Fisher Investments®

Stock Market Outlook

Independent Research & Market Analysis
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2016: Part 1

2016 Stock Market Outlook – Part I

Executive Summary

Global markets finished Q4 up 5.5%, but early 2016 volatility renewed the correction that began last year.[1] Volatility can be trying, especially as fearful headlines mount—a change from last autumn's relative media calm. Sensational coverage of steep drops can trigger a fight-or-flight urge, but this is frequently counterproductive. We believe now is a time for steely nerves. Corrections frequently come and go fast, rebounding sharply as sentiment turns. Such rallies come without warning, and attempting to time them is folly.

While the late-year correction diminished 2015 returns, stocks still beat most other asset classes. Still, last year's flattish returns paired with sharp volatility at 2016's outset are trying. However, once this sentiment-driven move ends, we believe fundamentals point to continued bull market ahead. Many fret recession or weak economic growth, but reality is far brighter. Politics may seem wild—particularly in the US—but still aren't problematic. Sentiment is too gloomy relative to reality, leaving ample room for more optimism ahead.

Presidential election years are usually positive, and historically America overwhelmingly outperforms as Election Day nears. The global economy is growing, with America, Europe and China healthier than most perceive. Falling oil prices are widely known, limiting their shock value. Folks fretted the Fed finally hiking rates last December, but we like that. False fears are bullish. The realization modestly higher short-term rates are an economic non-event, particularly with the yield curve steep, should dispel this myth. Meanwhile, the Fed likely does ever less as the election approaches. While the Fed portrays itself as apolitical, in reality, it's anything but.

Volatility is to be expected. It is even possible a second correction strikes later in 2016. However, we would expect such moves to be sentiment-driven and fleeting—calls for inaction, not action. The only time we counsel reducing equity exposure is when we believe a bear market is forming, and that time isn't now. Nor do we believe one is likely this year, though more volatility is always possible. Regardless, we believe now is a time to stay even-keeled and appreciate the positives others fail to see before they awaken and drive up stock prices.

How high stocks rise in 2016 hinges on sentiment's evolution. Does optimism emerge after fears are disproven? Or does skepticism weigh, spurred by headline-grabbing wild cards?

The Presidential election is one such wild card and remains too distant to handicap. Early polling doesn't predict primaries or November's vote—particularly now, given polls' recent misses. Congressional races are also up for grabs. This Presidential contest is notable for its many apparent abnormalities, particularly rising GOP outsiders. There is a strong likelihood these abnormalities fade, leaving a more traditional race. But alternatives are worth considering. (Appendix III)

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Nearly seven years in, this bull market remains perhaps history's least loved. Investors, still scarred from the financial crisis, can't shake skepticism. Many see signs of another 2008 lurking in every nook, even in tiny, obscure, isolated assets. However, one bear market's cause rarely triggers the next, so it's usually best to look elsewhere for an approaching bear. Most see America's economy as slow-growing and fragile. Many presume the eurozone economy is a quagmire, despite 10 straight quarters of growth—led lately by once-troubled Spain and Ireland. Geopolitical concerns and terrorism fears hog headlines. Worries about China—from an economic "hard landing" to misunderstood currency reform—dominate. Economic reality, however, shows continued (albeit slower) growth, consistent with the ongoing shift from heavy industry to consumption and services.

Today's media reflects and deepens skepticism. Dry articles presenting objective who, what, when, where, why and how are rare. Replacing them are sensational opinion pieces—intended or not—where reporters' views permeate front-page news. Advertorials—advertisements masquerading as articles—abound. Fact-checking is weak. Untraditional media sources with zero barriers to entry are ubiquitous. Discerning fact from fiction is increasingly difficult for most, fostering uncertainty. Uncertainty begets skepticism.

It wouldn't shock us if sentiment never reaches true euphoria in this cycle, with complacency instead marking the peak. Joylessness could keep returns below bull market averages, as the surging confidence that typically powers big returns in late-stage bulls never arrives. We might instead see a longer, slower grind higher, defying the many who call this bull "long in the tooth" and potentially making this history's longest bull market in time if not magnitude. However, the hyperbolic negative forecasts and surging fear accompanying January's poor start may imply sentiment may be capitulating—teeing up a strong rebound and perhaps a shift into optimism.

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Appendix I: A Tough January Doesn't Mean a Bad Year

January is off to a difficult start. Global stocks fell -10.2% in the first 12 trading days, before snapping back to finish the month down -6.0%.[2] January's volatility seems like a continuation of 2015's second-half correction—a short, sharp, sentiment-driven move exceeding -10%. While uncomfortable, corrections are normal in bull markets. Volatility is random, and pullbacks often end as suddenly as they began. Reacting to negativity does little more than lock in losses—a bad idea for investors needing equity-like returns.

World stocks fell as much as -16.8% from their May 21, 2015 peak, officially making this a double-bottom correction.[3] When stocks approached their first low in late-September 2015, sentiment remained relatively calm—atypical of corrections, which are usually accompanied by escalating fears. Now, fear is rising. As stocks breached their prior low, sensationalist headlines predicted more huge drops, encouraging hasty overreactions. One longtime bear saw "cataclysmic" conditions and urged investors to "sell (mostly) everything."[4] Another warned the S&P 500 could fall -75% this year.[5] Media hyped both forecasts, promoting fear, neglecting to mention both analysts similarly forecasted doom the past five years.

Hyperbolic negative forecasts abound—encouraging evidence sentiment might finally be capitulating, teeing up a strong rebound. While headlines shriek, none present new, bearish drivers. They cite long-running false fears, like potential deflation, the strong dollar, China's slowdown, low oil prices and Fed tightening. These aren't new fears, and fundamentally, little has changed.

Myopic Loss Aversion and Corrections

Humans have a psychological tendency to feel losses' pain more than twice as much as they enjoy an equivalent gain—myopic loss aversion, or prospect theory. This often triggers a fight-or-flight response to "stop the bleeding." The danger of making a behavioral error is omnipresent, but especially acute now. As Ken wrote in *The Only Three Questions That Count:* "Your brain is designed with bodily survival in mind, not financial survival. What may be a great instinct for avoiding ambush by a fanged beast can be very dangerous—completely harmful—when analyzing capital markets. Recognizing the symptoms of a financial brain gone haywire is the best defense against yourself."

This correction is somewhat long, but not abnormally so. Double-bottom corrections aren't rare, either. One also struck in 2011 as euro breakup fears rocked investors. Like last year, 2011 finished flat. Strong returns followed in 2012 and 2013.

No one can know when this correction will end. Perhaps, as you read this, it already has—turning points are clear only in hindsight. But we believe most of the downside lies behind us, not ahead of us. In our view, this is a time to ensure your strategy is consistent with your long-term goals and needs, adequately diversified and focused on what's to come in markets—not what already occurred. Then, steel your nerves.

January Is Ineffective

As volatility spiked, the so-called "January Effect" returned to headlines. This adage states January returns (or its first 5 or 10 days, depending which best fits the narrative) predict the year. This is false. Stocks don't move on seasonal patterns. Past performance doesn't dictate future returns, and history proves January is powerless. Of the 34 down Januarys since 1926, the S&P 500 finished the year higher in 18—just over half. Similarly, world stocks finished the year up after 9 of 17 down Januarys since 1970.[6]

This year's opening reminds us of 1998. Then, too, stocks stumbled early, declining over -4% in the year's first seven sessions.[7] Like today, headlines blamed "weak Asian economies," warning overvalued stocks would plunge further as Asia's troubles rippled globally. Yet fears proved false, and 1998 was great. By early July, markets were up over 20% for the year.[8] A nasty correction struck later that month, eventually knocking full-year returns negative. But world stocks rallied to finish 1998 up 24.3%.[9]

What's in Store for 2016?

