Introduction

Happy New Year! As 2015 drew to an end, US equity markets finished the year very close to where they began. While that may sound like a fairly benign outcome, it understates the dramatic swings that characterized the year. Unlike in other parts of the world, the US economy appeared to be on sound enough footing to give the Federal Reserve the confidence to increase interest rates for the first time since the period before the financial crisis. Meanwhile, commodity prices plunged, led by oil, resulting in sharp declines in energy stocks and high-yield bonds.

Stock markets in the US, as measured by the S&P 500 Index, were narrowly positive in 2015, rising 1.38%. However, if the benefit of dividends were excluded, the index actually dropped for the year, the first decline since the end of the financial crisis. These results also mask the fact that only a narrow group of stocks did well, with at least a third of the stocks in the index down more than 20% from their highs at year-end. Including dividends, the Dow Jones Industrial Average rose by only two-tenths of a percent, a return that also would have been negative without that income component. Given the steep drop in oil prices, it should come as no surprise that energy stocks lagged all other sectors this year, dropping by more than 20%, while consumer discretionary stocks led the way with a gain of 10.1%. In all, 5 of the 10 S&P 500 sectors were down for the year. The more volatile Russell 2000 Index of small-cap stocks dropped 4.41%, with more than half of those stocks down at least 20%. The MSCI-EAFE index of stocks in developed international markets was down only 0.39%, but stocks in emerging market countries did not fare as well, falling 14.6%. Investors feared that a strong US dollar and weak global growth would make it difficult for emerging countries with dollar-denominated debt but local currency income to meet obligations. These economies also depend on income from exporting raw materials, which have come under pressure as well. Despite the Fed increase, investors were not ready to flee the safety of high-quality bonds. The Barclays US Aggregate Bond Index managed to eke out a 0.55% gain for the year, after a slight drop of 0.57% for the quarter. Sluggish growth in many of the world's economies and an excess supply of oil combined to hammer the Bloomberg Commodity Index by 24.7% with oil sinking to $37.04/barrel, losing almost a third of its value during the year.

At the onset of 2016, the US economy continues on a path of modestly positive growth. The Fed has indicated it will be closely following data as a guide to policy but likely will embark on a period of gradual rate increases. At the same time, most other central banks are working in the other direction. Now that the bull market in US stocks is the longest since the 1990s tech-driven era, investors may have to temper expectations for outsized returns from this asset class, although there is greater potential from equities than from bonds. While we believe oil prices will stabilize, it is hard to see the catalyst for a substantial increase in prices in the near future since thus far producers have been reluctant to cut production for fear of losing market share to competitors, and any price increase likely will be met with additional supply.

4th Quarter Review

Performance Summary

Total Returns & Values for Selected Assets as of 12/31/15

	4Q 2015	YTD Return	Price / Value
Dow Jones Industrial Average	7.7%	0.2%	17,425
S&P 500 Index	7.0	1.4	2,044
NASDAQ Composite	8.7	7.0	5,623
Russell 2000 Index	3.6	-4.4	1,136
MSCI EAFE Index	4.7	-0.4	6,379
Barclay's Capital US Aggregate	-0.6	0.6	103
Barclay's Capital Municipal Bond	1.5	3.3	109
FX Rate – US$ per Euro	-2.7	-10.2	1.1
Gold – Continuous Contract	-4.9	-10.5	$1,060
Light Crude Oil – Continuous Contract	-17.9	-30.5	$37

Source: Factset

Economy

The economy's year-end performance was in line with recent experience, as growth failed to meaningfully improve from the 2% annual pace seen in the third quarter. Consumption continues to be the bright spot, buoyed by an environment of improving wages and lower gas and energy costs. Retail sales, excluding autos and gas purchases, surged 7.9% during the Thanksgiving-to-Christmas shopping season, building on the increase in personal consumption evidenced in the third quarter's GDP report. While lower oil prices help, further improvement within the labor market is even more important since it buoys confidence and encourages purchases of larger ticket items such as autos. Non-farm payrolls jumped over the first two months of the quarter, consistent with the heady pace from earlier in the year, and eased concerns following a brief summer lull. Auto sales responded accordingly, as a strong December pushed sales above 17.5 million in 2015, breaking the previous record from 2000.

The positive trends within retail should continue as we transition to 2016. Gas prices continue to fall and initial jobless claims, the most accurate and timely measure of labor conditions, remain comfortably below the 300,000 level that has persisted since February. We are mindful, however, of the negative impact the recent uptick in mergers and acquisitions could have on the labor front, as evidenced by DuPont's announcement of 1700 layoffs following its merger with Dow Chemical. The fallout from the plunge in oil prices likewise will take its toll on the nation's energy complex, where recent employment gains related to hydraulic fracturing and other methods of energy extraction will certainly reverse.

