Introduction

As the first quarter of 2016 drew to a close, both equity and bond markets in the US were above levels seen at the start of the year. This, however, belies the extreme volatility experienced by investors during this period as fears of a US economic recession and a resumption of oil price declines rattled the markets from the very first trading day of the year. As the quarter progressed, stable economic data, a recovery in oil prices, and dovish central bank policies helped to stabilize and then give a boost to markets. Meanwhile, commodity prices eked out a small gain, led by a sharp rise in the price of gold as well as a March rebound in oil prices from the early 2016 sell-off.

The US stock market, as measured by the S&P 500 index, was up 1.3% as the quarter ended, after dropping 5.9% in just the first five trading days of the year, the worst start to a year ever. After an eventual decline of more than 10%, a late-quarter rally erased the early decline entirely. The Dow Jones Industrial Average rose by 2.2%.

Investors flocked to the safety of high-dividend telecom and utility stocks which led the way with gains of 16.6% and 15.6% respectively. The more volatile Russell 2000 index of small-cap stocks was unable to make up for the early decline, dropping 1.5% in the first quarter, although boosted by a rally of nearly 8% in the month of March. The MSCI-EAFE index of stocks in developed international markets likewise was unable to shake off the early 2016 drop and returned negative 2.9%, although making up for some of the early damage with a 6.6% rally in March. Stocks in emerging market countries fared much better, rising 13.2% in this last month to end the quarter up 5.7%, beneficiaries of a weakening US dollar that makes it easier to meet debt obligations that are denominated in US dollars. The early 2016 flight-to-safety resulted in a 3.0% increase in the Barclays US Aggregate bond index, helped in part by the Federal Reserve signaling that a rate increase was off the table for the first quarter and that rate increases, in general, likely would be at a slower pace than many investors had anticipated. This resulted in the bellwether 10-year US Treasury yield falling back below 2%, ending the quarter at 1.79%. During this time, the Bloomberg commodity index managed a slight increase of 0.3% as a 16.5% rally in gold pushed the index into positive territory. A relief rally in oil after a steep drop early in the year increased the price of light crude by 3.5% to $38.34/barrel.

Looking ahead, the US economy continues to show modestly positive growth. The Fed is maintaining a data-driven approach to policy decisions but has indicated that interest rate increases likely will be made at a more measured pace and over a longer period of time than originally thought. At the same time, most other central banks are moving in the opposite direction, with negative interest rates becoming policy outside of the US. We are now 7 years into a bull market for US stocks, one of the longest on record, and we maintain that investors should temper growth expectations for this asset class, although we have not changed our view that there is greater return potential from equities than from bonds, and even more so with the recent rally in bonds. The rally in oil was losing momentum by quarter-end, and it is difficult to see the catalyst for substantial near-term price increases since thus far producers have been reluctant to cut global production and any price appreciation is apt to be met with additional supply.

1st Quarter Review

Performance Summary

Total Returns & Values for Selected Assets as of 3/31/16

	1Q 2016	YTD Return	Price / Value
Dow Jones Industrial Average	2.2%	2.2%	17,685
S&P 500 Index	1.3	1.3	2,060
Russell 2000 Index	-1.5	-1.5	1,114
MSCI EAFE Index	-2.9	-2.9	6,196
MSCI EM Index	5.8	5.8	1,735
Barclay's Capital US Aggregate	3.0	3.0	106
Barclay's Capital Municipal Bond	1.7	1.7	110
FX Rate – US$ per Euro	4.9	4.9	1.1
Gold – Continuous Contract	16.5	16.5	$1,236
Light Crude Oil – Continuous Contract	3.5	3.5	$38

Source: Factset

Economy

The US economy remained stuck in a mid-1% rate of growth in the first quarter, although fears of recession prevalent in the winter months abated by quarter-end. Failure to improve on the fourth quarter's 1.4% annual rate of growth was surprising given the rapid gains in disposable income that are accruing to consumers. Hiring trends remained healthy as evidenced by the 632,000 jobs created during the quarter, and wages continued their steady ascent, with average hourly earnings rising 2.3% over the past year. While oil prices seemed to bottom in mid-February, gas and energy prices remain low. Nonetheless, consumers chose risk-averse behavior during the quarter, with negative retail sales numbers in both January and February as individuals drove the savings rate to a one-year high of 5.4%.

