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FINANCIAL MARKET OVERVIEW

Calendar year 2015 was disappointing for investors. Very few investment categories were up slightly and most categories finished down 1% to 5%. Stocks started the year with modest positive gains during the first quarter and then ended down slightly during the second quarter. The third quarter was significantly negative for U.S. stocks falling 6% to 10% followed by a partial recovery of 6% - 8% during the fourth quarter. By year end, the broad stock market indexes were down about 2% or less, but when dividends are included, stock indexes ended the year between negative 2% to +0.6%.

The total return for the broad U.S. stock market during the fourth quarter was +5.65% and down -0.21% over the 2015 calendar year. The Dow Jones industrial Average closed up 7% during the fourth quarter and down 2.23% over the entire year.

Large-company *growth* stocks were the best performing stock category - up over 5% in 2015, but large-company *value* stocks were down over 4%. Both mid-cap and small-company stocks categories were down 1% to 8% in 2015.

International stocks were up 2.4% during the fourth quarter, but posted a negative 1.86% return for the entire calendar year. Emerging market stocks (small international companies) returns were down 2% during the 4th quarter and down over 17% in 2015.

Energy companies and energy mutual funds continued to decline during the fourth quarter – down over 6% and down 25% during the 2015 calendar year. Real estate (REIT's) advanced 5.5% during the fourth quarter and finished the year with a small 1% gain. Gold continued to slide 5% during the fourth quarter and lost over 10% during the entire 2015 calendar year.

Fixed income or bonds were down 1% to 2% during the fourth quarter as the Federal Reserve finally raised interest rates in December by a quarter point. Fixed income and bond funds ended the year up less than 1%.

The following chart displays sample returns of various asset categories during the fourth quarter and calendar year 2015:

Calendar Yr 2015	**4th Qtr. 2015**	**Index Return (*includes dividends reinvested*)**
- 2.23%	**+ 7.00%**	**Dow Jones Industrial Average (^DJI)**
+ 0.64%	**+ 6.41%**	**Standard & Poor's 500 Index (^GSPC)**
- 0.21 %	**+ 5.65%**	**DJ U.S. Total Stock Market (VTI)**
+ 5.73%	**+ 6.97%**	**Large-company stock-Growth (IWF)**
- 4.61%	**+ 4.91%**	**Large-company stock-Value (IWD)**
- 0.77%	**+ 3.74%**	**Mid-Size Stocks – Growth (IWP)**
- 5.65%	**+ 2.34%**	**Mid-Size Stocks – Value (IWS)**
- 1.64%	**+ 3.96%**	**Small-company stock- Growth (IWO)**
- 8.37%	**+ 2.04%**	**Small-company stock- Value (IWN)**
- 1.86%	**+ 2.44%**	**International (EFA)**
- 17.46%	**- 1.80%**	**Emerging Markets (EEM)**
+ 1.03%	**+ 5.55%**	**Real Estate Investment Trusts (VNQ)**
		Fixed Income
+ 0.24%	**- 0.74%**	**Short-term U.S. Treasury (SHY)** *(includes appreciation)*
+ 0.89%	**- 2.11%**	**Intermediate U.S. Treasury (IEF)** *(includes appreciation)*
		Alternative Investment Category
- 10.67%	**- 5.05%**	**Gold (GLD)**

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FINANCIAL MARKET OUTLOOK

Expect lower (below-average) investment returns for stocks, bonds and real estate in 2016 and brace yourselves for more volatility and surprising short-term price fluctuations. Very few investors are 100% invested in U.S. stocks, but if someone had invested all of their money in stocks, below are the annual U.S. stock market returns for the S&P 500 Index since the devastating 37% decline in 2008:

2009	2010	2011	2012	2013	2014	2015
26%	14.8%	2.1%	15.9%	32.1%	13.5%	1.4%

If we exclude dividends paid on stocks in the above index figures, the price performance in 2011 and 2015 would have been -0.4% and -0.7%.

The longevity of this seven-year expansion of economic growth and rising stock prices has only been better in three of the eleven previous expansions (since World War II). In hindsight, there are three primary reasons why U.S. stock performance was well-above average since 2009 and three primary reasons why the recent *downward trend* (32% in 2013, 13.5% in 2014 and down to 1.4% in 2015) will likely continue at least until 2017.

First, stocks generally advance strongly after a downturn. Following the -9%, -12% and -22% returns during 2000-2002, the stock market rose 28.3% in 2003. Following the 37% decline in stock prices in 2008, the stock market was up 26% in 2009. Second, the Federal Reserve dropped interest rates significantly and continuously since 2008. Lowering interest rates lowers borrowing costs (credit cards, home and business loans) for families and businesses and is a *temporary* strategy to help avoid a recession and to jump-start the economy. Third, the recent significant decline in energy (oil) and basic or raw material (copper, ore, aluminum, etc.) prices reduces the cost of building, manufacturing and driving and thus provides extra net profit to companies and more cash flow to consumers.

The first reason above (sharp rebound in stock prices following a sharp decline) doesn't apply in 2016 because we have had no significant stock price decline since 2008. The second reason (lower interest rates) is over – the Federal Reserve implemented their *first* interest rate *increase* in December and must raise interest rates several more times to reach their stated target rate. The third reason (lower gas and basic material costs) will not repeat itself either. The price of oil has fallen from over $100 per barrel in 2014 to $37 per barrel today and raw material/mining companies have already experienced drastic raw material price reductions and have lost over 30% of their stock values over the past 18 months.

