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Review

The old curse "may you live in interesting times" seems appropriate when reflecting on the stock market in 2015. We certainly had the requisite amounts of economic disorder and uncertainty to make the expression meaningful, from questions about Greece and the strength of the Chinese economy to geopolitical unrest, falling oil prices, and uncertainty about when the Fed would finally raise rates.

By mid-year, the S&P 500 index was right where it started. Then the Chinese devalued its currency in August, unleashing greater concern about the global economy in general. The S&P 500 dropped slightly more than 10% between August 18th and 25th. While it rebounded in October, the rally was not broad based. The S&P 500 ended the year down 0.7%. Dividends brought the total return for the large cap index to 1.38%. Mid-cap stocks did not enjoy the same strong fourth quarter as the large-cap stocks, and ended the year down slightly more than 2%. ETFs (exchange traded funds) that invest in multiple asset types as a way to diversify risk struggled in 2015, with a median loss of 5%.[1]

Market Index Performance Data: Total Return (%)[2]

Index	As of 12/31/2015 Q4 2015	Trailing 12 Months
S&P 500 Index	7.04%	1.38%
S&P 400 Index	2.60%	-2.18%
Barclay's Capital Intermediate-Term U.S. Government/Credit[3]	-0.20%	1.07%
Barclay's Capital U.S. Treasury 1-3 Years	-0.28%	0.56%

Outlook

Stock valuations remain historically high. While higher stock valuations make sense with lower bond yields, it does seem that stock prices may be bumping up against a ceiling in the absence of strong earnings growth. It is an open question whether significantly higher earnings will be forthcoming in 2016.

We anticipate continued modest growth in the US economy; as well as continued volatility in the stock market. The Federal Reserve saw enough strength in the US economy to raise interest rates, and we're finally seeing signs of wage growth. At the same time, some sectors appear to be slowing, and central banks in other countries continue to pursue some form of easing.

Most forecasts call for GDP growth a bit above 2 percent, inflation still a little under 2 percent, and a slightly improving labor market. We have important demographic shifts underway, with questions about labor force participation and productivity. The implication is probably more modest returns in the stock market in the next few years. We are expecting returns to average in the 4 to 6 percent range, rather than the historical average of 8 to 9 percent for the S&P 500 index. We also think the volatility we saw in the second half of 2015 will continue into 2016. In this environment, asset class and stock selection will be the key to success.

This will present its own challenges. For example, the outlook for the energy sector is still very cloudy. Tensions between Saudi Arabia and Iran make it unlikely OPEC will reduce output in the near term, suggesting that oil prices will remain low in the first part of 2016. Lower oil prices will constrain earnings for many companies, and may result in consolidation in the sector, among other impacts. Still, the energy sector requires attention and may be a source of good opportunities.

In addition, the time will come in the not too distant future to invest again in commodity funds and emerging market funds.

In Focus

This past November and December, a major United Nations climate change conference was held in Paris, France. 195 countries participated and came to a consensus agreement to take action with a goal of limiting global warming to less than two degrees centigrade. Investors need to pay attention, especially those looking to invest in the longer term.

While some have dismissed the agreement due to no formal enforcement mechanism, it is notable that previous attempts at reaching any kind of agreement have been acrimonious failures, usually with the developing nations and developed nations pointing fingers at each other. This time might be different, and the global community may have taken the first real joint steps towards reducing carbon emissions. Of course, a good investor can never say such a thing with too much comfort; recall the famous quote of revered investor John Templeton: “The four most dangerous words in investing are ‘This time it’s different’.”

One reason why it might be different this time is that it is becoming harder every day to deny the evidence pointing towards significant climate change and serious carbon based air pollution. Evidence includes:

- Continuing record high global average annual temperatures
- Melting ice caps and glaciers
- Warming oceans and dying coral reefs
- Terrible smog days in Beijing and Shanghai
- Rising sea levels (see the New Yorker article on Miami Beach)

In response, several major global powers, including most importantly the United States and China, have moved forward with proposals that would tangibly reduce carbon emissions. Powerful voices and political opportunity appear to have aligned nicely prior to the Paris Agreement.

Carbon emission is the main dragon to be slayed in the climate change conundrum. Most emissions are the byproduct of power generation for electricity and transportation. Economists agree that the most efficient way to decrease carbon emissions is to create effective carbon taxation systems. With carbon taxes, there will be predictable economic winners and losers, enforced through the policies of governments around the world. We expect a raft of policy changes to be implemented around the world, likely a combination of taxes on carbon producers and subsidies for alternate energy producers.

Looking farther out, we believe it will be prudent to include a filter linking a company’s carbon footprint to its future earnings growth. The analysis is apolitical, with a view to identifying long-term trends affecting future profitability and potential impact on a company’s stock price. Some stocks will likely see carbon induced tailwinds, other stocks are best to be avoided.

If global policy has truly started to shift on carbon emissions, the change will have a momentum that will continue to build for at least a decade or two, putting us well past 2030. If they have not already done so, all long-term investors need start thinking about this today.

1. Wang, Lu. "The Year Nothing Worked: Stocks, Bonds, Cash Go Nowhere." Bloomberg Business. 27 Dec. 2015. Web. 28 Dec. 2015. <http://www.bloomberg.com/news/articles/2015-12-28/the-year-nothing-worked-stocks-bonds-cash-go-nowhere-in-2015?cmpid=yhoo.headline>.
2. S&P 500 Data: http://us.spindices.com/indices/equity/sp-500. S&P 400 Data: http://us.spindices.com/indices/equity/sp-400.
Barclay’s Index Data: https://index.barcap.com/Benchmark_Indices/Aggregate/Bond_Indices.