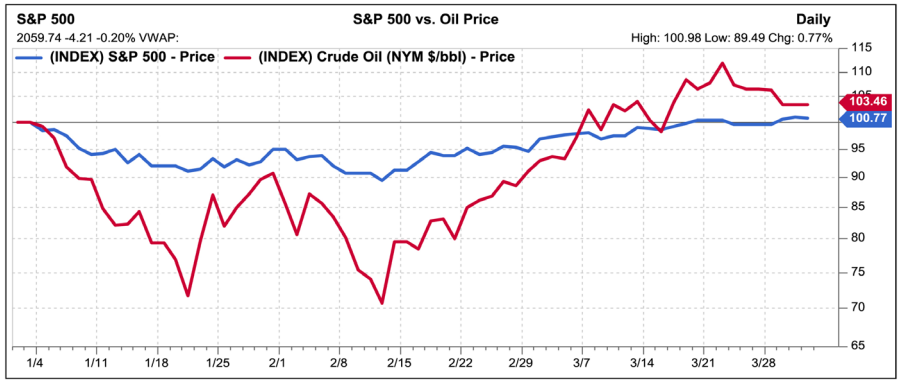
Outside of the consumer sector, dollar strength early in the quarter took its toll on manufacturing. Continuing the trend established in the fourth quarter, the Institute for Supply Management's (ISM) manufacturing survey contracted for five straight months through February before rebounding in March after a period of dollar weakness following the surprisingly dovish Fed meeting. Durable goods orders likewise were weak as well, posting negative rates of growth in three of the past four months. More domestic measures of industrial activity such as construction spending and industrial production also pointed to weakness. Despite low mortgage rates, housing's contribution to growth was inconsistent, as existing home sales collapsed in February at the same time housing starts rebounded from weakness in December and January.

Despite the inconsistent data, much of which can be explained by the warm start to the winter (which impacted apparel sales) and the January snowstorm (which snarled the populous northeast corridor), we expect the economy to improve over the balance of the year. While one month is hardly a trend, the March ISM manufacturing survey showed broad-based strength, including the forward-looking new orders component. The regional Fed industrial surveys heading into the national ISM release showed improvement concurrent with the reversal in the value of the dollar. The halt to the dollar rally coincided with the Fed meeting, which projected a much slower path of tightening than it did as recently as December. Equity markets and other "risk assets" rallied considerably, which should serve to underpin consumer confidence, going forward, through the traditional "wealth effect".

While the path of the dollar and supportive Fed policy are cyclical tailwinds, labor market advances and marked improvement in the consumer's balance sheet should provide the fuel for a more durable spending environment moving forward. Stock market gains are nice but disproportionately benefit the affluent who do not necessarily augment their spending as the markets rise. Those whose spending could be more additive to consumption growth are lower-wage workers who are more dependent on a stable paycheck than capital gains. The fact that the economy continues to create jobs concurrent with an increase in the labor participation rate is a huge positive. Layoffs as measured by initial jobless claims recently touched a 15-year low of 253,000 in early March. The elevated savings rate can be thought of as dry powder that may be deployed as confidence continues to improve, which we believe will be the case in time. As a result, we forecast a low 2% annual rate of growth to prevail over the balance of the year, with above-average volatility as we head into the 2016 presidential election.

