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Mid-Quarter Commentary as of February 22, 2016
By John M. Silvis, CFA
Chief Investment Officer

The global equity markets have gotten off to a rocky start in 2016 with the S&P 500 Index, representing the domestic markets, down -4.49% since the beginning of the year. That is a marked improvement from the low earlier this month when the index was down -10.27%, reaching its low so far this year. The global equity market, represented by the MSCI All Country World Index (ACWI), has declined -5.96% year-to-date and has officially reached bear market status (having declined over 20% from its peak back in May of 2015). The ACWI has bounced as well having been down over -11.27% at its low earlier this month.

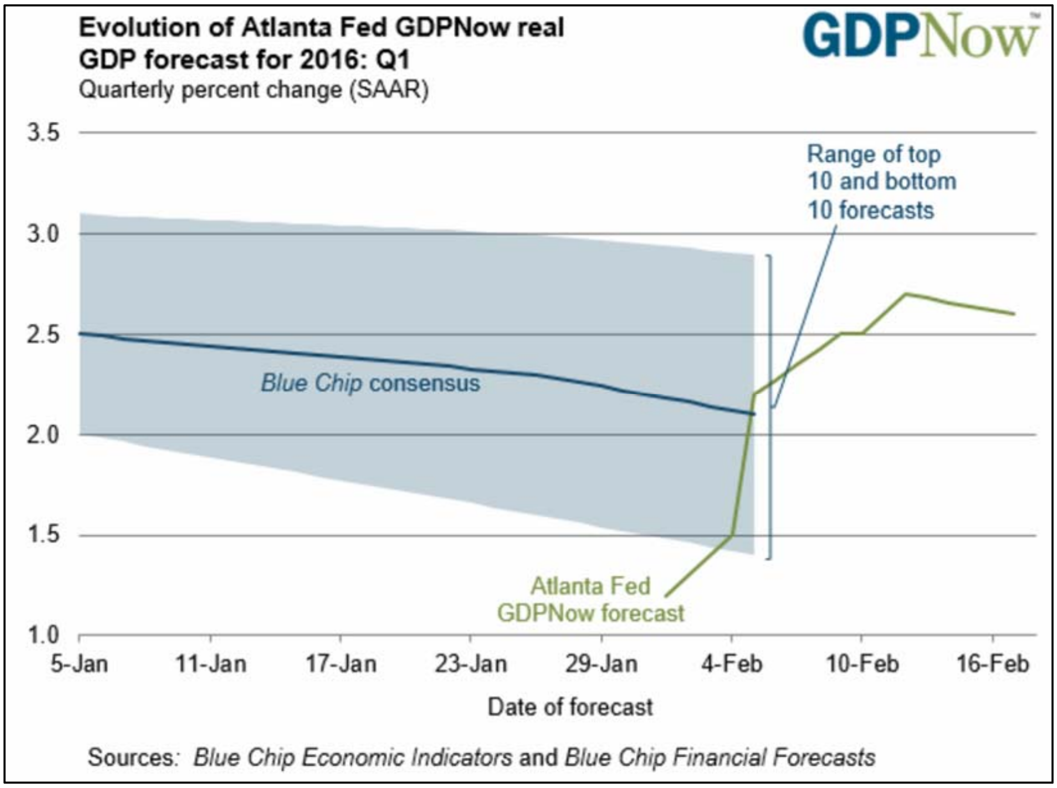
The volatility in the capital markets, dating back to the peak in the S&P 500 Index in May, has been led by a number of factors. One of the main factors has been the decline in the price of crude oil over the past few years. From its peak in the fall of 2013, oil prices have fallen over 80% peak to trough and nearly 8% since the beginning of the year. Equity markets have historically had an inverse relationship with oil prices, meaning markets went up when oil prices went down. But the relationship reversed last year when markets (both domestically and globally) became concerned that the falling price of oil as well as other commodities was a sign of slower global growth and fears of a global recession began to rise. No one yet has correctly predicted the bottom in oil prices but with prices under $27 per barrel, it feels like we are in the later stages of the beginning of a bottom which may take several weeks or months to form. **Unless the equity markets break the positive correlation with oil prices, oil needs to find its footing so the markets can follow.**

