RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

2015 YEAR-END MARKET COMMENTARY

January 2016

EXECUTIVE SUMMARY

Equity markets lacked conviction through much of 2015, as a number of unexpected events put a lid on returns for the year. The second half of the year was particularly volatile, amid uncertainty over Federal Reserve policy, the continued decline in oil and commodity prices, global macroeconomic crises in Greece and China, the sudden end to Iranian economic sanctions, and the rise of unconventional presidential candidates. All in all, it was a difficult backdrop for equity returns. The S&P 500 still managed to finish the year basically unchanged, thanks, in large part, to the contributions of the so-called "FANG" stocks – i.e., Facebook, Amazon, Netflix and Google – and similar growth-oriented stocks. Like many other value-oriented strategies, the RDM equity composite was down slightly for the year and trailed the broader S&P 500 index by a couple of percentage points, in large part because these high growth stocks do not fit a traditional value-oriented portfolio and due to continued weakness in the energy sector. However, the RDM equity composite still outperformed the Russell 1000 Value Index, its most comparable benchmark. Additionally, in the fourth quarter RDM's composite rebounded strongly from the third quarter, gaining over 5%.

While the worst of the crises in China and Greece have faded from the headlines, the Fed's decision-making, the direction of oil prices and the outcome of the presidential elections will remain significant issues for investors heading into 2016. Overall, we believe the Fed's decision to raise the Fed Funds rate by 0.25% at its December meeting was a positive development for the economy and equities. This decision reflects the progress that the U.S. economy has made in recovering from the Great Recession and signals that the Fed believes the economy can begin to withstand higher rates. Additionally, tighter accommodative policy will tend to prevent the likelihood of asset bubbles and give the Fed some leeway to continue to raise rates gradually over time or cut rates again to zero if another crisis should emerge.

Another significant market development was the collapse of commodity prices in 2015. In particular, the rebound of oil prices in the second quarter, followed by a second leg downward in the third and fourth quarters, appear to foreshadow continued weakness in oil prices through the beginning of 2016. A persistent over-supply of oil from OPEC and U.S. shale producers and weak demand from the global economy have combined to keep prices low. However, the impact of low prices will cause producers to cut capital expenditures and forego unprofitable development projects in the near future, putting a floor under oil prices.

Looking ahead to 2016, we expect mid-single digit returns from equities, including outperformance from financials and pharmaceuticals and some recovery in the energy and materials sectors towards the end of the year and into 2017. We are overweight financials and pharmaceuticals, due in part to the significance of their dividend yield in this current low growth environment, and we continue to hold most of our energy positions in anticipation of a recovery within a 3-5 year investment window.

Federal Reserve Finally Raises Rates

After months of speculation, the Federal Reserve finally pulled the trigger on a much-awaited interest rate hike. As anticipated, the Fed announced a 0.25% increase in the Fed Funds rate, which is an important guidepost for interest rates set by banks for everything from mortgage loans to deposit rates. The Fed took this first step away from the 0% rate that had been in place since the Great Recession due to progress made in employment and further indications that persistently low inflation in the U.S. economy is a function of transitory factors, such as the historic collapse of energy prices (discussed below).

The first rate hike has mostly positive implications for the U.S. economy and equity markets. To summarize:

- The rate hike signals the Fed's confidence in the economic recovery and reflects moderate economic improvement, most notably in employment. Fed confidence tends to support investor confidence in economic conditions.

- Less accommodative policy lessens the potential for asset bubbles and reduces incentives towards risk-taking. By holding interest rates near zero for an extended period of time, the Fed induced investor risk-taking and dissuaded savings in an intentional effort to spur investment in the economy. However, at some point the risk of creating asset bubbles outweighs the benefits from accommodative policy. An example of a bubble caused by distorted incentives can be found in the history of the Great Recession and the real estate bubble of the mid-2000s. The near collapse of the banking system was due, in part, to the proliferation of subprime mortgages that banks were incentivized to issue due to government programs intended to spread the American dream of homeownership. The collapse of lending standards and dangerous risk-taking was, therefore, a partial byproduct of distorted incentives created by heavy-handed policymakers.

