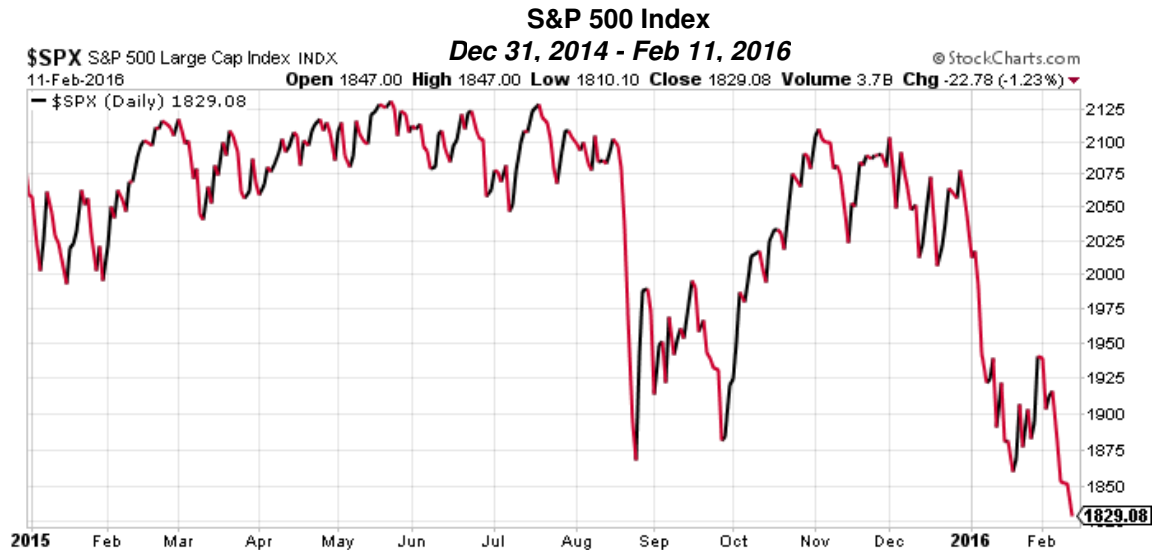


INVESTMENT BACKDROP

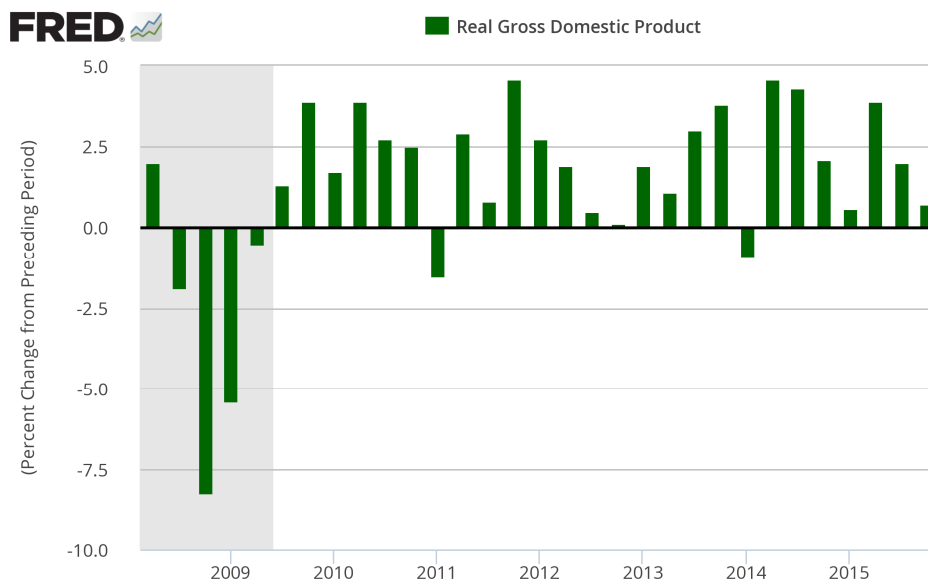
Early 2016

U.S. stocks sold off late last summer, then quickly recovered, but have since pulled back again. This recent stock market weakness follows four years of relative calm. Sharp moves in currency and commodity markets and fears of a Chinese slowdown have unnerved stock investors. But is the backdrop really as dire as many claim? Everyone says that corrections are healthy until they actually occur.