Another factor that has added pressure to the current market conditions has been the uncertainty of Federal Reserve and the direction and speed of monetary policy as we head into 2016. The Fed, as was expected, finally raised interest rates at their December meeting of the FOMC. They also published their interest rate forecast for the coming year, indicating four additional rate hikes of 25 basis points (a quarter of a percent) in 2016. As market conditions deteriorated at the end of the year and economic data was slower than expected, the capital markets started to discount the number of rate hikes to be expected in 2016, lowering consensus to only one rate hike in 2016. After holding back on raising rates at the January meeting, it's likely the Fed will need to move their forecast closer to the market expectations. **This chasm has contributed to the volatility experienced over the last few weeks and should dissipate in the coming weeks as the Fed signals its moves will be more "data dependent" going forward.**

China and their government's handling of the economy and its equity markets has drawn a spotlight from markets around the world. Many are now coming to grips with the reality that China's growth is slowing and experiencing growing pains as it transitions to a consumer based economy. The Chinese government started down the path of devaluing their currency, the Yuan, starting back in August of last year. Since then, they have continued to ease monetary and fiscal policy while lowering the value of the currency in the hopes of stimulating their slowing economy. While it's early in the process, there are signs that the economy is starting to gain some traction but will likely not realize the official target of economic growth in the 6.5 to 7.0% range. **Further signs of stabilization in China will alleviate some of the concerns of capital markets around the world.**

While the equity markets may already be anticipating a recession, in reality the economy is still on firm ground. Evercore ISI, a macroeconomic research group, puts the likelihood of a recession at less than 25% in 2016. Gross Domestic

Product (GDP) grew just over 2.4% in 2015 and is showing signs that the long term trend of 2-2.5% growth is likely to be achieved again this year. The Atlanta Federal Reserve Bank has developed an econometric model that has been accurate at predicting economic growth over the past few quarters and has been cited in many popular news shows to give an idea of where the economy is headed. Its most recent reading stands at 2.6% for the first quarter of 2016 (see below), far from any indication of a looming recession.



The unemployment rate recently fell under 5%, forecasting that the economy in the U.S. is closing in on full employment. Weekly unemployment claims remained under 300,000 for the 50th consecutive week, pointing to a strong and improving labor market. Finally, the Citigroup Economic Surprise Index, an aggregate reading of economic measures that were reported better than expected by the consensus readings, has recently hooked upwards and should point to better data in the weeks or months ahead.

Overseas, Europe grew 1.5% in 2015, fueled by the steady diet of more monetary easing by the European Central Bank (ECB). There is an expectation that more stimulus is on the way for the Eurozone after ECB President Draghi stated that the ECB “is ready to do its part” to make the euro area more resilient. The slowdown in China, one of its bigger trading partners, is having an effect on the region and has been a drag over the last few quarters. The ECB moved to negative interest rates on excess reserves from the bank in hopes of generating more loans to stimulate the economy. This has put pressure on the banks in Europe as well as their capital markets.

More pain is likely in the emerging markets in 2016 as it relates to their slowing economies. Both Russian and Brazil are struggling with recessions brought on by declining commodity prices. The fear is that it develops into a prolonged depression that could spread to other emerging market countries. How much equity markets have discounted the poor economic conditions remains to be seen, but markets will likely respond before the economy does. While we remain cautious on emerging market equities, opportunities may present themselves as we move into the back half of the year.

On the domestic front, Large Cap equites continued their dominance over both Small and Mid-Cap sized companies in 2015 and have remained on top so far in 2016. Defensive sectors have outperformed since the beginning of the year with Consumer Staples, Utilities and Telecom leading the way. Financials, which have been one of the worse performing sectors this year, have come under pressure as interest rates fall and pressure from European banks spreads to the U.S. If the U.S. Dollar, which has fallen slightly this year, continues its recent trend sectors such as Materials, Industrials and Technology should do better in the coming months. Earnings, which were basically flat in 2015, should see modest gains this year proving not all is lost in 2016.