Nonetheless, we see the recent momentum as sufficient to overcome the persistent headwinds that kept the economy from operating at the pace of growth you would expect from the employment and consumption data. We view the Fed's December 16th rate increase positively as it begins a process of normalization and implies confidence in the economic outlook. However, the downside of the Fed's action is that it will solidify and perhaps intensify the recent appreciation of the US dollar versus many of its trading partners' currencies. A stronger dollar negatively impacts export-oriented manufacturers, who had a terrible year in 2015, as US goods became more expensive and less competitive for cautious global consumers. We expect manufacturing will continue to struggle as the Fed's tightening policy runs counter to easier monetary strategies employed by our major trading partners. Continued soft demand from China and a downturn in Europe would reinforce these problems.

Capital spending within the energy sector also will detract from growth, as it did in 2015, barring a meaningful rise in oil prices. This seems unlikely given Saudi Arabia's quest to flood the market with supply to drive out the higher-cost producers, many of whom reside in the US. While the diminishing impact on growth from energy-infrastructure capital spending is meaningful, the lower energy costs are accretive to consumer spending and in time we believe will be a net positive for the aggregate rate of growth within the US. Also, we believe housing activity will be a net contributor to growth since the Fed is apt to tread lightly with rate increases and pause at any sign of trouble. We expect further labor improvement, especially among the younger generations who drive household formation, to counter a modest deterioration in housing affordability due to slightly higher mortgage rates.

In aggregate we expect the low-2% pace of growth will prevail this year with similar trends driving the economy's performance. While the onset of tighter monetary policy would normally be cause for concern, we believe the "dovish-leaning" Fed is aware of the risks and that more properly priced credit will actually revive banks' willingness to make loans. The risk to our forecast is that the recent employment improvement does not hold and manufacturing's woes deepen with a further global slowdown, which negatively impacts consumption and housing. We deem this unlikely and believe trend growth seems like the right forecast for the coming year.

Equities

2015 was a lackluster year for US equity investors, with the S&P 500 only returning 1.38% for the year, inclusive of dividends. Other US market indices fared less well, with the Dow Jones Industrial Average gaining only 0.21% and small-capitalization US stocks falling by 4.4%. Outside the US, returns for markets in developed economies were impacted by the strong dollar. In local currency, the EAFE index rose 5.3% but fell 0.39% when measured in dollars.

The equity market headwinds experienced across developed markets were particularly challenging for emerging markets. An appreciating US dollar, falling commodity prices, and anemic global trade pressured these markets, which luckily were offset by declining inflation and stable consumption, allowing for a market decline rather than a collapse. In dollar terms, emerging market equities declined 14.9%, led down by Latin American markets that fell by 31%. The strong dollar was a large factor in these declines. When measured in local currencies, emerging markets fell by only 5.8%.

Equity markets spent the first half of 2015 in a very narrow range with little volatility. As the 3rd quarter approached, concerns rose of a global slowdown emanating from China and were reinforced by the Fed's decision not to raise rates in September. The S&P 500 declined by 12.3% from its May 21st peak to the bottom reached on August 25th, a correction not experienced since 2011. By the end of September, the S&P 500 was down 5.3% for the year.

Source: Factset, 1919 Investment Counsel

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The 4th quarter brought relief as all sectors of the market recorded positive returns, with materials and healthcare stocks leading the way. The continued weakness in oil and gas prices led to capitulation by many investors for a near-term price recovery. This shift impacted the industrial sector as capital spending plans by energy-related businesses were reduced significantly. For the year, consumer discretionary stocks led the market, driven by the meteoric 118% rise of Amazon stock and an astonishing 134% increase in Netflix. These high-expectations companies are now priced at 356x and 557x their respective earnings.

Similar to 2011, positive returns for the S&P 500 were driven by a small handful of companies like Amazon and Netflix. As outlined in the following table, excluding only the five biggest contributors reduced the index return to -1.3% for the year. Were you to eliminate the top 25, the return would decline to -3.4%. This level of performance concentration is unusual but is similar to the 2011 environment when investors focused on contagion risks from the European sovereign debt crisis and the credit downgrade of US Treasuries. We do not expect this narrow market to persist throughout 2016 and are wary of stocks with lofty valuations.

