WIMMER ASSOCIATES

QUARTERLY REPORT

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A LETTER FROM KATHY

"If something cannot go on forever, it will stop" - Herbert Stein, What I Think: Essays on Economics, Politics & Life

Dear Friends,

The S&P 500 Index declined 0.7% in 2015 and is down 9% so far this year. While these are not encouraging numbers it's worth noting that the index is nevertheless up 180% from its trough in 2009. Although we have several concerns about the markets in 2016, we approach the future with caution, not fear. An investor's first concern may be to preserve one's capital, but it is also of paramount importance to seek positive returns within one's risk tolerance. It is not always possible to realize market gains amidst the economic downturns and political cycles that add to share price volatility, but it is helpful to take a long-term perspective.

While we previously viewed the economy as being in the mid-cycle of business expansion, we now believe that the U.S. economy is closer to the late-cycle of expansion, as the rate of profit growth is generally positive (excluding energy and commodities) but declining. Real Gross Domestic Product (GDP) rose at 2.4% in 2015, the same as in 2014. A greater concern is that the fourth quarter of 2015 only saw an annual growth rate of 0.7%, reflecting a slowdown in the economy. While the United States is overwhelmingly a service based economy (70% of U.S. GDP), U.S. manufacturers are facing headwinds as the strong U.S. dollar makes exports more expensive and slowing emerging markets dry up demand for U.S. goods. The Institute for Supply Management's Manufacturing Index has registered 50.0 or below since September 30th, 2015, signaling contraction in manufacturing over the past four months. Yet, to put this into context, manufacturing only accounts for 12% of total U.S. GDP. The manufacturing decline is not necessarily a sign of recession. The U.S. consumer remains strong, buoyed by the $1000 in energy savings per capita per year based on reduced oil and gas costs.

Below we review the markets, monetary policy and economic developments in 2015. We conclude with our take on prospects for 2016, with our thoughts on potential positives and negatives for the U.S. and the world.~

Cordially,

Kathy Wimmer, CFA, CIC
President

KEY FACTS FOR 2016

- *Annual gift exclusion $14,000*
- *Estate, gift and generation-skipping tax exemption $5,450,000*
- *Highest marginal estate tax rate 40%*
- *IRA contribution limits $5,500, plus another $1,000 for those over fifty*
- *SIMPLE IRA and 401(k) contribution limits $12,500, plus another $3,000 for those over fifty*
- *401(k) contribution limits $18,000, plus another $6,000 for those over fifty*
- *SEP IRA contribution limits 25% of compensation, max of $53,000*
- *Top Federal tax rate is 39.6% on income over $415,050 (single filers)*

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2015—The Market Takes a Roundtrip

Last year stocks posted their worst year since the Great Recession of 2008. Global growth receded as commodity markets collapsed, while China hit the brakes on building out its infrastructure. The broad-based S&P 500 index fell 0.7% in 2015, which was disappointing, but nothing compared to the -40% slump in 2008. Six of the ten S&P market sectors declined in 2015, with consumer discretionary rising more than 8%, while the energy sector saw the worst performance with a decline of 24%. The technology-laden Nasdaq Composite Index rose 5.7% in 2015, led by the so-called "FANG" stocks: Facebook, Amazon, Netflix and Google. Pundits have coined "BARF" stocks as the flipside of FANG stocks. "BARF" includes mining and materials laggards, BHP, AngloGold, Rio Tinto and Freeport McMoran. We generally avoided materials and mining stocks, as producers built out huge new mining operations just as China's super cycle appeared to be in decline. The Nasdaq Biotech index continued its upward trajectory in 2015, with a rise of 11% as a record number of new drugs were approved by the FDA, leading to breakthrough treatments and cures in immuno-oncology and hepatitis C. These new treatments are extremely expensive and have become fodder for politicians trying to score points with beleaguered patients.