The short term remains somewhat uncertain due to the Fed, oil prices and a slowdown in China. However, the long term still looks solid in our view while acknowledging that more volatility and clarity are needed for the markets to continue on their secular bull run.

Fixed Income Commentary as of February 23, 2016
By Rick D'Amico, CFA
Manager of Investments

The recent weakening in global financial conditions likely has the Fed on hold in the near term, as the fed fund futures market is currently pricing in just an 8.0% chance that the Fed raises its benchmark interest rate in March. In fact, the market is currently not pricing in a single rate hike this year. While it is very unlikely the Fed will raise interest rates four times this year as signaled in their December meeting, in our view, the market may be underestimating the probability of an interest rate increase this year. This is especially true if core inflation measures have indeed troughed and continue to drift higher and first quarter GDP remains on track at the current 2.6% pace as forecast by the Atlanta Fed GDPNow model. Cornerstone Macro's Roberto Perli's base case currently calls for two interest rate increases in 2016, which appears to be a more reasonable scenario in our view.

U.S. 10-year Treasury yields broke through an important technical support level at 2.04% in mid-January and have since moved sharply lower, currently trading at 1.80%. Mixed economic data, low yields globally and uncertainty surrounding energy prices, the Fed and slowing growth in China have resulted in a flight to quality, creating demand for U.S. treasuries and driving yields lower to start 2016. The Barclays U.S. Aggregate has returned a solid 1.93% year-to-date, driven primarily by strong returns in longer dated treasuries which have been the best performing sector, returning 8.83%. The free fall in commodities prices has caused stress in several sectors of the high yield and investment grade credit markets, as energy and metals and mining names remain under significant pressure. At this time, we favor investment corporates over high yield and remain cautious on government securities given current yield levels.

Social Security Changes in 2016 Will Limit Benefit Planning Strategies
Christopher R. Isabella, CPA/PFS, CGMA
Partner

The Bipartisan Budget Act of 2015 signed into law by President Obama on November 2, 2015 changes the social security strategies known as "file and suspend" and "claim now, claim more later."

Unintended loopholes came into existence when Congress passed the Senior Citizens Freedom to Work Act in 2000. The purpose of this act was to allow seniors who had begun receiving Social Security benefits to go back to work and to postpone, or suspend, their stream of Social Security benefits. It was these suspension rules that paved the way for both "file and suspend," and "claim now, claim more later" planning strategies.

For those born before 1955, full retirement age (FRA) for Social Security retirement benefits is age 66. Those who delay taking benefits beyond FRA receive an 8% increase in their monthly benefit for each 12 months of delayed retirement credits (DRCs) that they accrue. For example, a 66-year old today may receive a benefit of as much as $2,639 per month by taking benefits at FRA. However, if that person waits until age 70 to claim benefits, accruing four years of DRCs in the process, the monthly benefit will be 32% higher, or $3,483 per month (before adjustments for inflation). This 32% income differential will apply until the end of the worker's life and can also be assumed as a survivor benefit by the worker's spouse.

File and Suspend: In a typical example of "file and suspend," both spouses must be at least FRA. Let's assume they are each 66 years old. The high-earning spouse files for benefits, allowing the low-earning spouse to claim spousal benefits on the high-earner's benefit. At the same time, the high-earner would stop (suspend) their social security benefits until their age 70 to earn the higher payout.

This 32% higher benefit would be available until the high-earner's death, at which time the low-earner would switch from the spousal benefit they are receiving to the benefit the high earner was receiving.