Source: stockcharts.com

The U.S. economy has traction, largely propelled by the consumer (70% of GDP). Economic growth continues to be uneven from quarter to quarter but has been running at around a 2.5% annual rate.

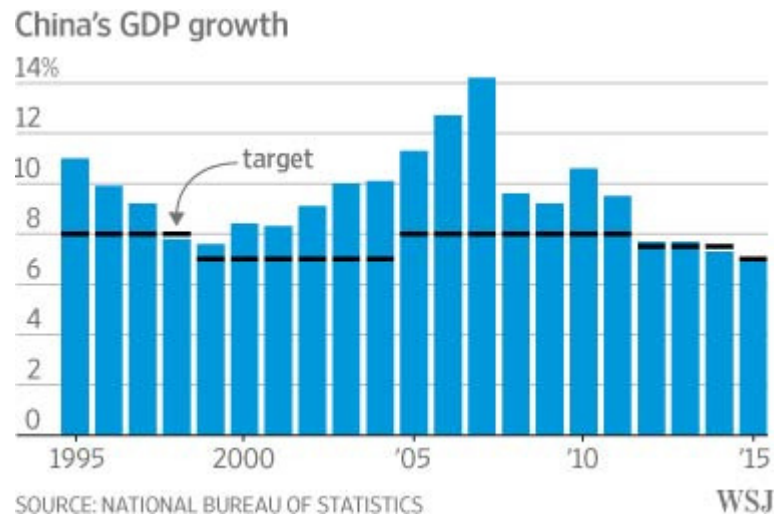


Source: US. Bureau of Economic Analysis
research.stlouisfed.org

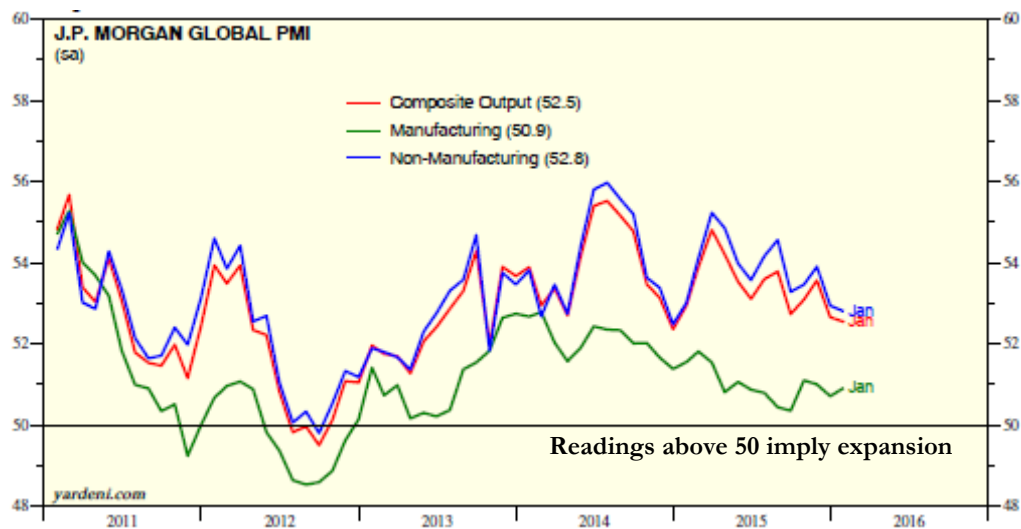
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KANAWHA
CAPITAL MANAGEMENT

China's economic growth rate has been slipping for a number of years, a natural occurrence as a nation industrializes. However, fears of a "hard landing" have stoked U.S. financial markets, leading to stock price weakness over the last six months. That outcome still seems remote and Chinese policymakers have substantial resources to counter a downturn.