	*2015**	*2014*	*2013*	*2012*	*2011*	*2010*	*2009*	*2008*	*2007*	*2006*
S&P 500 Return	1.4	13.7	32.4	16.0	2.1	15.1	26.5	-37.0	5.5	15.8
Top 5	2.6	2.7	2.9	2.8	2.3	2.9	5.8	0.5	2.8	3.5
Top 10	3.4	3.9	5.2	4.3	3.4	4.3	8.7	0.6	4.1	5.3
Top 25	4.8	6.3	9.9	7.1	5.1	7.2	13.5	0.7	6.7	9.1
Less Top 5	-1.3	11.0	29.5	13.2	-0.2	12.2	20.7	-37.5	2.7	12.3
Less Top 10	-2.1	9.8	27.2	11.7	-1.3	10.8	17.8	-37.6	1.4	10.5
Less Top 25	-3.4	7.4	22.5	8.9	-3.0	7.9	13.0	-37.7	-1.2	6.7
Top 5 as % of total	191%	20%	9%	17%	109%	19%	22%	-1%	50%	22%
Top 10 as % of total	249%	28%	16%	27%	159%	28%	33%	-2%	75%	34%
Top 25 as % of total	349%	46%	30%	44%	244%	48%	51%	-2%	121%	58%

Combines Alphabet (Google) Classes A & C into one

Source: Factset, 1919 Investment Counsel

We maintain our positive outlook on stocks within the financial sector as improving economic activity and rising interest rates should lift profits for banks. The healthcare sector continues to deliver attractive growth, albeit with an increased valuation, and we look for companies that provide cost-reduction solutions or compelling new product pipelines, while recognizing some risk from the upcoming election cycle. We continue to expect the consumer to benefit from falling energy prices and an improving labor market and do not believe that an increase in interest rates will overwhelm these powerful economic stimulants. This view leads us to favor companies in the consumer discretionary sector focused on home improvement, household durables, auto components and retailing.

At the end of 2014, analysts estimated earnings for companies in the S&P 500 to grow by 16%, although this forecast declined rapidly in early 2015 as oil prices fell and the dollar appreciated. Currently, 2015 operating earnings for the S&P 500 are estimated to decline by 5.9%. If energy is excluded, this number jumps to a positive but modest 5.6%. We anticipate oil prices stabilizing and the earnings drag from declining energy prices and a stronger dollar abating as the year progresses. This should allow for an earnings growth rebound in 2016 close to 10%. Not all of this earnings increase will translate into price appreciation as some continued P/E multiple compression is consistent with a Fed tightening cycle, but it should imply a mid-single digit return for US equities.

Outside the US, any signs of increased inflation in Europe may put further QE on hold. However continued US dollar strength may be a headwind to returns for domestic investors. While the valuations in the emerging markets are intriguing, we continue to prefer US equities until dollar appreciation abates and energy markets show 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. However, the Chinese consumer has importantly demonstrated resilience in the face of slowing growth and Chinese equity market turbulence. This is an important positive sign for multinational companies like Apple who depend heavily on the continued Chinese appetite for new products. As China moves forward with its transition, policy and politics will play an important role in the delicate balance with growth. If the US dollar were to strengthen further, Chinese leaders would probably feel compelled to again allow the yuan to devalue, causing additional pressure on emerging markets.

Other areas that we are watching in 2016 include the path of the Fed tightening cycle and the impact on emerging markets. On the geopolitical front, the increased tensions with Russia, widening terrorist threats, and a rise in populism and protectionism across the globe all merit concern. In the first half of 2016, we expect higher volatility across global equity markets as uncertainty over global growth, central bank policies, elections and energy prices weigh on investor confidence. However, given the backdrop of rising rates and a strong US dollar, we believe that domestic equities currently offer the best relative return potential even if it is only a mid-single digit result.

Fixed Income

Fixed income returns were quite disparate in the fourth quarter and for the year as a whole, as taxable bond performance was lackluster while municipal bonds recorded some of the best returns within the entire capital market complex. Slightly higher Treasury yields coupled with weakness in the corporate bond sector to drive a loss in the Barclays Aggregate Bond Index, a proxy for the investment grade taxable market, of 0.60% in the fourth quarter. For the year, the index barely finished in the black, posting an annual total return of just 0.55%. Conversely, buoyed by a late-year reduction in new issuance and continued inflows into mutual funds, tax-free bonds performed extremely well, surging 1.50% in the final quarter alone and 3.30% for the year as measured by the Barclays Municipal Bond Index.

The big headline for all credit markets was the Fed's long-awaited 25 basis point rate increase at their December meeting, following seven years of a zero-percent interest rate policy. The Fed went to great lengths to communicate its intentions, since this was to be the first rate increase in nearly ten years, so price movements and volatility within the bond market were subdued in its aftermath. As the Fed began the process of normalizing short-term rates, ten-year Treasury yields drifted a quarter percent higher during the fourth quarter, ending the year at 2.27%, not far from the 2.17% level that prevailed a year earlier. While the Fed directly impacts movements in the shortest maturities, inflation expectations play a larger role in longer dated bond yields. As oil and commodity prices collapsed, headline inflation data produced little to fear, especially in an environment of continued modest wage gains. While of late the core CPI showed signs of life, the Fed's preferred measure of inflation, the core PCE, remained entrenched at a 1.3% annual rate for the entire year, well below the Fed's 2% target. With pricing power difficult to come by, Treasury bond yields remained relatively well behaved compared to what you would normally see early in a Fed tightening cycle. We expect this to continue, although we do anticipate ten-year yields to slowly grind toward 3% next year, and will look to extend our below-benchmark duration on any meaningful rise in interest rates.

