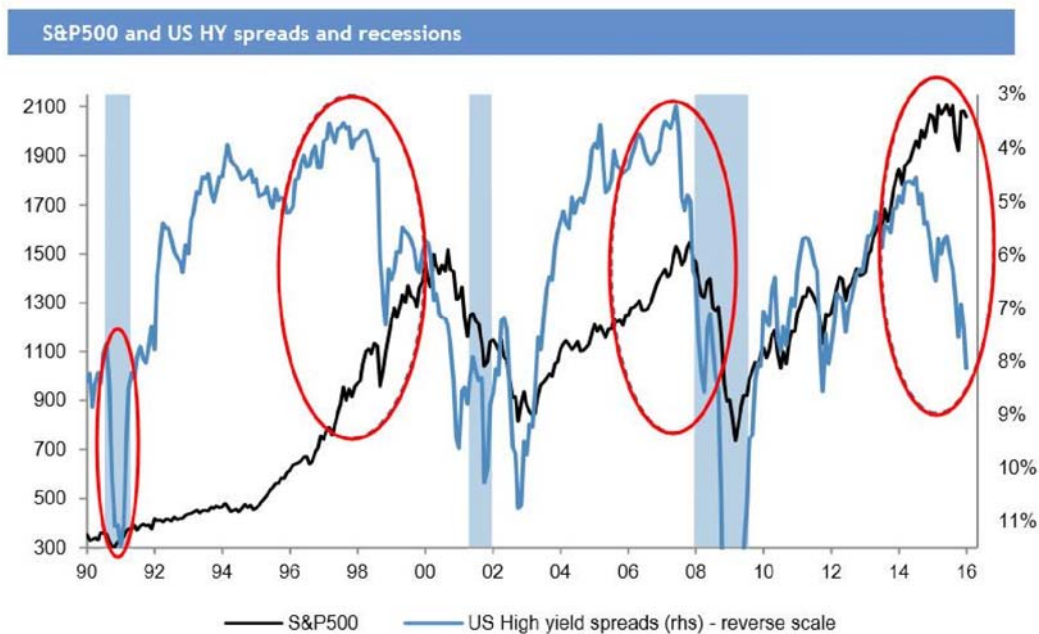


The first point to make is that we are staying fully invested during the market retreat that has been the big story in January 2016. Going to cash is nothing more than a recipe to enjoy permanent losses in one's portfolio. Moreover, we don't see flashing signals that we are embarking on a prolonged bear market, which usually coincides with a recession.

Recessions, in turn, are typically borne out of severe imbalances/bubbles forming in an economy. In the 1980s, we had a commercial real estate bubble and bust (some of you will remember this as the Savings and Loan Crisis). In the 1990s, the bubble in technology stocks presaged a recession, and the housing bubble helped fuel the 2008 Great Recession.

It is true that we have real issues brewing in credit markets right now and that, historically, rising credit spreads often indicate a coming recession. (See Figure 4.) I am concerned about this, but so far the problems with credit appear to be mostly concentrated in the energy sector and are not spreading to the broader universe.

Figure 4. S&P 500 and High Yield Spreads



Source: Doubleline, J.P. Morgan

As such, the only change we are making for the moment to is lighten up on high-yield and floating rate debt because we expect both to be highly volatile over the coming year, providing poor risk-adjusted returns. We are largely replacing this with municipal debt (and



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lengthening duration in selective portfolios). And we are taking the opportunity to harvest tax losses and eliminate orphan individual securities in some portfolios.

Going forward, our view is that U.S. stocks are going to have a tough year and will be lucky to see low single-digit returns. Key determinants of the path they will take include Fed policy, inflation, currency volatility and earnings/valuation.

In contrast, Europe is likely to do a bit better on a currency-hedged basis, but emerging markets are going to suffer even further, for all of the reasons discussed earlier in this report. Therefore, we are not planning to rebalance the very small emerging market equity position we have in most all portfolios and will not be buying any time soon (unless China does an about-face). We will be tweaking up our allocation to Europe and largely holding on to our overweight U.S. position. Europe and Japan have provided us with too many “head fakes” in recent years to make a more aggressive bet.

Finally, my own new year’s resolution is to tinker less with the portfolios than perhaps I have in the past. Returns are made by the big positioning decisions one takes, not the little moves. It’s probably the best lesson I have learned as a professional portfolio manager.