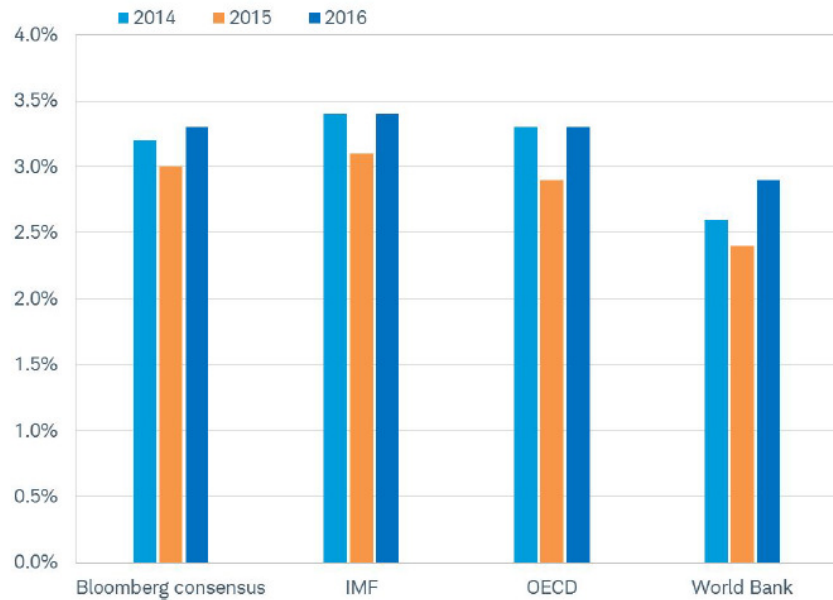


Most signs still point towards an expanding global economy. The developing world remains the weak spot, particularly those economies reliant on natural resources. Central banks in most developed economies continue to ease.



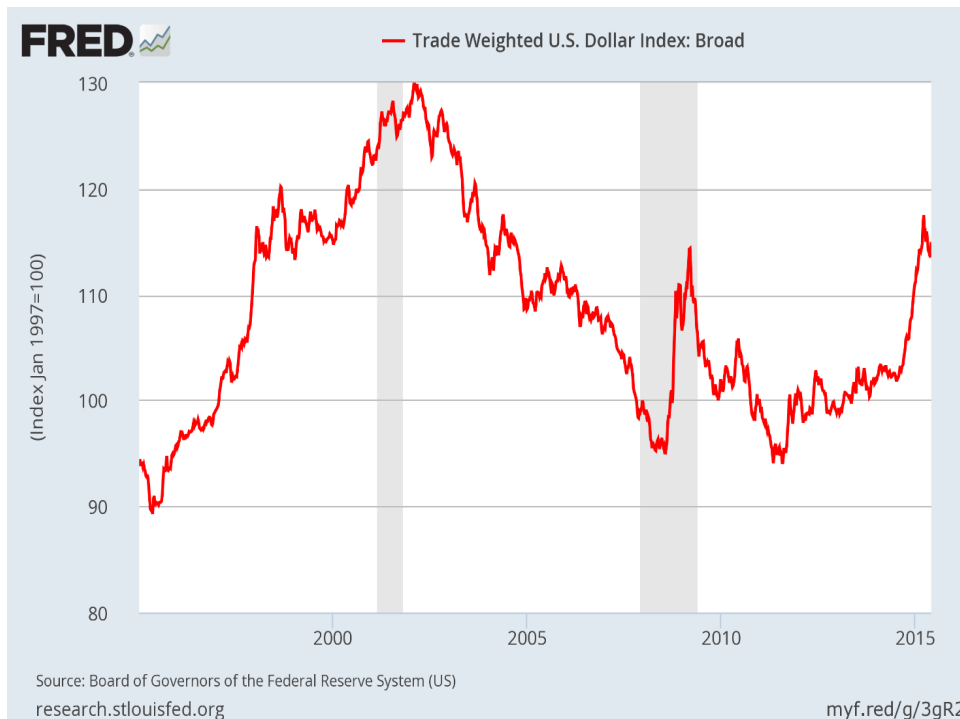
So the outlook is for modest economic growth in 2016 and a pickup from the prior year.