Unfortunately, the corporate bond sector, which has been extremely additive to returns over the past few years, buckled somewhat approaching year-end. After narrowing for years due to investors' insatiable quest for income in a yield-starved world, credit spreads widened significantly in 2015. While fixed income mutual fund outflows was the main culprit, credit rating downgrades outpaced upgrades by a ratio of 2:1, a sign of overall credit deterioration. Although much of the carnage was focused within the energy complex, we agree with forecasts that expect the corporate default rate to reach 3.3% by late next year versus 2.5% currently. While we consider the blocking of redemptions by Third Avenue's Focused Credit Fund to be an extreme example of illiquidity and more specific to the junk bond space, the Office of Financial Research within the US Treasury concluded that the recurrence of such an event is likely. With the possibility that poor liquidity and volatile

conditions could increase within the sector in 2016, we favor our current strategy of staying in high-quality securities and will continue to trim our overweight to corporate bonds in coming months.

Municipal bonds, on the other hand, are benefitting from enhanced demand from investors. After-tax returns for individuals in the top tax brackets are well above what is available in the taxable market of comparable maturity and quality. While the taxable bond funds saw widespread redemptions and net selling from foreign central banks, municipal bond funds enjoyed inflows for twelve straight weeks through year-end, including the most in any week during the week ended December 11th. At the same time, the overall size of the market is shrinking. According to Bloomberg, net issuance was negative in 2015 for a fifth straight year, as more bonds are called away and mature than are sold. The result is a somewhat pricy market in our opinion. Given our anticipation for modestly higher interest rates next year and an uptick in issuance as more deferred infrastructure projects come online, we have been focusing on shorter maturities of late and will look to augment income streams next year as better opportunities arise.

Commodities

The 2015 rout in the commodity markets continued in the fourth quarter as declines in oil and gold prices contributed to a multi-year retrenchment in this asset class, which dropped for the fifth consecutive year. The Bloomberg Commodity Index finished the quarter down 10.55%, bringing the year-to-date return to a negative 24.7%. Investors remained concerned that waning economic demand, as a result of slowing global growth, would put further downward pressure on commodity prices. Oil, the largest component of the commodity index, ended the year at $37.76/barrel, a drop of 30.5% in 2015 and more than 60% in just the last two years. Surprisingly, despite the sharp decline, supplies surged as producers did not want to lose market share to competitors. Iraq came back online with oil, Saudi Arabia vowed to provide enough supply to meet increases in oil demand and, as recently as last week, OPEC confirmed production growth among its members in 2016. Adding to that, the lifting of sanctions against Iran will push an estimated 500,000 barrels of additional oil into the market. The US supplanted Saudi Arabia and Russia as the world's largest oil producer, and in December President Obama signed legislation to lift the 40-year ban on exporting US oil, put in place during the oil crisis of the 1970s. Gold dropped for the third straight year, down 10.5%, amid the broader commodity rout, diminished inflationary concerns, and US interest rate increases.

As we start 2016, we believe continued weak economic demand will keep a lid on commodity prices, especially in light of ample supply. While the worst of the oil rout may possibly be over, the same supply/demand imbalances that caused such turmoil during 2015 remain in place. Furthermore, additional interest rate hikes likely will result in further appreciation of the US dollar, meaning commodities will remain expensive to buyers overseas since they are priced in US dollars. We remain underweight this asset class.

Conclusion

In summary, we believe that the US economy will continue to experience growth of slightly above 2% over the next year, on the low range but still positive. We expect the 10-year Treasury yield to slowly grind toward 3% by the end of 2016, higher than it is now, but held in check by low inflation and weak growth in economies outside of the US. We continue to favor stocks over bonds but expect that the volatility we witnessed in the second half of 2015 will be a fact of life in this year. Our preference is for US stocks over international ones due to economic growth, a strong dollar and rising interest rates. We remain neutral to US small-cap stocks and continue to underweight stocks in international developed markets as well as those in emerging economies. As valuations become more compelling in international markets, we likely will become more inclined to overweight those areas, but we prefer to wait until US dollar strength abates and the energy sector shows signs of stabilizing. Our muted enthusiasm for bonds is primarily due to the lack of return potential as interest rates remain historically low. Likewise, with overall global growth remaining relatively tepid and the oil market in some disarray, we remain underweight commodities.