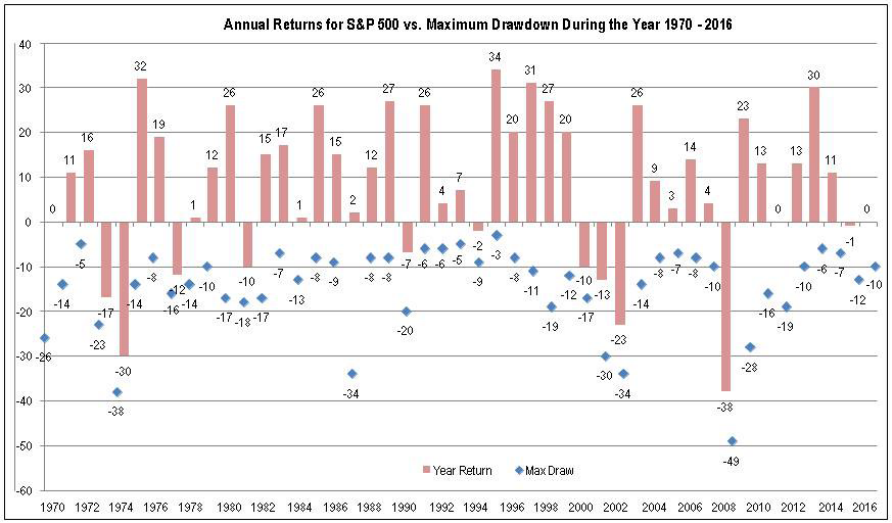
Equities

After the new year began, investors adopted a glass half-empty viewpoint, one we did not share. Recession and credit-risk concerns mounted due to slower growth in China, rapidly declining oil prices and a strong US dollar. As evidence of this concern, the US markets had their worst start to a year, with the S&P 500 declining 10.5% by February 11th while billions of dollars flowed out of US equity mutual funds. This left US large cap stocks declining to levels they reached last summer when the Chinese equity markets began their swoon as the yuan was allowed to decline modestly. Small-cap US stocks fell further to a loss of 16% by the market low as investors reduced their appetite for the richer valuation commanded by this segment. Developed international markets as measured by the MSCI-EAFE index bottomed out after a 15.5% drop. Per the chart below, as oil rebounded and recession risks abated in the second half of the quarter, equity markets rebounded and recovered all or most of their declines.



Source: Factset

While quick and sharp market corrections are unsettling, and the volatility may well continue throughout 2016, it is important to maintain a healthy perspective and remember that this is a normal event. Since 1970, the S&P 500 has increased in 33 of the 46 years with a median annual appreciation of 12%. In every one of these 46 years, the market experienced a drawdown from its peak; while some were more significant, the median magnitude of the decline was 13% within a range of 3% to 49%.

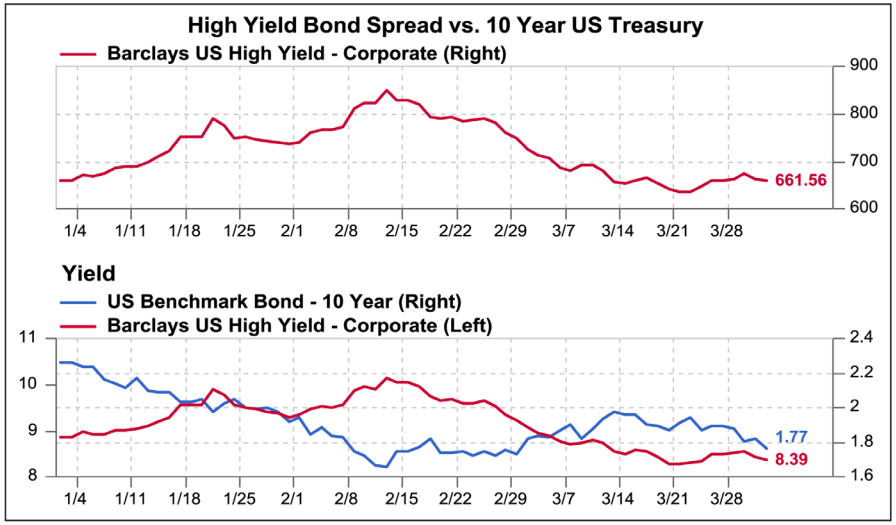


Source: Factset, 1919 Investment Counsel

While the Chinese transition to a consumer-based economy is ongoing, it is proceeding at a much slower pace than necessary to maintain the rapid growth contribution to the global economy upon which the world had come to depend. China's burden of an excess supply of housing and factory capacity will continue to act as an economic drag. Related to this slower growth in China is the excess global supply of oil and gas. While certain market participants, especially in the US, have reduced the number of oil rigs in operation by 72% since the October 2014 peak, the global inventory of oil and gas continues to rise. With the advent of Iranian oil returning to the energy markets as US and European sanctions were lifted, Saudi Arabia fought to maintain market share even as prices fell. Given Iran's great need for capital and the current geopolitical tensions with the Saudis, it seems unlikely that this source of supply pressure will decline in the near future.