After a flattish 2015 and volatile January, many question 2016's potential. Some wonder if the sun has set on the almost seven-year-old bull market. It's understandable, given rampant fearful headlines. But with positive economic and political drivers, we expect the bull market to continue in 2016. How much gusto it has hinges on sentiment.

To us, this year's key question is: Will good news finally spur optimism, inspiring investors to bid stocks higher; or will skepticism persist, dampening returns as in 2015?

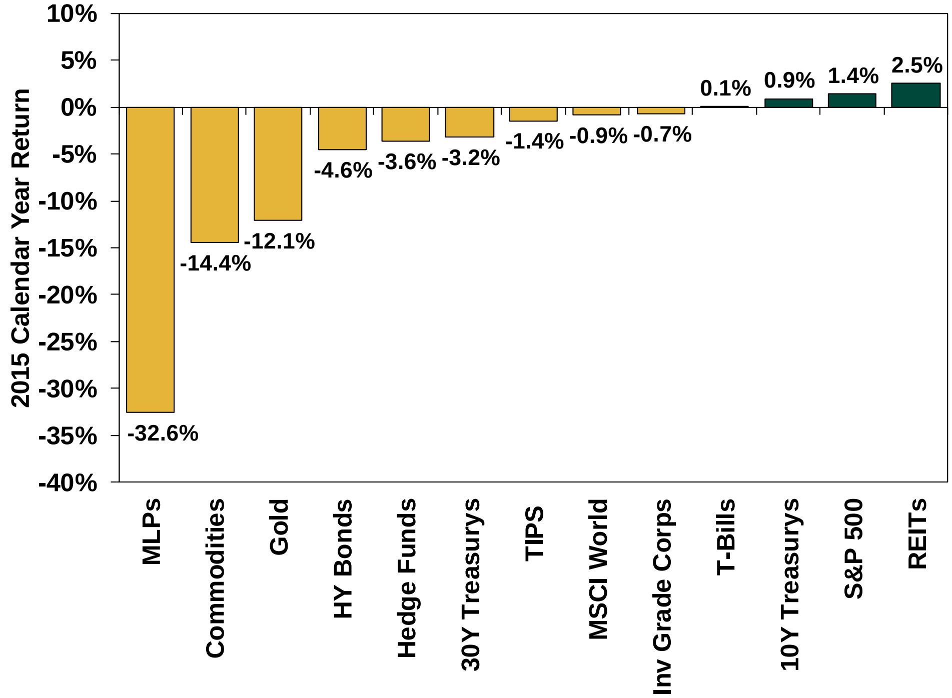
The answer likely determines whether 2016 is another tepid year or a more memorable year of growing optimism. It could swing on several wild cards, as we'll discuss.

How big 2016 returns are matters mostly in hindsight—it will be how the year is remembered, and could affect 2017 sentiment. If your goals, needs, time horizon and other factors are aligned with owning stocks, we believe the difference between ok and great returns isn't significant. We recommend clients reduce equity exposure only if we believe a bear market is forming. We don't think this is likely in 2016. Expectations remain too low, not too high. Risks always exist, but we don't see huge, negative developments lurking unnoticed. Today's negatives are small, widely discussed or long-running false fears. Absent a sound reason to be bearish, we're bullish.

2015 in Review

2015's tepid stock and bond returns, combined with commodities' negativity, prompted many to dub it a year "nothing worked." Perhaps overstated, but it is true no major asset class posted big positive results in 2015. (Exhibit 1)

Exhibit 1: Asset Class Returns in 2015



Source: FactSet, as of 1/6/2016. Indexes shown (from left to right): Alerian MLP Index; CRB Commodity Spot Index; Gold Spot Price; BofA Merrill Lynch High Yield Cash Pay Index; HFRX Global Hedge Fund Index; BofA Merrill Lynch Current 30-Year Treasury Index; Barclays US Treasury TIPS; MSCI World (with net dividends); Barclays US Corporate Inv. Grade; BofA Merrill Lynch US 3-month T-Bill Index; BOFA ML US Current 10-year Treasury Index; S&P 500; and MSCI US REIT indexes. 12/31/2014 to 12/31/2015. All figures are total returns.

Avoiding error is key to investing. If you invest for long-term growth, and you held a diverse, global portfolio through the ups and downs, maintaining discipline was the right move. Trading heavily could easily have harmed more than helped, and owning stocks keeps you positioned for the gains we believe await.

Blah Years Don't Foretell Bears

The blah 2015 frustrated many, but equity returns come in clumpy patches. Getting bull markets' good clumps requires participating in their not-as-good clumps—a trade-off. Last year's returns are no reason for gloom in 2016—good years often follow blah years. Excluding last year, nine years posted returns between -5% and +5% since 1932. The next year was double-digit positive eight times, an above-average frequency of positive returns. (Exhibit 2's table shows the individual years, and the chart plots the average return and frequency of positivity in years following blah years.) The one negative year after a blah year, 1940, occurred amid a five-year bear market. This doesn't ensure a great 2016 follows a muted 2015, but it does show blah years don't regularly foretell weakness or trouble.

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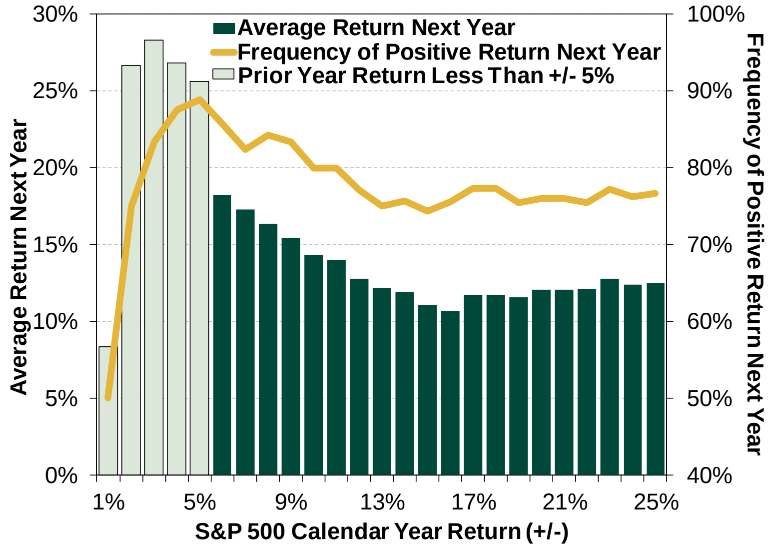
Exhibit 2: S&P 500 Returns: Often Big After Flattish Years

Year	S&P 500 Returns <+/-5%	Following Year Return
1934	-2.3%	47.2%
1939	-0.9%	-10.1%
1953	-1.1%	52.4%
1960	0.5%	26.8%
1970	4.0%	14.3%
1990	-3.1%	30.5%
1994	1.3%	37.6%
2005	4.9%	15.8%
2011	2.1%	16.0%
2015	1.4%	?
Average		25.6%



Source: Global Financial Data, Inc., as of 1/4/2016. S&P 500 total return, 1926 – 2015.

Why Be Bullish?