Here's the problem with expecting continued above-average stock market performance. One, temporarily lowering interest rates for 7 years and having the benefit of drastically lower gas/raw material prices *should have* resulted in *above-average economic growth and expansion* by now. Yet Gross Domestic Product or GDP (sum total of all goods and services produced in a year) is still well-below average and stock prices are currently at a price level that normally reflects above-average growth.

Economic growth in the U.S. and around the world remains very weak. The U.S. GDP growth rate (adjusted for inflation) has averaged 2.2% over the past 7 years ranging from -0.24% to 2.73%. The long-term average GDP growth rate is above 3%. When you consider the fact that interest rates are at a 65-year low and gas and material prices have plummeted, one would logically expect higher GDP growth – at least equal to or above the 3% average. But, it hasn't happened yet – GDP growth is still below our country's long-term average.

Two, interest rates are now on their way up and the psychological support that declining interest rates provide is over. Stocks are still collectively selling at premium price levels. Under "normal" economic conditions, the overall stock market has sold for about 14.5 times earnings – an average P/E Ratio of 14.5. Today, based on the previous 4 quarters of corporate earnings, the overall P/E ratio is over 22! Even under the best economic times, a P/E Ratio above 20 has

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eventually resulted in a significant market decline. Instead, if you would like to use optimistic "analysts' projections or estimates" of 2016 future earnings, the overall market P/E ratio is still 17.4. Both price-to-earnings ratios above are exceptionally high given our slow economic growth rate.

Another fact worth mentioning is the number of companies whose stock prices are actually rising is getting smaller. If we *exclude* the stock price performance of Amazon, Alphabet (formerly Google), Microsoft, Facebook and 4 other big companies, the overall U.S. stock market would have been *down 4%* during 2015. Weak economic growth combined with fewer rising company stock prices is troublesome.

We have been waiting and have been told that the recovery is slowly coming along. Granted, we are thankful that our economy is growing - even at a below-average rate of 2%. But, that is not the point. The point is: Stock prices are high relative to economic growth rates here and abroad and prices have been at an overly optimistic level for a few years. At the current levels, overall stock prices are ALREADY *reflecting this expectation for higher economic growth*. Yet, after 7 years, economic growth is still below-average. If growth doesn't materialize (quickly), stock prices will adjust downward. When collective stock prices already reflect an expectation of higher economic growth, even the slightest disappointing news can cause wild price fluctuations. A recent example is the volatility we experienced in mid-August through September when the U.S. stock market dropped 12% in less than 2 months.

Lastly, 2016 is an election year. Aside from politics and debating contrasting economic policies, the bottom line is: Nothing is going to change with regard to economic policy and nothing to improve the current circumstances is going to be proposed or passed into law in 2016.

While we don't expect a deep bear market, recession, or a sudden dramatic drop in stock prices similar to what we experienced in 2008, we will admit there is a big "disconnect" between rational stock market pricing and the fairness or reasonableness of current stock market values. It really depends on whether global economic growth continues to slide, holds steady or improves. Prior to August 2015, the consensus had been that economic growth, while still trending below-average, was expected to improve. We then witnessed a nasty 12% decline in the stock market over a 45-day period from mid-August through September followed by a partial recovery by the end of the year. The evidence so far suggests that expectations are still more optimistic than what actual economic growth would justify. This is what bothers us the most.

Investment Outlook and Recommendations

Normally, the investment management process involves evaluating and selecting individual securities or asset classes (stocks bonds, real estate, gold, etc.) that advisors believe will provide the best positive investment return. Today, many advisors are concerned with identifying which asset classes might decline *less* than others during a volatile market environment. This admission is very uncomfortable to state publicly. Exercising caution and using patience when reinvesting the current large money market balances in client accounts is most important at this time.

Again, we are just as likely to re-purchase some of the securities we sold in August as we are in recommending new stocks or different asset classes. It is not clear which direction to pursue for 2016. At this time, we expect to maintain the current asset allocation and investment selections for most of our clients. Implementing all investment recommendations for new clients (new accounts over the past year) may take longer than expected. Additional investment purchases may be implemented during market weaknesses. We will simply have to use our judgment.

We do have a short list of stocks and other securities that appear to be attractive purchase recommendations; however, at this time we do not have a strong conviction that the financial markets have completed their course in finding a "new" fair market valuation. Any purchase suggestions or recommendations that we could identify

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at this time could change dramatically; therefore, **we will not include any purchase recommendations on the blue sheets you are accustomed to receiving at quarter-end.** Uncertainty and volatility is uncomfortable, but price adjustments always bring fair values and opportunities as well.

COPIES OF 2015 INCOME TAX RETURNS

The beginning of the 2015 income tax filing process begins today. Please request your income tax preparer to send paper or electronic (email) copies of your 2015 income tax returns to our office as soon as possible after completion. Our investment decisions, income tax management and retirement planning strategies are greatly improved when we have your most recent income tax returns in our files.

ANNOUNCEMENTS

Pam's daughter, Annie, welcomed her third child into the world! Yes, Pam is now a Grandma for the third time. Grace AnneTaylor was born Dec 30th at a healthy 8 lbs. and 20.5 inches long. Congratulations to Nana Pam, Annie, Randy, Wyatt & Myles for this addition to their family.

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