Cobblestone Advisor

Investment Brief

January 25, 2016

COBBLESTONE CAPITAL ADVISORS, LLC

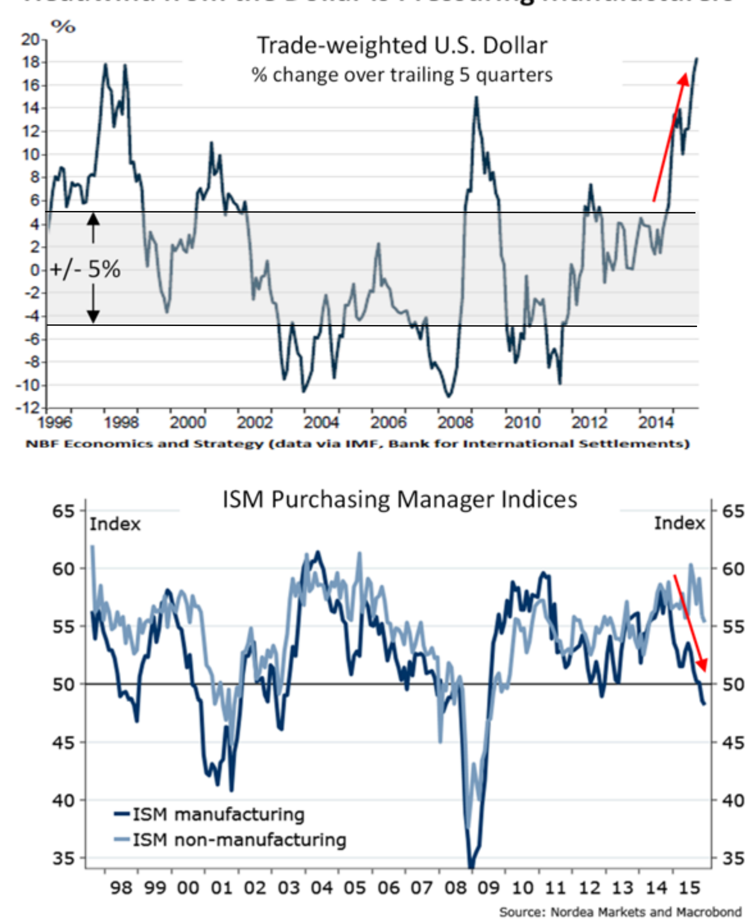
Turbulent Start for the New Year

Recession Fears Escalate

The swift and steep drop in stocks during the first few weeks of 2016 is a clear sign that investors fear a recession is imminent. Related commentary has focused on the plunge in oil prices, the slowdown in China's economy, and signs of weakness in the U.S. manufacturing sector. Yet a broad range of leading indicators suggest that growth will continue and that the odds of a recession are quite low. We believe that investors are overestimating the likelihood of a downturn in the economy and, therefore, have meaningfully increased the likelihood of positive surprises as the year unfolds. In short, 2016 should be a better year than its first few weeks would suggest.

The case for pessimism is understandable. To start with, last year was a dud. As seen in the table below, returns across asset classes were low or negative in 2015, a disappointment that was accompanied by considerable volatility. Although the headwinds last year were typical of those that tend to surface mid-cycle, the ensuing slowdown and volatility sowed doubt.

Headwind from the Dollar is Pressuring Manufacturers



In addition, last year was impacted by a sharp appreciation in the value of the U.S. dollar versus the currencies of our main trading partners. The dollar's surge has been extremely consequential, amplifying the collapse in the price of oil, triggering a slowdown in the manufacturing sector (evident in the adjacent charts), and forcing China to abandon its long-held currency peg between the Yuan and the dollar. The combined ripple effects have been significant and unnerving.

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Total Return Ending 12/31/2015				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
MSCI All Country World Index	5.0%	-2.4%	-2.4%	7.7%	6.1%	4.7%
Russell 3000 Stock Index	6.3%	0.5%	0.5%	14.7%	12.1%	7.3%
S&P 500 Stock Index	7.0%	1.4%	1.4%	15.1%	12.5%	7.3%
Russell 2000 (Small Cap Stocks)	3.6%	-4.4%	-4.4%	11.6%	9.2%	6.8%
MSCI EAFE (International Stocks)	4.7%	-0.8%	-0.8%	5.0%	3.6%	3.0%
MSCI EMF (Emerging Markets)	0.7%	-14.9%	-14.9%	-6.7%	-4.8%	3.6%
Barclays US Aggregate Index	-0.6%	0.5%	0.5%	1.4%	3.2%	4.5%
FTSE NAREIT All Equity REITs	7.7%	2.8%	2.8%	10.6%	11.9%	7.4%
CPI (thru November 2015)	-0.4%	1.1%	0.5%	1.0%	1.6%	1.8%