Overseas markets in developed countries were slightly negative as the MSCI EAFE Index declined -0.8% in 2015. On the other hand, developing countries suffered through 2015, with the MSCI Emerging Markets Index off -14.9%. Their economies are overly reliant on the export of primary materials, such as oil, copper and iron ore. All of these primary industries have been over-producing, just as China's great infrastructure build-out is completed and demand for these products has plummeted.

The Federal Reserve increased the target Federal Funds Overnight Rate for the first time in nearly a decade, from 0-.25% to .25%-.50%. The Fed states in its December press release that "the stance of monetary policy remains accommodative after this increase, thereby supporting further improvement in labor market conditions and a return to 2 percent inflation." On the other hand, the Fed signaled an additional four interest rate hikes for 2016. This appeared to spook the stock and bond markets, as investors pulled funds from equities and high-yield bonds over concern that the Fed is over-reacting in light of continued tepid economic growth and low inflation.

In fact, the Fed is trying to balance a normalization of short-term rates, with ongoing accommodation of long-term rates by maintaining its policy of reinvesting its holdings of agency debt and agency mortgage-backed securities as well as rolling over maturing Treasury securities at auction. What is worth noting is that the Fed's policy is diverging from most foreign central banks, where interest rates are now mostly negative, in an effort to weaken their own currencies, forestall deflation and encourage exports aided by cheapened currencies. Consequently, we are seeing a strong U.S. dollar versus the euro, krona, yen and yuan.

The International Monetary Fund (IMF) estimates the world economy grew at a rate of 3.1% annually in 2015, down from 3.4% in 2014, mainly reflecting the slowdown in China and developing countries, which remain heavily dependent on exporting commodities. e.g., Russia (oil) and Brazil (copper and iron ore). GDP growth was down -3.8% in Russia, with Brazil off -3.7%, in 2015 according to the IMF. In contrast, the U.S. economy grew at an annual rate of 2.4% in 2015, which was even with 2014's growth rate. Of some concern is that the U.S. annualized rate of growth slowed to an anemic annual rate of 0.7% during the last three months 2015. Much of the slowdown can be attributed to the reduction to 1999 levels in oil and gas drilling, as the Baker and Hughes rig count saw a 70% decline over the year. This was reflected in the sharp decline of investment in business structures, which further hindered growth in capital equipment investment. The oil and gas supply chain affects many parts of the industrial economy, including steel

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manufacturing, valve makers, and railways, trucking firms, steel mills and pipe makers.

While economic news in the U.S. oil patch appears bleak, the bright side is that the U.S. consumer is saving $1,000 a year in lower energy costs, through lower heating bills and declining gasoline prices. The U.S. and most developed countries remain oil importers, so while a decrease in the cost of energy can have negative effects on the economy in the short-term, the long-term effects should be beneficial to consumer saving and expenditures. Indeed, U.S. consumer spending remained the brightest spot in the fourth quarter of 2015, contributing 1.46 % points to real U.S. GDP growth, though even this was reduced from 2.04 % in the third quarter and 2.42% in the second. The key takeaway here is that the U.S. economy remains resilient and the consumer is "King".

Employment continued to improve throughout 2015 and into January as the unemployment rate dropped to 4.9% in the most recent reading. Critics contend that the unemployment rate is misleading and point to the historically low Labor Participation Rate of 62.7% at the end of January. While many have dropped out of the workforce or remain underemployed since the Great Recession, it is important to note the trend of the Labor Participation Rate, which has climbed by 0.3% over the past four months. Another positive labor development is that employees are starting to see increases in wages, with a 0.5% increase in January alone. Work hours are expanding as well, putting more disposable cash into the pockets of U.S. consumers. The real annual wage growth rate for all of 2015 was a healthy 2.15% in the U.S., pointing to diminishing slack in the U.S. domestic labor market.~

2016—Markets Correct Amidst Global Challenges

The IMF predicts that both the U.S. and the world economy will improve on 2015's results, with modest gains in GDP growth being led by Asian countries and recovering developed countries. The rebalancing of China's economy from its infrastructure build-out and export-led manufacturing focus to a Chinese domestic consumer driven economy will add to global market and currency volatility. There is concern among economists that China's currency may be overvalued by as much as 20% and that depreciation on that order would wreak havoc on fellow Asian economies. This could lead to a protectionist backlash against China in the U.S. Congress.