Economic fundamentals point to continued growth. Developed-world yield curves are positively sloped. Business lending is robust in America and recovering in the UK and eurozone. The Conference Board's Leading Economic Indexes (LEI) are in long uptrends. In US LEI's 57-year published history, no recession has begun while it was high and rising. Manufacturing has wobbled in America and parts of Europe, but these economies are service-based. Manufacturing represents just 12.1% of US GDP.[10] Service-sector data, though less-noticed, are much stronger. A strong service sector outweighs slight manufacturing weakness.

America's expansion is stronger than many perceive. Many bemoan slow growth, longing for the go-go 1990s. Yet the 1990s' growth wasn't exactly torrid. That expansion is the third-slowest on record—a long grind. It felt bigger because inflation was higher—nominal GDP (not adjusted for inflation) growth was faster. Nice, but illusory. Since late 2013, this expansion's real (inflation-adjusted) GDP growth rates aren't far removed from real GDP growth throughout the 1990s. With modest growth and ultra-low inflation, we're in a "Goldilocks" economy.

China, too, is stronger than most believe. GDP grew 6.9% in 2015, despite handwringing about faltering trade and manufacturing.[11] While heavy industry slowed, services and retail sales are growing nicely, extending the long-running shift from export- and factory-led growth to services and domestic consumption. The slowdown is a side effect, and China still contributes heavily to global GDP.

China fears escalated in January when mainland stocks plunged and the yuan weakened, but the global reaction seems overblown. Domestic Chinese markets (A-shares) are firewalled from global markets. They are mostly off-limits to foreigners, so there is no fundamental transmission

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mechanism for a Chinese slide to go global. Moreover, A-shares don't foretell China's economy. They have had nine drops exceeding -20% since 1996—but no recession. (Exhibit 3)

Exhibit 3: Nine Shanghai Bears, No Recessions

Source: FactSet, as of 1/19/2016. Shanghai Composite Index and China GDP, 12/31/1995 – 1/15/2016.

As for currency fears, the yuan has fallen just -5.6% since the central bank allowed it to weaken last August.[12] The British pound has fallen -9.0%, but Britain isn't imploding.[13] Nor is this a desperate move to "steal" growth by making exports cheaper abroad—commonly dubbed a "currency war." Boosting exports—a dubious aim—would take far more.

Oil's slide is another net positive, particularly now that the shock is waning. There are losers, but the winners outnumber and outweigh them. Brazil, Russia and Middle Eastern petrostates are hurting, but they are a fraction of global GDP. Other heavy producers like Mexico and Canada have more diverse economies, with service sectors large enough to offset. Major developed countries like the US, UK and most eurozone states get sizable boosts from cheap oil and natural gas. Low commodity prices reduce many businesses' input costs. Cheaper fuel prices reduce factories and retailers' shipping costs. Even service firms benefit from reduced power costs. All help boost earnings outside of the Energy sector.

Politically, gridlock in America and most of Europe keeps legislative risk low—a positive. Markets dislike the uncertainty active legislatures bring by disrupting property rights, regulation or the distribution of resources. Moreover, US election years are overwhelmingly positive, with the US outperforming foreign as the election nears. (Appendix III)

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Sentiment Is the Swing Factor

Fundamentally, 2016 has the ingredients for a great year. But whether we get one depends on whether investors get cheerier and bid up share prices.

Usually confidence ascends late in a bull as folks shed worries, get more optimistic and eventually reach euphoria. The 1990s bull's second half saw years of rational optimism, helping drive double-digit returns in five straight years. But sentiment has progressed glacially in this bull. Nearly seven years in, skepticism persists and joylessness abounds.

Why is sentiment stuck? It's an academic question without a clear answer, but we can hypothesize. We increasingly seem to live in an upside-down world, where things like the media, monetary policy and politics don't do what people expect. Hence confusion reigns, fueling investors' skepticism. Prolonged skepticism could result as investors grapple with the unknown.

Media has changed. There is very little traditional journalism—straightforward articles presenting only "who, what, where, when, why and how." Bias and opinion now infect even basic reporting, making it hard to discern fact from fiction. It's often subtle, evident through word choice: Saying Congress "failed" to do something, rather than "didn't," shows the writer believes "something" was good or necessary—an opinion, distorting the facts. Many articles—editorials and reports alike—include unsupported generalizations, false dilemmas, cherry-picked numbers and unsourced data. Without independently fact-checking articles, it is increasingly difficult to know what is credible.

Monetary policy is also topsy-turvy. For instance: Eurozone inflation keeps missing expectations, even though the ECB launched quantitative easing (QE)—supposedly inflationary stimulus—last March. So the ECB extended QE in October, yet prices remain stuck. We've long believed QE is pushing on a string, and its fecklessness doesn't surprise us. QE flattens yield curves, crimping bank lending and inflation. But most miss this, instead believing the QE-as-stimulus narrative. When QE doesn't stimulate despite repeated attempts, it forestalls optimism.

In past years, the optimal US Presidential candidate would be a two-term governor with demonstrable success. Now, that is poison. Even in a three-person Democratic race, Martin O'Malley barely got coverage. Scott Walker, Rick Perry, George Pataki and Bobby Jindal exited the GOP race. Jeb Bush, Chris Christie and John Kasich are barely hanging in. Outsiders poll favorably and garner most media coverage. First-term Senators are on their heels. Even though Republicans derided Barack Obama's relative inexperience as a first-term Senator in 2008, their primary "establishment" candidates sport similar resumes.

As *Vox's* Matthew Yglesias observed recently: "The presidency is, among other things, a complicated administrative job that seems to have a lot in common with being chief executive of a state. But the nationalization of politics appears to have created a dynamic in which the nomination contests are more about who you are than what you've done, in a way that favors deep engagement with the national media ecology over the inevitable fuzziness that comes with running an institution."[14] That encapsulates the upside-down world.

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Wild Cards Abound

Sentiment's evolution in this upside-down world will influence 2016 returns. It could hinge on a few wild cards. Some are potential negatives that could knock the wind out of otherwise healthy markets. They shouldn't cause bear markets, as they lack size and a fundamental tie to stocks, but they could knock sentiment temporarily. We aren't forecasting these events—they merely exemplify events that could make wobbly sentiment even shakier.

Russian President Vladimir Putin getting even more adventurous abroad is one such wild card, as it could heighten fears of global geopolitical conflict. President Obama issuing a sweeping Executive Order could also roil sentiment, driving uncertainty and making businesses second-guess risk-taking. Donald Trump potentially winning the election is another wild card, as is Hillary Clinton being indicted after locking up the nomination. Again, none of these are inherently negative. But they could shock sentiment, muting full-year returns.

On the flipside, some potentially good wild cards could raise cheer. These wouldn't bring fundamental change, either, but they could help prove long-running fears false, driving optimism. It could turn big fears into big WOWs.

What could do this? Perhaps Putin stays home and focuses on rebuilding Russia's economy—easing geopolitical jitters. So could Middle East tensions cooling. China improving noticeably could be a wow. So could the US election ultimately being run-of-the-mill, or people realizing December's rate hike didn't hurt. All could bring investors the feeling of clarity, boosting optimism, risk-taking and returns.

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Appendix II: Bond Market Review and Outlook

Interest Rate Outlook

In 2015, 10-year Treasury rates rose only 10 basis points (0.10%) to 2.27%.[15] Rates endured volatile bursts—falling to 1.64% in January then peaking at 2.48% in June—but were overall directionless.[16]

Long-term interest rates again appear unlikely to change materially in 2016. Like last year, opposing drivers may cause rate volatility, but should largely cancel. The Fed hiking short-term rates, improving labor markets and rising wages should exert upward pressure. But low inflation expectations and Japanese and eurozone quantitative easing (QE) likely keep their bond yields low—helping cap US yields. Large institutional investors, banks and insurers are fairly indifferent between high-grade sovereign bonds, so lower rates abroad should support demand for Treasurys. These opposing drivers suggest big, sustained rate moves are unlikely, though short-term, sentiment-driven volatility will come.