World GDP by Forecaster and Year



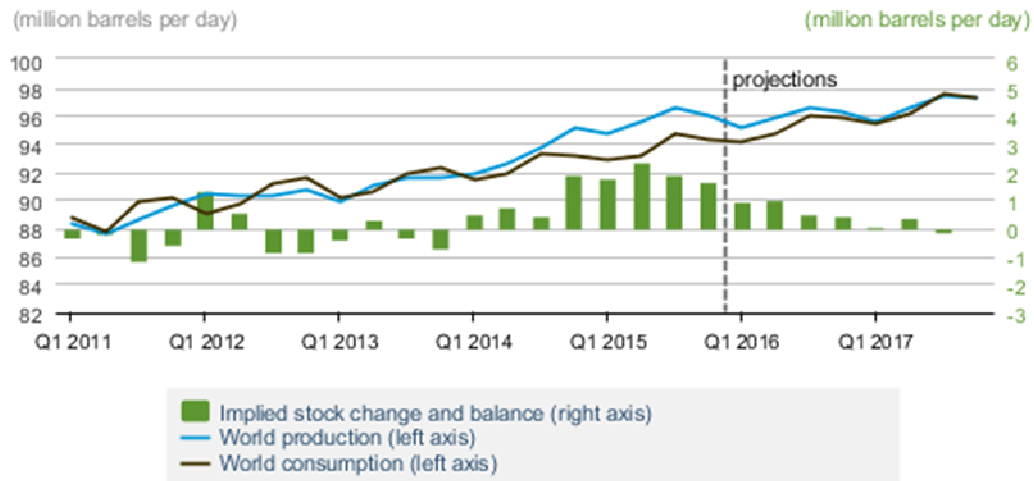
Source: Charles Schwab

The dollar has spiked, pressuring U.S. exports as they have become more expensive for foreign buyers. This has hindered economic growth and dampened the earnings of exporters. The higher dollar has also effectively reduced revenues of U.S. multinationals as they translate their local currency sales back into the home currency.



Often, plummeting oil prices stem from falling consumption and signal a global slowdown. The current down cycle has instead been driven by robust production, not lower demand. Surging U.S. shale oil output collided with rising OPEC supply. Lower oil prices, if sustained, will eventually force excess supply off the market.

World Liquid Fuels Production and Consumption Balance



 Source: Short-Term Energy Outlook, January 2016

Falling oil prices have negatively impacted the energy and industrial sectors. However, in theory, because the U.S. is a net consumer of oil, lower prices cannot be all bad. Households have seen their gasoline expenditures drop by more than half. In recent months, stock prices have been closely tracking crude oil prices on a day-to-day basis. So as oil prices have dropped, so have stocks. But historically, large declines in oil prices have been followed by stock market gains.

Period	Oil Price Decline	1 Yr S&P 500 Return After Oil Price Decline
Oct '85 to Mar '86	66%	+37.7%
Sept '90 to Feb '91	53%	+16.0%
Dec '96 to Nov '98	56%	+20.9%
Jun '08 to Jan '09	70%	+33.1%
Jun '14 to Jan '16	65%	?

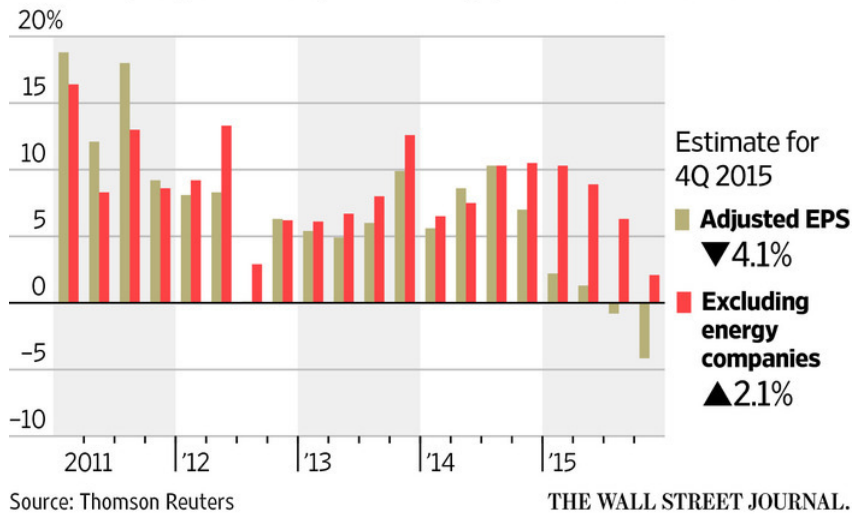
Source: Hartford Funds; Cumberland Advisors

Corporate profits have been weak for several quarters largely due to collapsing energy sector earnings and the negative impact of the strong dollar. Excluding energy companies, S&P 500 profit growth has been sluggish (low-to-mid single-digit range) but not a disaster.