- Over time, higher interest rates will incentivize saving and improve investment income for retirees and other conservative investors. This will benefit those investors living on a fixed income who have taken more risk than is optimal to achieve their required level of income payments. Higher interest rates also provide a long-term economic benefit for investors as they will be able to invest more conservatively near retirement-age and thus are less vulnerable to economic downturns.

- The Fed's statement after its December meeting was about as dovish as possible, despite the highly anticipated first rate hike in years. The Fed has signaled that monetary policy will remain historically accommodative for the foreseeable future. To this point, interest rates are still near all time lows and the Fed has indicated that the path of rate hikes will be very gradual. This rate hike path will potentially grow by as little as 1% each year whereas recent prior tightening periods have seen rates grow closer to 2-3% each year. The combination of low interest rates and a very gradual tightening of monetary policy will further support economic expansion.

- The most obvious beneficiary of higher interest rates are the large money-center banks. They stand to benefit from higher interest rate spreads, which directly bolsters bank profitability. For example, in the immediate aftermath of the Fed's rate decision in December, most major

banks raised their prime rate in tandem with the Fed Funds rate. Notably, however, these banks did not also raise their deposit rate, or the interest rate paid to depositors. This is just one example of how the largest banks can profit more in a rising rate environment and we expect bank stocks to outperform as rates continue to rise.

Commodity Sell-Off Worsens

The continued sell-off in WTI and Brent Crude Oil prices during 2015 was a central market concern throughout the year. The sell-off that began in the third quarter 2014 continued unabated throughout 2015 due to a number of factors:

- An over-supply of oil has flooded world markets because OPEC continues to pump oil at a record pace while non-OPEC producers (like the U.S. shale producers) also have not significantly slowed their oil production. Currently, the world is producing approximately 2 million barrels a day more oil than is being consumed, causing stockpiles to grow and prices to drop. Despite this glut, OPEC surprisingly decided not to curtail production to prop up oil prices, as has been their historical role as a cartel. Instead, OPEC effectively removed its production quota (which it usually ignored anyway) and will keep output near its current level of 31.5 million barrels per day. This was a decision largely spearheaded by Saudi Arabia in an effort to maintain or increase its market share, as many other OPEC nations desire higher oil prices to balance their sovereign budgets.

- In the wake of the Fed's monetary policy shifts in recent years towards less accommodation and higher interest rates, the U.S. dollar surged in 2015. A stronger dollar has the effect of decreasing the price of commodities, such as oil, that are traded in U.S. dollar denominations. In effect, a stronger dollar means less dollars are required to buy the same barrel of oil – hence, oil prices denominated in dollars tend to decline as the dollar strengthens.

- Global economic stagnation has played a role in low oil prices. In particular, a slowdown in China's economy contributed to the declines of many commodities in 2015, including oil, gas, gold and copper. As we discussed in earlier market commentaries, China is transitioning from a manufacturing to service-oriented economy as it liberalizes business restraints towards freer capital markets. Economists expect this process to be bumpy and cause a slowdown in economic growth there from boom years to a more sustainable mid-single digit growth range. However, economic data during 2015 seemed to indicate that the slowdown may be worse than expected - more likely a "hard landing" that would make China's stated goal of 7% GDP growth difficult to achieve. As a major importer and exporter of many commodities, including oil, such economic weakness acted as a headwind for oil prices during 2015.

- The easing of economic sanctions by the U.S. on Iran is a negative for oil prices. Iranian oil production is expected to begin again in 2016, adding potentially an additional 1 million barrels of oil per day to the already existing oil glut.

While many of the headwinds for oil that existed in 2015 are projected to continue into 2016, we believe it is probable the worst is behind us for the sector. First, the sheer pace of price declines cannot continue forever. With oil at current prices, small to mid-size producers will have no choice but to curtail production and table future development expenses. In fact, some smaller producers may go through

forced restructurings or sales to larger producers as their cost of financing operations increases. Therefore, aggregate oil output will likely fall throughout 2016 and perhaps longer, barring unforeseen developments or a production increase by OPEC. Additionally, current oil industry economics are not profitable for the majority of OPEC nations. Internally within OPEC, the pressure on Saudi Arabia to back down from their price war with U.S. and other non-OPEC producers will amplify. Due to these factors and an expectation of an improving economic picture in Europe, there are reasons for optimism moving into 2016 and beyond.