Sour sentiment roiled corporate bonds in 2015, but we expect brighter days ahead. Last year, worries abounded: Rate-hike fears, allegedly declining bond market liquidity, high-yield bonds, an equity market correction and continued commodities weakness pushed yields higher and prices lower. Credit spreads (the difference in yield between bond types) rose, and corporate bonds underperformed. We believe most fears affecting corporates are temporary, likely to fade when volatility passes.

High-Yield Bonds, a More Detailed Look

Fears focused on high-yield corporates, down -4.6% in 2015. Many presume this is a canary in the coal mine for the economy.[17] But high yield's fall isn't predictive. It mostly reflects weak commodity prices. In Q4, liquidity concerns stole headlines after three funds announced their liquidation, but the issues are fund-specific. High yield's weakness was largely sentiment-driven.

As Exhibit 4 shows, rising spreads were much more pronounced within the Energy and Materials sectors than other high-yield bond segments. Commodity-exposed sectors show far higher spreads than other areas of the high-yield market.

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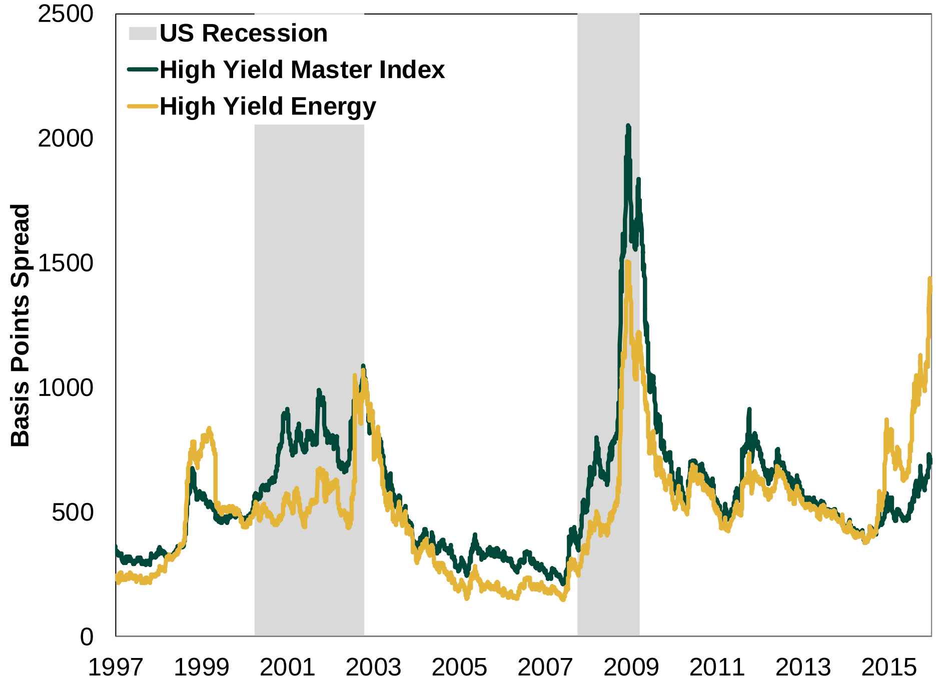
Exhibit 4: High-Yield Spreads Over Treasurys Widen, Driven by Energy



Source: FactSet, as of 12/31/2015. BofA/Merrill Lynch High-Yield Master II and High-Yield Energy Index yields minus the BofA Merrill Lynch 5-7 year US Treasury Index yield.

Many note stocks and high-yield bonds tend to track each other, as both are influenced by broad economic conditions. Hence some pundits puzzled over why the S&P 500 rose slightly in 2015 while high-yield bonds fell—suggesting high-yield's weakness foretold trouble for stocks. However, most high-yield issuers are small-cap value firms, so comparing high-yield returns to the Russell 2000 or the Russell 2000 Value is a more apples-to-apples comparison. Those two gauges fell -4.8% and -8.0%, respectively, echoing high yield's weakness.[18] Moreover, high yield's outsized weight to commodity-exposed industries is a key culprit. (Exhibit 5) Energy stocks and Energy high-yield bonds are moving concurrently. (Exhibit 6) Bonds don't know anything stocks are unaware of.

Earnings and revenues explain the similar moves. While commodities firms suffer, earnings elsewhere are healthy. Larger, more creditworthy firms often outperform smaller firms as bull markets mature. These two factors largely explain high yield's weakness.

For small, single-commodity oil and metal producers, plunging prices make servicing debt difficult, raising default expectations. Some suggest this means credit markets foretell trouble, but defaults, too, are isolated: Most are concentrated in Energy and Materials, with little increase elsewhere, muting the market-wide rise.

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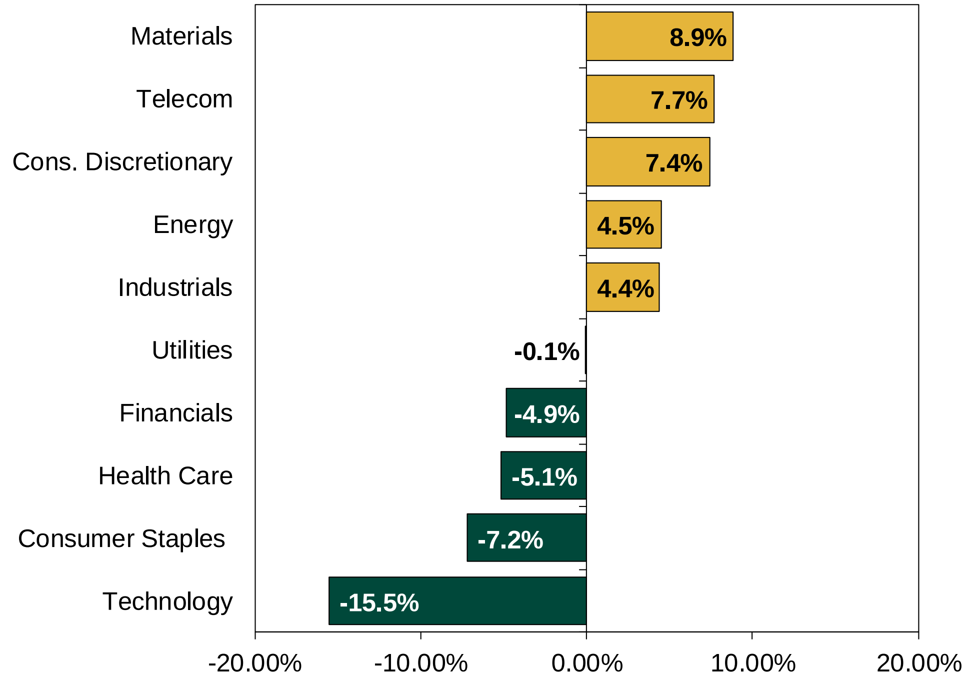
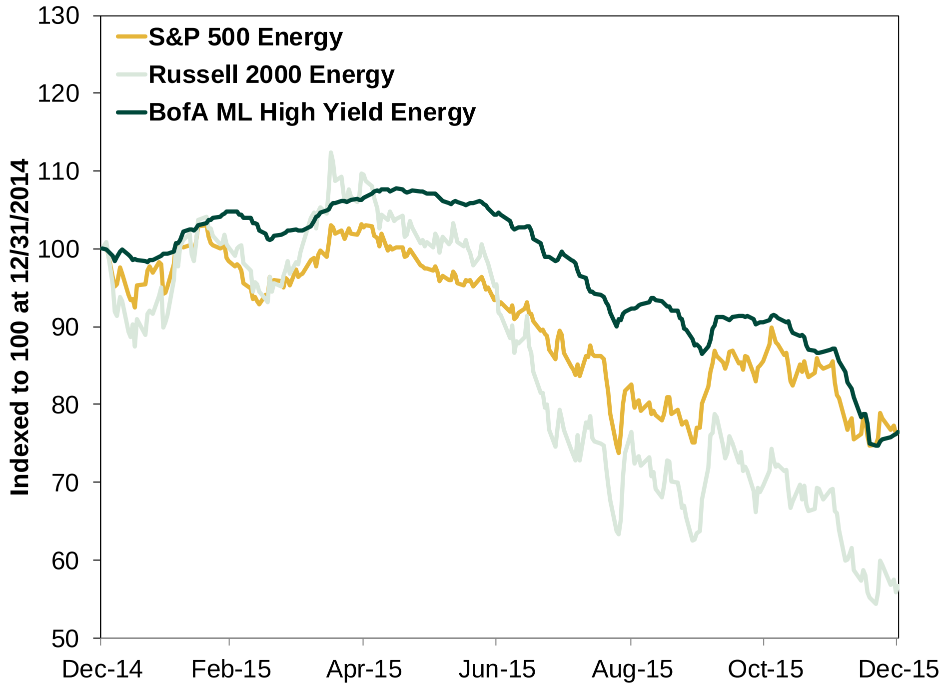
Exhibit 5: Sector Differences, US High-Yield Bonds Minus US Stocks