The ramifications of sharply lower oil prices likely will determine the path of US and global equity markets in the near-term. There is a natural conflict between the stimulative and dampening effects from these acute price declines. Weak oil prices have caused a dramatic reduction in capital spending plans for energy-related projects which have contributed to a manufacturing slowdown. Oil companies and their suppliers are rushing to right-size labor forces, cutting 320,000 jobs globally, according to Graves & Co. On the positive side, significantly lower energy prices are an important new source of disposable income for consumers. For each one penny decline in the price of gasoline, US households save over $1 billion combined. The Energy Information Administration currently forecasts the average price per gallon of gasoline will drop to $1.89 in 2016 from $3.36 in 2014. This implies $147 billion of additional income for households to spend in other areas.

In addition to instilling fear in the equity markets, declining oil prices increased concerns for investors in high-yield bonds. The impaired ability of some energy companies to service their debt or access the markets to fund capital spending raised the required level of compensation to attract willing lenders. The energy sector was the primary focus of the fear, but yield spreads widened across many sectors of the high-yield bond market. The current spread of high-yield bonds to US Treasuries, while still elevated at 662 basis points, is down from the recent peak of 850 and well below the levels of the 2008-2009 crisis. Although the peak risk spread seems to be behind us, it merits watching as an expanding credit event could throw the US economy into a recession. This is not our expectation and we are of the belief that there continue to be powerful positive drivers for the US economy.



Source: Factset

Our view is that the US is on a path to improving GDP growth led by real personal income growth and the associated boost to consumer confidence and spending. It is this positive view of the economy that leads us to our positive outlook for US equities. As is often the case, there are combinations of headwinds and tailwinds affecting the US economy and equity markets.

Economic and Market Drivers

Tailwinds	***Headwinds***
Improving Real Personal Income	Slowing Global Growth
Low Inflation	Aging Demographics in Developed Markets
Low Energy Prices	China Over Investment
Low Mortgage Rates	Higher US Equity Valuations
Household Formation Increasing	Reduced Capital Spending in Energy
Accomodative Central Banks	

The healthcare sector continues to deliver attractive growth, albeit with some risks in this area from the upcoming election cycle. We look for companies that provide cost-reduction solutions or compelling new product pipelines. The US consumer should continue to benefit from falling energy prices and an improving labor market, and this view leads us to companies in the Consumer Discretionary sector focused on home improvement, household durables, auto components and retailing.

As we look forward in 2016, we anticipate oil prices stabilizing as supply contracts and reaches equilibrium. The continuing earnings drag from declining energy prices and a stronger US dollar should abate as the year progresses. This will allow for a rebound in earnings growth in 2016 with the S&P 500 operating earnings growing close to 20% from the depressed results in 2015. We look for revenue growth of around 4% after declining 3% in 2015. After this rebound, earnings will only have grown at total of 6% over the last two years. We expect a mid single-digit total return for US equities in 2016 as economic growth remains positive but modest. Outside the US, accommodative central bank policies remain the norm in order to reach a desirable inflation level. While the valuations in emerging markets stocks are intriguing, we continue to prefer US equities until dollar appreciation abates and energy markets show clear signs of stabilizing. We expect China will continue on its path towards a consumer-based economy, and this transition will remain coincident with a slowdown in the rate of growth there.

On the geopolitical front the increased tensions with Russia, widening terrorist threat, rise in populism and protectionism across the globe all continue to merit concern.

We expect the higher volatility witnessed in the first quarter to persist at least throughout the first half of 2016 as uncertainty about global growth, upcoming US elections, and volatile energy prices weigh on investor confidence. We believe that the improving strength of the US economy is supportive of investor confidence and equity prices.

Fixed Income

After a tumultuous start to the year, the Barclays Aggregate Bond Index managed to string together a very respectable 3.03% return for the quarter. Risk assets staged a remarkable reversal beginning in mid-February, carrying through March, to post extremely solid numbers. Lower-quality corporate bonds and longer-dated securities generated the highest returns as recession risks moderated, central banks acted accordingly, and oil prices rose. With negative interest rates elsewhere in the world, the US proved to be the beneficiary of capital seeking positive yields.

Not surprisingly, high-grade spreads retraced much of the widening that had taken place since the end of last year. In addition to the global rotation into credit, flows into fixed income mutual funds and ETFs were constructive in boosting demand for corporate bonds. Despite heavy new supply, the technical picture reflected one of too much money chasing too few bonds. Between mergers and acquisitions continuing to drive the need for debt and capital flowing away from negative rates, the demand/supply imbalance tilted favorably toward investment-grade bonds. We believe this dynamic will continue for the next several months.