2016 Outlook

Summary of 2016 Projections	
S&P 500	2,221
Dow Jones Industrial Average	18,878
Nasdaq	5,620
Inflation	1.8 – 2.0%
Ten Year Treasury Rates	3.2%
GDP	2.5%
Oil	$50 / barrel

*based on projected 2016 P/E of 17.5 and projected 2016 S&P 500 earnings of $126.94.

As mentioned in our introduction, we foresee mid-single digit gains in the S&P 500 in 2016 based on our projections of corporate earnings and an estimate of the 2016 market P/E ratio.

Currently, 2016 S&P 500 aggregate corporate earnings are projected to reach $126.94 per share, which is above the 2015 corporate earnings of $117.55. While 2015 corporate earnings came in below estimates, most of this underperformance was due to the drag of the energy sector. Even including the energy sector, corporate earnings were virtually flat. We anticipate some bounce in the energy sector and at least slow growth elsewhere heading into 2016. We also believe that the S&P 500 forward price-to-earnings ratio multiple of approximately 16 is appropriate considering that we are in the expansionary phase of the current business cycle. At a reasonable trailing P/E multiple of 17.5, in line with historical ranges of U.S. economic expansion periods, the S&P 500 would reach 2,221 by year-end 2016. We also project (i) below-Fed target inflation of 1.8 - 2% for 2016, due in part to weak energy prices, (ii) Treasury bond yields to rise roughly in tandem with increases in the Fed Funds rate over the year, and (iii) a minor increase in GDP growth, as the strong dollar and weakness overseas puts a lid on potential growth.

Like the Federal Reserve, we view the weakness in energy as a unique and transitory development that will not persist over the long-term. However, it is likely to remain a drag on corporate earnings through at least next year and likely into 2017, based on the projections of oil prices by OPEC and other industry players. Currently, the futures market projects oil prices to remain below $45 per barrel through 2016. This represents approximately 30% upside to year-end 2015 prices, but is still significantly below the 2014 highs of over $100 per barrel. Additionally, energy sector corporate earnings are expected to decline in 2016, but by a more modest 10% as opposed to the near 60% decline in 2015.

Regardless, we believe that the U.S. economy still has room to grow. Mediocre sub-3% economic growth in the U.S. has persisted over the recovery and inflation remains low, signaling that the economy is not near the point of over-heating. While unemployment has dropped to 5% in the U.S., some of these gains can be attributed to a decrease in the labor participation rate (i.e. individuals dropping out of the labor force entirely due to early retirement or frustration) and a shift from full-time employment to part-time or under-employment. Lastly, it has been years since fiscal policy changes have supported, rather than frustrated, businesses and investors through lower taxes, less regulation or other pro-business, growth-oriented measures. We are optimistic that U.S. fiscal policy will become more pro-growth, but

we recognize that the current populist-themed political environment does not bode well for significant changes in that direction.

Relatedly, it is important to note that 2016 is an election year. Market predictions based on election year trends are sometimes interesting as general information, but it is difficult to discern any particular market trend from recent elections. Since 1928 there have only been four election years with negative returns in the S&P 500, although two have occurred since 2000 (2008 McCain vs. Obama and 2000 Bush vs. Gore). In both of those recent negative election years, like the current election, there was no incumbent running in the election, however there were major economic shocks occurring at the same time (the tech bubble and financial crisis, respectively). It is hard to say what these historical trends signal – i.e., whether the overall trend of positive-return election years outweighs the two recent negative years. We feel that it is far more prudent to maintain a sound investment strategy focused on long-term economic trends and the proper allocation for each client's specific risk profile and investment objectives.

As usual, all comments are welcome.