Source: FactSet, Bank of America/Merrill Lynch, as of 1/19/2016. BofA/ML High Yield Master II Index sector weights minus S&P 500, 12/31/2015.

Exhibit 6: Energy High Yield Bonds vs. S&P 500 Energy and Russell 2000 Energy



Source: FactSet, as of 1/19/2016. BofA Merrill Lynch High-Yield Master II Index, S&P 500 Energy and Russell 2000 Energy total returns, indexed to 100 at 12/31/2014. 12/31/2014 – 12/31/2015.

Bond Market Liquidity

For most of 2015, fears ran rampant that bond market liquidity—the ability to quickly redeem an asset for cash without moving the price much—had evaporated due to regulatory shifts, causing larger price and yield swings. High-yield Exchange-Traded Funds (ETFs) became critics' targets, with prominent investors claiming they provide only illusory liquidity because they are composed of illiquid assets, despite trading like stocks. Though these criticisms overlook key facts—namely ETFs' ability to add liquidity—outflows plagued high-yield ETFs. Compounding matters, in December, as markets seemed to be recovering from the correction and bond spreads were contracting, one high-yield mutual fund—Third Avenue Focused Credit Fund—halted redemptions and announced it would liquidate over a few months, distributing proceeds to investors.

The freeze drove worries high-yield liquidity issues were being exposed, risking a vicious cycle of redemptions and fund closures. The next day, two high-yield hedge funds reinforced fears—one announcing liquidation plans, the other confirming it already had. High-yield bonds reeled.

Investors' response seems like a knee-jerk, sentiment-led overreaction. The underlying facts illuminate the disconnect between fears and reality. These funds aren't plain-vanilla high-yield, but *distressed debt*, the junkiest junk. The hedge funds don't have to report holdings, but *The Wall Street Journal* reported one faced "heavy losses on so-called distressed investments including junk bonds, post-reorganization equities and other special situations." Third Avenue's fund also focused on *distressed* debt. Nearly half its assets were in very low-rated bonds (below B), and another 40% were in non-rated firms. Nearly half its holdings were in some stage of bankruptcy or restructuring. One of its top 25 holdings was a claim on Lehman Brothers' ashes. Broader high-yield ETFs, by comparison, hold mostly higher-rated debt and only 9% below B.

Largely underappreciated: The large-scale selling that hit high-yield ETFs didn't encounter liquidity issues, rebuking fears. Even during December's huge volume sessions, which featured heavy outflows, major high-yield ETF prices didn't materially diverge from their underlying holdings. Pundits fear ETFs create an illusion of liquidity, but ETFs actually add liquidity. ETF trades usually don't touch the underlying bonds. Over the 30 trading days ended 12/31/2015—a period when high-yield ETF volumes and outflows spiked—one major high-yield ETF traded an average $6.80 for every $1 of related bond trading.[19] High-yield bond fears seem quite disconnected from reality.

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Appendix III: An Upside-Down Election

As always, we favor no candidate or party and assess politics solely to analyze how it may impact markets. We believe political bias is blinding and dangerous for investors.

The Presidential election is about nine months away, but it remains too early to handicap. Early polling doesn't predict primary races, let alone November's vote—especially given polls' recent misses (e.g., last year's UK election). Struggling candidates could surge, while early favorites often slip. Plus, as we write, 13 candidates remain in the fray.

A GOP Primary Primer

The Presidential primaries are just beginning, and the "silly season" is giving way to serious campaigning. On the GOP side, five candidates have withdrawn since September, winnowing the field to a still-robust 11 (as of this writing).

Even handicapping a likely pack of leading contenders seems premature. Polls highlight Donald Trump, Ted Cruz and Marco Rubio, but polling rarely predicts primary results, which hinge on turnout and undecided voters. Heading into the Iowa caucus, polls showed Trump topping the GOP slate. Yet Cruz won handily, while Trump barely edged Rubio for second place. While some believe results in Iowa and New Hampshire are predictive, history suggests this isn't so accurate. Iowa victors include Rick Santorum in 2012 and Mike Huckabee in 2008—yet Mitt Romney (finished second) and John McCain (finished fourth) took the Republican nomination. McCain won New Hampshire in 2000, as did Pat Buchanan in 1996. The eventual nominees—George W. Bush and Bob Dole—finished second.

Will people vote as they poll, or are they just blowing off steam? Only time will tell. Voters often say one thing in polls when considering hypotheticals, then do something else in the voting booth after weighing the likely ramifications of a certain choice.

Yet, globally, anti-establishment parties and candidates are rising. Though ideologies vary, all fuel the narrative of "outsiders" disrupting mainstream politics. Their results have been mixed. Greece's far-left Syriza won two elections in 2015, and leftist Jeremy Corbyn won the UK Labour Party's leadership. Far-left Podemos finished third in Spain's general election but cut deeply into mainstream parties' support. The euroskeptic UKIP (Britain) and Front National (France) made noise but fizzled when votes were tallied. As noted in Appendix I, this is a wild card potentially spooking sentiment.

Clinton's Challenges

Hillary Clinton seems likely to win the Democratic nomination, but she remains an atypical Presidential victor—especially for a Democratic candidate. The history of the President's party winning third terms goes against her. Since WWII, only Franklin D. Roosevelt/Harry Truman and George H.W. Bush extended their party's two-term stay. They also rode the coattails of an enormously popular predecessor, an edge Clinton lacks.

Plus, Clinton struggles to present a fresh, new image to mask her well-known political scars, perhaps why she hasn't pulled away from her primary challenger, Bernie Sanders. Against a stronger front-runner, the self-avowed socialist Senator who long refused to identify as a Democrat would stand little chance. This is why Democrats tend to favor fresh, blank-slate faces over battle-tested war horses—yet former Maryland Governor Martin O'Malley was an afterthought nationally and left the race after winning just 1% in Iowa. This, like the GOP contest, is an upside-down race in an upside-down world.