Declining Expectations

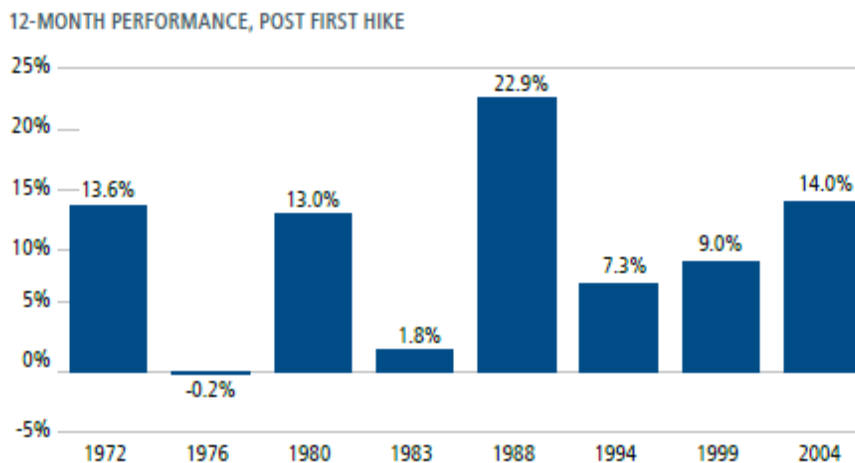
Large companies are expected to report sharply lower earnings per share for the fourth quarter, thanks to steep declines at energy companies.

Year-over-year growth in adjusted earnings per share for the S&P 500



The Federal Reserve increased the target for short-term rates in December. Interest rates are very low and have room to normalize without stifling the economy. During past rate tightening cycles, stocks have generally managed positive returns.

FIGURE 2. S&P 500 RETURNS AFTER RATE HIKES

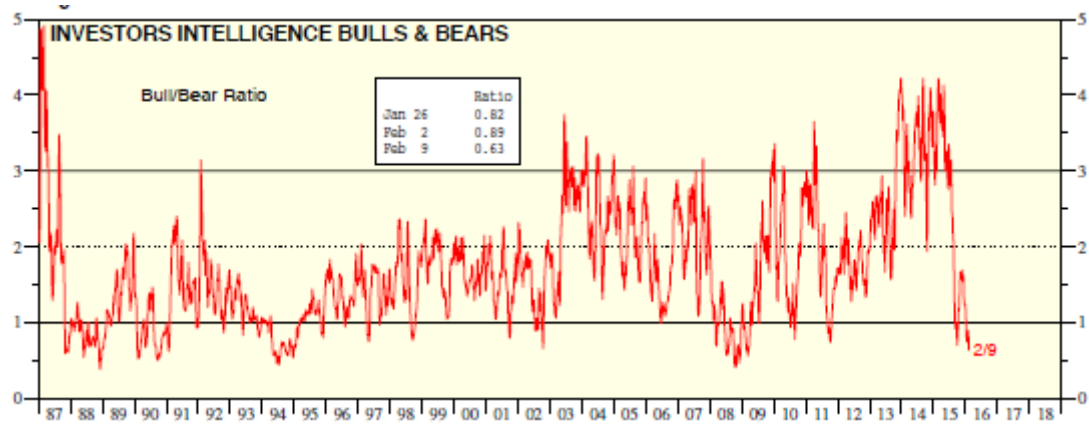


Past performance is no guarantee of future results.
Source: Cornerstone Macro. "Positioning For A Fed Tightening Cycle," September 16, 2015.

Much of the day to day price action seems disconnected from underlying fundamentals. Instead, it is largely being driven by swings in sentiment — which can be erratic and change sharply.



Anxiety about stocks seems to be pervasive. Not surprisingly, the number of bulls is at a very low level compared to the number bears. But such readings tend to occur towards the end of a correction.



Source: yardeni.com