The Case for Not Selling

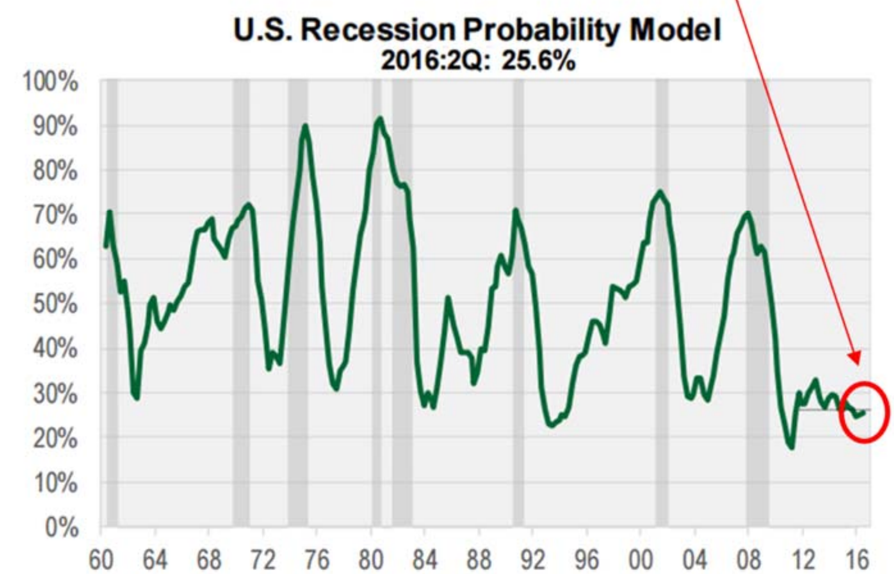
Recently weak asset returns, slowing growth, less accommodative monetary policy, and fallout from the dollar's surge have created an atmosphere of uncertainty that warrants both attention and respect. The judgement at hand is whether to sell, sit still, or buy. And, in this regard, we are focused far more on leading economic indicators than on the market's recent plunge. In and of itself, "the market" is simply a reflection of people buying and selling. It is not prescient and it often - especially in the short run - is wrong. Although we know intellectually that it is far better to buy low than to sell low, investors frequently do the opposite. And this tendency can be amplified by herd behavior - the confirmation bias of crowds. As a consequence, the market often is a barometer of heightened emotion rather than valuable insight.

We see opportunity in today's lower prices, especially given the low odds of a recession. As seen in the accompanying table and chart, a wide range of leading economic indicators indicate that the U.S. economy is far more likely to continue growing this year than contract. In addition, we expect global monetary stimulus to support expansion overseas, with the primary exception being those companies, regions, or countries heavily reliant on energy or commodity exports.

Odds of a Recession Are Low

U.S. Recession Risk Indicators
2016:2Q

		Lead	Latest Reading	Probability	Recession Signal
1.	U.S. Non-Mtg Delinquency Rate (ABA)	4 Qtrs.	1.4%	0.1%	No
2.	U.S. CPI Energy (4 Qtr. Avg. Y/Y%)	3	-14.4%	1.8%	No
3.	U.S. Average Hourly Earnings Y/Y%	4	2.2%	14.1%	No
4.	U.S. Output Gap % Potential GDP	6	-3.0%	23.5%	No
5.	U.S. Investment % GDP	4	16.2%	24.6%	No
6.	U.S. 10-Yr. Treasury and 3-Mo. T-Bill Spread	3	215 BP	28.2%	No
7.	U.S. Real Personal Income (8 Qtr. Avg. Y/Y%)	4	2.4%	29.0%	No
8.	Fed Funds Rate, Level and 2 Yr. BP Ch.	4	0.5%	30.6%	No
9.	Global 10-Year Yield 3 Yr. % Ch.	2	-59.4%	36.6%	No
10.	U.S. Mtg Rate (30-Yr. Fixed) 2 Yr. BP Ch.	2	-51 BP	42.3%	No
11.	BAA Yield 2 Yr. BP Ch.	1	5 BP	51.3% e	Yes
	Average			25.6%	No



Source: Cornerstone Macro, Cobblestone

While it is impossible to tell whether the recent market sell-off has run its course, we believe that many securities have already fallen appreciably below their fair value. With pessimism high, prices low, fundamentals holding steady, and leading indicators signaling further growth ahead, we expect to be active in the weeks ahead taking advantage of new opportunities. As always, please feel free to call if you would like to discuss portfolio strategy or your own investment objectives. We welcome touching base and sharing perspectives.

In Summary Continued growth in the U.S. should support equity markets. The U.S. will lead better economic activity overseas. Volatility will persist as interest rates normalize and doubts remain about global growth.

Asset Mix

Growth Assets - Above normal weighting. Maintain U.S. equity exposure with modest overweight to European and Pacific-Rim equities.

Capital Preservation Assets - Carry extra cash for opportunities that arise during sell-offs. Emphasize corporate & mortgage based U.S. dollar-denominated issuers.

Inflation Protection Assets - Modestly below normal weightings. TIPs are attractively priced.