What We're Weighing

For all the early races' abnormalities, the oddities likely fade, leaving a mainstream Republican against Clinton. Historical precedent includes the 1968 Democratic primary, when socialist Eugene McCarthy and populist Robert Kennedy (assassinated in the summer) dominated early, but the establishment Hubert H. Humphrey eventually won the nomination (losing the general election to establishment Republican Richard Nixon). Should this happen, we would expect traditional Presidential cycle market trends to apply: a positive election year, with US outperforming as the contest nears.

Exhibit 7: The Presidential Term Anomaly

Party	President	First Year		Second Year		Third Year		Fourth Year	
R	Coolidge	1925	N/A	1926	11.1%	1927	37.1%	1928	43.3%
R	Hoover	1929	-8.9%	1930	-25.3%	1931	-43.9%	1932	-8.9%
D	FDR -- 1st	1933	52.9%	1934	-2.3%	1935	47.2%	1936	32.8%
D	FDR -- 2nd	1937	-35.3%	1938	33.2%	1939	-0.9%	1940	-10.1%
D	FDR -- 3rd	1941	-11.8%	1942	21.1%	1943	25.8%	1944	19.7%
D	FDR / Truman	1945	36.5%	1946	-8.2%	1947	5.2%	1948	5.1%
D	Truman	1949	18.1%	1950	30.6%	1951	24.6%	1952	18.5%
R	Ike -- 1st	1953	-1.1%	1954	52.4%	1955	31.4%	1956	6.6%
R	Ike -- 2nd	1957	-10.9%	1958	43.3%	1959	11.9%	1960	0.5%
D	Kennedy / Johnson	1961	26.8%	1962	-8.8%	1963	22.7%	1964	16.4%
D	Johnson	1965	12.4%	1966	-10.1%	1967	23.9%	1968	11.0%
R	Nixon	1969	-8.5%	1970	4.0%	1971	14.3%	1972	18.9%
R	Nixon / Ford	1973	-14.8%	1974	-26.5%	1975	37.3%	1976	23.7%
D	Carter	1977	-7.4%	1978	6.4%	1979	18.4%	1980	32.3%
R	Reagan -- 1st	1981	-5.1%	1982	21.5%	1983	22.5%	1984	6.2%
R	Reagan -- 2nd	1985	31.6%	1986	18.6%	1987	5.2%	1988	16.6%
R	Bush	1989	31.7%	1990	-3.1%	1991	30.5%	1992	7.6%
D	Clinton -- 1st	1993	10.1%	1994	1.3%	1995	37.6%	1996	23.0%
D	Clinton -- 2nd	1997	33.4%	1998	28.6%	1999	21.0%	2000	-9.1%
R	Bush, G.W.-- 1st	2001	-11.9%	2002	-22.1%	2003	28.7%	2004	10.9%
R	Bush, G.W.-- 2nd	2005	4.9%	2006	15.8%	2007	5.5%	2008	-37.0%
D	Obama -- 1st	2009	26.5%	2010	15.1%	2011	2.1%	2012	16.0%
D	Obama -- 2nd	2013	32.4%	2014	13.7%	2015	1.4%	2016	?
	Republicans		0.7%		8.2%		16.4%		8.0%
	Democrats		16.2%		10.0%		19.1%		14.1%
	All		9.2%		9.1%		17.8%		11.1%

Source: Global Financial Data, Inc., as of 1/22/2016.

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Exhibit 8: The US Typically Outperforms as Elections Near

			May 31 - December 31 Returns		
Year	Election Winner	Incumbent	USA	Foreign	US Minus Foreign
1928	Hoover - R	Coolidge- R	21.8%	2.5%	19.3%
1932	Hoover - R	FDR - D	54.8%	11.4%	43.4%
1936	FDR - D	FDR - D	19.3%	2.1%	17.2%
1940	FDR - D	FDR - D	14.1%	10.5%	3.6%
1944	FDR - D	FDR - D	7.5%	-28.4%	36.0%
1948	Truman - D	FDR - D	-8.9%	-23.9%	15.0%
1952	Ike - R	Truman - D	11.4%	7.1%	4.2%
1956	Ike - R	Ike - R	3.3%	-1.0%	4.3%
1960	JFK - D	Ike - R	4.1%	3.2%	0.9%
1964	LBJ - D	LBJ - D	5.4%	-2.1%	7.5%
1968	Nixon - R	LBJ - D	5.2%	3.0%	2.2%
1972	Nixon - R	Nixon - R	8.0%	9.7%	-1.8%
1976	Carter - D	Ford - R	7.3%	1.8%	5.5%
1980	Reagan - R	Carter - D	22.0%	13.4%	8.6%
1984	Reagan - R	Reagan - R	11.1%	4.1%	7.0%
1988	Bush - R	Reagan - R	5.9%	12.5%	-6.6%
1992	Clinton - D	Bush - R	4.9%	-8.1%	13.0%
1996	Clinton - D	Clinton - D	10.7%	1.1%	9.6%
2000	GW Bush - R	Clinton - D	-7.1%	-7.7%	0.7%
2004	GW Bush - R	GW Bush - R	8.1%	16.4%	-8.3%
2008	Obama - D	GW Bush - R	-35.5%	-42.3%	6.8%
2012	Obama - D	Obama - D	8.8%	20.3%	-11.5%
		Average	8.3%	0.3%	8.0%
		Median	7.7%	2.8%	6.2%

Source: Global Financial Data, Inc., as of 1/21/2016. USA returns are the S&P 500 price index. Foreign is the GFD World Ex. US Price Index. May 31 – December 31 returns, 1928 – 2012.

Under this a traditional election scenario, a Republican victory could set up the "perverse inverse," markets' tendency to rally in election years when Republicans win, then deliver below-average returns the next. The Republicans sweeping Congress would compound this by eliminating the bullish gridlock stocks have enjoyed since 2011. While Congressional races are up for grabs, the GOP has some advantages. In the House, incumbents are tough to beat. In the Senate, the Democrats have the structural edge, defending fewer seats in states that voted Republican in 2008 and 2012. But winning a majority will likely require unseating very popular incumbents, including Rob Portman (OH), Chuck Grassley (IA) and John McCain (AZ). Marco Rubio's FL seat is another potential must-win. The Democrats must campaign almost flawlessly to seize the Senate.

On the flipside, if the Democratic nominee wins the Presidency and generates coattails, the Democrats could sweep. That could imply lower returns this year but stronger returns in 2017, as markets first fear radical change, then realize campaign pledges seldom become reality.

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President Trump, Clinton Indictment and Other Possibilities

But what if abnormalities persist, or even come to fruition? What if Donald Trump wins? Most experts presume he will fade and an "establishment" candidate will triumph. But what if they don't? For all his bluster, we have no idea what a President Trump would actually do, and uncertainty could drive volatility.

But a President Trump also seems unlikely to cause a bear market. Stocks move most on policies, not personalities, and there is little evidence bellicose rhetoric translates into actual policy. Very little of Trump's stated agenda can be enacted by fiat. For example, Trump says he will renegotiate or end 1994's North American Free Trade Agreement. Yet this was an act of Congress that requires legislation to undo. Most legislators (in both parties) don't support this or other Trump proposals—making radical change unlikely.