Planning concept: This is a form of "longevity insurance." Higher-earners with adequate cash flow near-term (or where pulling cash out of other sources won't adversely impact their long-term planning) would wait until age 70 and receive a higher amount until their death, at which point their spouse would receive the new higher benefit. Their spouse would get social security as a percentage of their spouse's benefit (50% as of the spouse's FRA) during the "suspend" period to help with family cash flow.

What the New Law Will Do: The new law provides that the suspension of a worker's benefit will result in the suspension of **all** family benefits (e.g., the spousal benefits mentioned above). This will force the couple to choose between spousal benefits with no delayed retirement benefits or wait four years to earn maximum benefits. This also delays the spousal benefits. During that four-year period, the low-earner could possibly claim a lower benefit based on their work record.

The effective date of this provision is 180 days after enactment of the law, or April 30th, 2016.

Claim Now, Claim More Later: An example of "claim now, claim more later" is a version of "file and suspend." Assume the low-earner's benefit is below the spousal benefit, but adding the 32% increase from delayed retirement to age 70, the low-earner's own benefit would then be greater than the applicable % of the spousal benefit. In this case, the low-earner claims the spousal benefit under "file and suspend." Then they switch to their own benefit at age 70, claiming the higher amount created by delayed retirement benefits.

Planning concept: This creates higher overall social security benefits where the fact pattern is right. It creates a version of longevity insurance (although not a huge increase in benefits) in most cases.

What the New Law Will Do: The new law states when a claim is made for one benefit, a claim is made for all benefits to which the person is entitled, thus eliminating the ability to switch between benefits. This provision applies to all persons who have not reached age 62 by 12/31/2015. This provision applies only to retirement and spousal benefits and does not apply to survivor benefits. A widow or widower will still retain the ability to select either survivor benefits or retirement benefits and to later switch to the other.

Summary:

- If you have already filed and suspended or have begun "claim now, claim more later," you will be unaffected by the new changes.
- If you are planning to "file and suspend," the key action related to the law is the application to suspend benefits. It is this application that must be made by April 29, 2016. So if you have already "filed and suspended" or if you file and submit the application to suspend by April 29, 2016, your suspension will remain valid until you un-suspend it, typically at age 70.
- Any application for a suspension of benefits after April 29, 2016, will result in all family benefits being suspended.
- If you are planning to enter into a "claim now, claim more later" strategy, your ability to claim different retirement benefits at different times is available to all eligible persons who were at least age 62 by 12/31/15. The "claim now, claim more later" strategy will work so long as the "file and suspend" strategy is completed as discussed above.
- For the high-earner over age 70, and low-earner at least 62 by 12/31/15, "claim now, claim more later" scenario is still available.

To discuss how these changes may limit your benefit planning strategies, please contact a member of your Fairport team.

Fairport News
Read about our most recent community involvement, speaking engagements, conferences and continuing education.

Ken Coleman recently joined a local, privately owned manufacturing company Board of Advisors. Ken also began his second term as Greater Cleveland Partnership Government Affairs Council Member.

Emily Drake and **John Silvis** are attending the Commonfund Forum in Florida later this week on behalf of BRIA and Saint Luke's Foundation. In its 18th year, the Commonfund Forum is the preeminent annual conference for institutional investors. The forum provides timely information, thoughtful analysis and unique perspectives – all from recognized experts in the worlds of investment management, economics, business and finance, government, academia and the media.

Heather Ettinger presented "SHE-Change: Women's Emerging Role in the Family, Business and Society and Its Impact on the Financial Services Industry" to the Cleveland-Akron Society of Financial Service Professionals last week. Using demographic data and her own research through the Family Wealth Advisors Council, Heather shared communication strategies and deliverables for niche markets of women, reviewed case studies and best practices and discussed the impact on the financial services industry going forward.

John Silvis kept current on investment strategies and trends by attending the world's largest exchange-traded funds (ETF) conference, Inside ETFs, in Florida at the end of January. He joined 1,700 financial advisors, ETF strategists and leading ETF institutions to find new opportunities, trade investment strategies and establish new connections.

Newsletter Disclosures
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