Within the tax-free bond space, municipal bonds underperformed the taxable market, although the 1.7% quarterly return for the Barclays Municipal Bond Index was solid on an absolute basis. Supply remains subdued, as 12% fewer bonds were sold through March compared to last year's pace. Somewhat surprisingly given the low prevailing level of interest rates, flows into municipal mutual funds remained positive, which underpinned demand in a supply-starved market. Traditionally, tax season is a period of weakness for the tax-free bond market as individuals liquidate holdings to pay taxes. While we saw this behavior late in the quarter, it seems there is enough pent-up demand to support the market and dilute the traditional calendar year patterns.

While trading volumes within the taxable market could hardly be considered robust, they do not appear to be as thin as they were in the latter half of 2015. Despite a persistence of low inventory on the part of dealers, the healthier demand from overseas investors has helped to improve liquidity. With the increase in risk appetite, lower-quality credits may offer some value, as we believe spreads still have room to tighten. We also believe that a flatter yield curve remains the right call, which supports the barbell strategy we have been advocating for some time.

We are mindful, however, that inflationary pressures are rising. While the Fed's decision to pause its tightening campaign in March was not a surprise, the sharp downward adjustment to its forecasted pace of rate increases did raise a few eyebrows. The risk is that the Fed falls behind the inflation curve, which would in time cause yields on longer maturities to rise and force the Fed to respond by more aggressively raising short-term interest rates. At this point, however, we agree with the Fed's assessment that the risks of a policy mistake are asymmetric. It would be easier to raise rates to curb inflationary pressures than it would be to provide additional stimulus to the economy with interest rates already low and little meaningful fiscal policy to support growth. That being said, we are mindful of the impact of inflation on fixed income returns and remain committed to a conservative duration stance given the low prevailing yields on longer-dated bonds.

Commodities

The first quarter provided some relief for beleaguered commodity markets. After five consecutive years of declines, commodity markets, as measured by the Bloomberg Commodity index, rose a slight 0.34%, helped into positive territory by a March rally of nearly 4%. Oil, the largest component of the index, rose 3.5% to end the quarter at $38.34/barrel, after a strong March rally. While this recovery in oil prices was a welcome relief, it followed a sharp decline of nearly 30% in the first half of the quarter amid the turbulence in the equity markets. After hitting a low of $26.04 in mid-February, the commodity rallied as high as $42 in late March before the rally seemed to lose steam. There was good news in the gold market as the metal rallied a surprising 16.5% after three straight years of declines, with most of the increase coming early in the quarter. This was the largest quarterly increase for the metal since the mid-1980s which seemed to be driven by its role as a safe haven, as well as that of an inflation hedge amid talk of negative interest rates and a weaker US dollar.

As 2016 continues, we believe relatively weak global economic demand will keep a lid on commodity prices, especially in light of ample supply. Major oil producers seem unlikely to freeze output, especially in the Middle East as Iran continues to ramp up production subsequent to economic sanctions being lifted. At the same time, optimistic data in the US and calmer markets already have dampened the price of gold from the first quarter rally. Additionally, a resumption of interest rate hikes at some point by the Fed should result in further US dollar appreciation, meaning commodities that are priced in US dollars will be more expensive to buyers overseas. We remain underweight this asset class.

Conclusion

In summary, we maintain our view that the US economy will continue to experience growth of slightly above 2% this year, on the low range but still positive. After the drop in the 10-year Treasury yield earlier this year, we now expect the benchmark to reach only the mid-2% range by the end of 2016, above its current 1.7% level, but held in check by low inflation and weak growth outside of the US. Because of this economic outlook, we continue to favor stocks over bonds but would not be surprised if the volatility we witnessed early in the first quarter continues throughout the year. At this time, our preference is for US stocks relative to international ones due to better growth prospects, at least until oil prices stabilize and dollar strength abates. We remain neutral to US small-cap stocks. Our muted enthusiasm for bonds continues to be due to the lack of return potential in this low interest rate environment. Likewise, with overall global growth at relatively tepid levels and the prospect of ongoing oil market volatility, we continue to be underweight commodities.