There is also the possibility a third-party candidate (such as former New York Mayor Michael Bloomberg or even Trump) runs, like businessman Ross Perot did in 1992. Perot won almost 19% of the popular vote then—among the most successful third-party runs ever—but won zero Electoral College votes. More importantly for investors, his running didn't cause a bear market.

On the Democratic side, it is possible Clinton is indicted for past controversies after it's too late to *not* nominate her. However, scandal and legal troubles aren't foreign to the Presidency and needn't roil markets. Bill Clinton faced impeachment in 1998, yet the decade-long 1990s bull persisted. Nixon's resignation happened during a bear market but wasn't the proximate cause. And on the eve of 1992's election, the indictment of Caspar Weinberger, President Ronald Reagan's Secretary of Defense, brought allegations that George H.W. Bush lied about his involvement in the Iran-Contra Affair. Though later proven untrue, some Republicans argue this negative press contributed to Bush's defeat—regardless, the bull market romped on.

As campaigns escalate and rhetoric reaches fever pitch, don't get caught up in the bluster—with so much unknown, and so many competing proposals and viewpoints jockeying for attention, we are long on possibilities but short on probabilities. Markets move on probabilities, but for now, there is just noise. Later, as outcomes become possible to handicap, is the time to start considering more actionable takeaways.

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Appendix IV: Common Questions From Client Events

One factor that sets Fisher Investments apart from other firms is our dedication to educating clients. We believe it is very important that clients have a clear understanding of how we view the investment world—and grasp the process by which we manage portfolios. As such, we invest heavily each year in holding a variety of client events nationwide, at which senior members of our firm—including our Investment Policy Committee—interact with clients. These client-only events are held in various settings—large group Forecast Seminars in urban centers, online Webinars, medium-sized Client Forums, small group Investment Roundtables and more. For some of these events, we lead off with prepared remarks about salient parts of our process and outlook. But all of our events have open Q&A—an opportunity to interact directly with their portfolio manager.

Some questions arise at almost every event. Here are some of the most common we've encountered recently and a brief response, to give you a sense of what you might hear at a Fisher Investments client event.

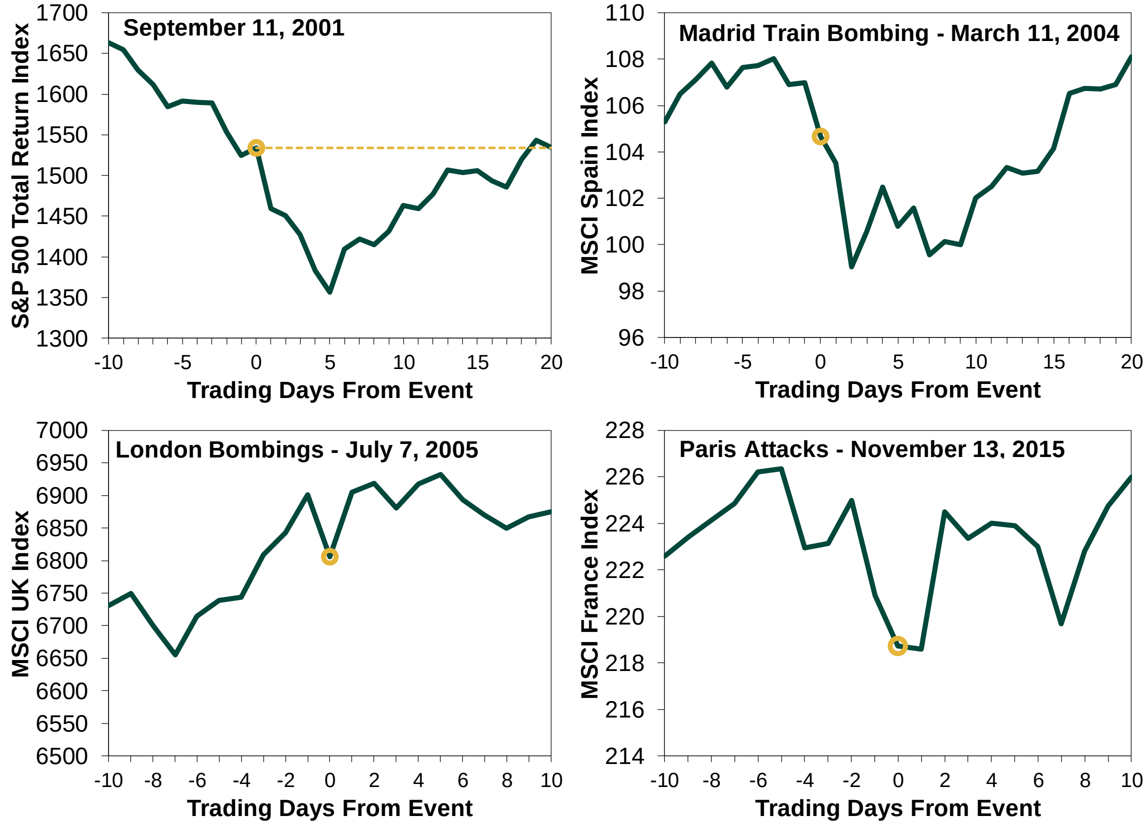
Will Terrorist Attacks in America, Europe and Asia Hurt Stocks?

We don't believe so. Despite its horrors, terrorism alone has never caused a bear market, and we think it's unlikely to do so anytime soon. Terrorist attacks can temporarily spook stocks, but they lack the economic impact to knock trillions off global output. The world economy tops $77 trillion, so a terrorist attack would need to quash several trillion of economic activity to materially dent global growth—unlikely. While the damage to property and human lives is terrible, impact on everyday commerce tends to be small. Even 9/11 didn't cause a recession. It occurred amid a recession that began in March 2001 and ended that November, two months after the attacks.

Market returns surrounding terrorist attacks vet this out. 9/11 occurred during a bear market, but the downturn began back in March 2000 when the Tech Bubble popped. 9/11 itself stoked volatility, but it was relatively short-lived. The S&P 500 fell 11.6% in the first five trading days after markets reopened, but regained the lost ground by October 11.[20] From the attacks through year-end, US stocks rose 5.5%.[21]

More recent terrorist attacks have had similarly fleeting impacts, demonstrating the unfortunate reality that these tragedies no longer shock mankind. After the 2004 Madrid train bombing, the 2005 London bombing and the November 2015 Paris attacks, stocks dipped only for days or less. (Exhibit 11) The same holds for the Boston Marathon bombing and scores of other terror attacks in recent years.

Exhibit 11: Terrorism Doesn't Sink Stocks



Source: FactSet, as of 11/24/2015. S&P 500 Total Return Index, 8/24/2001 – 10/12/2001; MSCI Spain Index, 2/26/2004 – 4/8/2004; MSCI UK Index, 6/22/2005 – 8/4/2005; MSCI France Index, 10/30/2015 – 11/30/2015. Index levels shown are in local currency and include dividends.

Will High US Debt Destroy the Economy and Stocks?

Not in the foreseeable future. America's $18.9 trillion in gross national debt—105% of GDP—makes scary headlines, but the risks are vastly overstated.[22]

The $18.9 trillion figure refers to gross public debt—the entire amount outstanding. However, the government owns about $5.3 trillion, and money you owe yourself effectively cancels.[23] Hence we assess net public debt, which logically excludes intergovernmental holdings. Net public debt is currently about $13.6 trillion, or 75% of GDP.

Though this figure has risen in recent years, it isn't abnormally high. It spiked to 109% during WWII as the Treasury borrowed to finance military spending, but economic calamity didn't ensue. After the war, we didn't pay off the debt: Rapid economic growth reduced debt as a percentage of GDP, but the absolute amount owed didn't materially fall. Similarly, UK net debt soared past 200% of GDP throughout the 18th and 19th centuries, the height of Britain's empire. The Industrial Revolution flourished despite the heavy debt load.