As economies continue to restructure and improve, we do not see any indication that a "recession" or negative U.S. GDP growth is in the cards. It appears that we are in the late stage of the economic cycle, where growth continues, but acceleration opportunities are limited. The Fed is limited in its ability to further stimulate the U.S. economy through monetary policy. The U.S. Congress is unlikely to stimulate fiscal policy by further increasing the national deficit. Both the U.S. consumer and the financial industry have restructured their balance sheets; both are much better capitalized today than in 2008, which should support personal consumption and ongoing liquidity in U.S. stock and bond markets.

The Federal Reserve increased short-term interest rates in December and indicated that more rate hikes would be in the works. Interest rate hikes increase the value of the U.S. dollar, which hurts U.S. manufacturers and exporters. Increasing U.S. interest rates also adversely impact the high-yield bond market, where 67% of the U.S. market is tied to the struggling oil and gas market. Rising U.S. interest rates are also cited as one of the culprits contributing to the recent and continuing decline in U.S. stock prices.

Economists generally believe that central banks around the world must work in concert to manage

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Investment Counsel

155 North Lake Avenue, Suite 440
Pasadena, California 91101
626-683-3150

www.wimmerassociates.com

We strive to optimize our clients' financial well being by coordinating investment decisions with other professionals in the fields of taxation and estate planning.

2016—Markets Correct Amidst Global Challenges (continued from page 3)

interest rates and currencies. It appears, however, that the U.S. Federal Reserve has diverged in policy from the major central banks in Europe and Asia by increasing rates when other developed countries are instituting negative interest rates. We do not think the Fed is ignorant of the market's concerns and believe that the Fed Open Market Committee will refine its message and back away from its interest hiking policy as "data" will indicate that further rate hikes in U.S. interest rates would be harmful to the U.S. and developing economies. Rising U.S. interest rates and a stronger U.S. dollar would have an especially deleterious effect on developing nations which have issued their sovereign and private sector debts denominated in U.S. dollars. A rising U.S. dollar makes their U.S. dollar denominated debt significantly more expensive to service in their local currency terms. We believe that the volatility in global equity markets from the latter part of 2015 through New Year 2016 are attributable to the U.S. Fed spooking investors with the threat of tightening U.S. monetary policy. Federal Reserve Chair Janet Yellen most likely now recognizes the negative feedback loop that has been created by her recent U.S. Federal Funds rate hike, a subsequent stronger U.S. dollar, weaker manufacturing, increasing credit and currency stresses in the developed and developing countries' economies and the persistent broad global equity market slump. Many economists and pundits believe that Yellen and her Board of Governors will now take into account the adverse effects recent U.S. interest rate rises are having on the U.S. and global economies and markets and will modify their strategy to better coordinate U.S. monetary policy with other central banks. It appears that further U.S. interest rate hikes will be put on hold out of economic necessity. Jan Hatzius of Goldman Sachs reassures in Bloomberg that, "The probability of a slump in the U.S. is just 18 percent and 23 percent over the next twelve and twenty four months respectively".

"The recent market weakness should provide good risk-adjusted opportunities for those brave enough to defy Mr. Market's gloomy prognosis about the world economy," Hatzius and colleagues said in a weekend report.."

At Wimmer Associates, we always keep our eyes open for conservative, compelling investment opportunities, despite the volatility and vicissitudes of the markets.~

Disclosure: "Be careful about reading health books, you may die of a misprint." Mark Twain Keep that in mind as you read these articles. We obtain data from sources we believe are reliable but they should not be relied upon for making life-changing decisions.