Debt becomes problematic only when debt service becomes unaffordable. US debt is at its most affordable in decades. Interest payments relative to GDP and tax revenue are lower than they were for all of the 1980s and 1990s—great periods for the US economy and stocks.

Exhibit 12: Net Public Debt

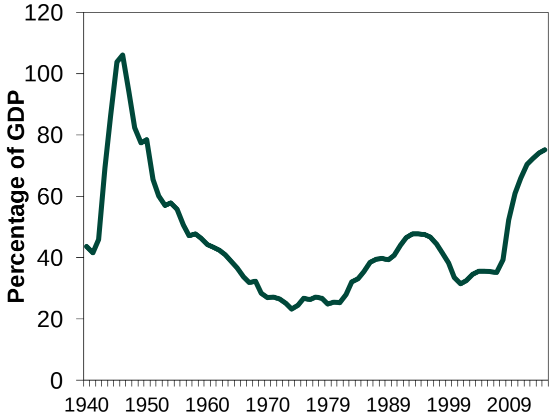
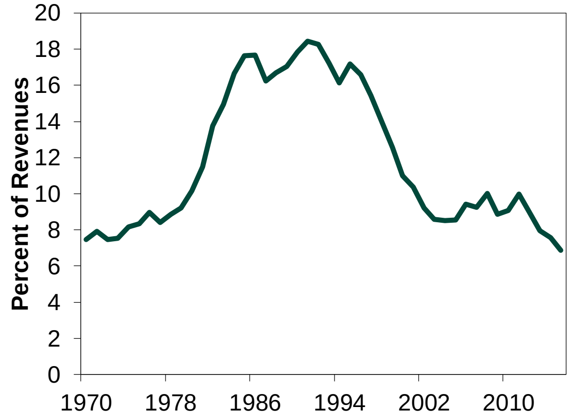


Exhibit 13: Interest's Share of Tax Revenue



Source: White House Office of Management and Budget (OMB), Federal Reserve Bank of St. Louis, as of 1/19/2016. Net public debt as a percentage of GDP is the OMB estimate for 2015.

For debt to become problematic, interest rates or deficit spending must skyrocket and stay there. The weighted average yield on all US debt is currently just 2.04%, and higher rates impact newly issued bonds only.[24] For interest costs to break the bank, most of our maturing debt would have to be refinanced at drastically higher rates. Since Treasurys' average maturity is currently 5.8 years, it would take years for higher rates to radically impact affordability.[25] The deficit, at 2.9% of GDP, is not high by historical standards.

While it is impossible to know what the far future holds, nearer term, the likelihood of soaring interest rates is exceedingly low. US debt is broadly considered among the lowest default risks globally, with the deepest, most liquid capital markets. Demand for US debt remains high globally, inflation is low and US Treasury issuance has slowed, limiting supply.

Some fear China—a large holder of US debt— will sell Treasurys en masse, sending rates skyward. But China has been selling US debt for nearly a year, and rates remain low. While China is America's biggest foreign creditor, it is far from the biggest owner of US debt. US investors—banks, mutual funds and other institutional investors—own around $4.5 trillion while China owns $1.2 - $1.4 trillion, about 7.7% of total US debt. It is highly unlikely China would sell all its holdings at once, as doing so would cause the yuan to soar, driving instability. But if they did, yields would likely spike briefly, then fall as other investors swoop in for a bargain.

With the Amount of Geopolitical Turmoil Globally, Should I Own Gold?

We don't believe so. Gold holds emotional appeal for some, but it is merely a commodity with little physical demand outside of jewelry, and prone to big sentiment-driven swings. We don't believe it belongs in long-term investors' portfolios, as it has lower long-term returns and higher volatility than stocks. Success with gold requires amazing market timing.

Gold is not a "safe haven" against volatility or geopolitical risk. Gold fell -44% from its 2011 record high through 2015's close, a period including: The Boston Marathon bombing; skirmishes between Israel and Hamas; terrorist attacks in Africa, Paris, Beirut, California and Asia; Egypt's coup; Syria's civil war; Russia's invasion of Ukraine and Islamic State's rise.[26]

Gold's "stable" reputation comes from its history of backing money, but gold's price was only stable because governments fixed it. Now that gold trades freely, it is quite volatile, prone to huge swings in both directions. Gold booms tend to be few and far between, too. Consider: Gold hit a record high $850 per ounce on January 21, 1980. It didn't eclipse this mark until January 2008—almost three decades later.[27] Now it has fallen for more than four years. The only true "safe haven" is cash, but even this loses to inflation over time.

We hope you've found this information helpful. Please contact Fisher Investments at 800-568-5082 for more information on our outlook and services or to arrange an appointment with one of our representatives for a complimentary review of your portfolio. To follow our daily commentary on market and economic events, please visit www.MarketMinder.com. Alternatively, you can sign up here for MarketMinder's weekly newsletter.

The Investment Policy Committee

Aaron Anderson, Ken Fisher, Bill Glaser and Jeff Silk

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[1] Source: FactSet, as of 1/4/2016. MSCI World Index return with net dividends, 9/30/2015 – 12/31/2015.
[2] Source: FactSet, as of 1/19/2016. MSCI World Index return with net dividends, 12/31/2015 – 1/29/2016.

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[3] Ibid, 5/21/2015 – 1/29/2016.
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[6] Source: Global Financial Data, Inc. and FactSet, as of 1/20/2016. S&P 500 annual total return, 1926 – 2015. MSCI World Index annual return with net dividends, 1970 – 2015.
[7] Source: FactSet, as of 1/20/2016. MSCI World Index price return, 12/31/1997 – 1/12/1998.
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[9] Ibid. MSCI World Index with net dividends, 12/31/1997 – 12/31/1998.
[10] Source: US Bureau of Economic Analysis, as of 1/26/2015.
[11] Source: FactSet, as of 1/19/2016.
[12] Source: FactSet, as of 1/19/2016. US dollars per China renminbi, 8/10/2015 – 1/15/2016.
[13] Ibid, as of 1/19/2016. US dollars per British pounds, 8/10/2015 – 1/15/2016.
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[15] Source: FactSet, as of 1/20/2016. 10-Year US Treasury yield, 12/31/2014 – 12/31/2015.
[16] Ibid.
[17] Ibid. BofA Merrill Lynch High-Yield Master II Index total return, 12/31/2014 – 12/31/2015.
[18] Ibid. Russell 2000 and Russell 2000 Value Index total returns, 12/31/2014 – 12/31/2015.
[19] Source: Bloomberg, as of 1/27/2016. ETF in question is ticker HYG, iShares IBoxx High Yield Bond ETF.
[20] Source: FactSet, as of 1/20/2016. S&P 500 total return, 9/10/2001 – 10/12/2001.
[21] Ibid, S&P 500 total return, 9/10/2001 – 12/31/2001.
[22] Source: US Bureau of Economic Analysis and Treasury, as of 1/15/2016. Q3 nominal GDP and gross public debt.
[23] Source: US Treasury, as of 1/15/2016.
[24] Source: Treasury Direct, as of 12/31/2015.
[25] Source: Bloomberg, as of 12/31/2015.
[26] Ibid, 9/6/2011 – 12/31/2015.
[27] Source: FactSet, as of 1/25/2016. Gold spot price, 12/31/1972 – 12/31/2015.

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