RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

FIRST QUARTER 2016 MARKET COMMENTARY

April 2016

EXECUTIVE SUMMARY

Fears of a global recession shook equity markets in the first quarter, sending stocks sharply lower in January, only to bottom in mid-February and recover by the end of March. In addition to recession concerns, the culprits behind the decline were the continued weakness of oil and gas prices; instability in China caused by economic growth deceleration and the Chinese government's heavy-handed attempts at currency manipulation; and uncertainty over the timing and speed of the Federal Reserve's projected interest rate hikes. A temporary halt to company stock buybacks before earnings season in January also may have exacerbated the market's volatility.

Despite the market weakness in January and February, the S&P 500, Dow Jones and Russell Value indices rebounded to finish the quarter up between 1%-2%. RDM's composite of value equity-oriented accounts also rebounded significantly (~ 7%) in March, finishing the quarter almost flat.

A laggard in equities this quarter was the financial sector. Bank stocks have been hampered by the threat of a global recession, the possibility of energy company loan defaults, and low interest rates. However, concerns of a global economic recession are overdone and not supported by the underlying economic data when one considers the transitory effects of weakness in commodities and strength of the U.S. dollar. Additionally, while the market is legitimately concerned that low energy prices will cause some energy companies to default on bank loans, the market is pricing in too high a likelihood that this will bring down the sector as a whole. Energy loans make up only about 1-3% of the outstanding loans for the large, national and regional banks in our portfolio, so there would have to be a significant, unforeseen chain reaction before these banks are impacted. Finally, the Fed's reluctance to raise interest rates in the face of global economic weakness will continue to pressure the banks' net interest margin and put a lid on earnings. But, banks now have strong enough balance sheets and other source of earnings to carry them until the interest rate environment improves.

The other laggard last quarter was the healthcare sector. This was somewhat surprising considering that large cap healthcare stocks, with their recession resistant products and high dividend yields, are less volatile than many other sectors if a recession is thought to be imminent. However, pharmaceutical stocks, in particular biotechnology stocks, were hurt by political threats to restrict the cost of prescription drugs. As we near the presidential election, the drug pricing rhetoric likely will further heat up. While we trimmed some pharmaceutical stocks last quarter, we continue to favor this sector due in part to the speed of technological advancement and the increasing life expectancies of the baby boomer population.

In contrast, the energy and materials sectors rebounded last quarter. Energy stocks and the equity markets as a whole have been increasingly tightly correlated to movements in oil prices. As the over-supply of crude has persisted since mid-2014, investors have increasingly feared that the over-supply is due more and more to a lack of demand. Economic weakness in China has only contributed to this sentiment. As the crisis persisted at the beginning of the year, markets increasingly panicked that the situation foreshadowed a global recession. We believe the oil crisis is primarily a temporary product of OPEC's price actions and U.S. shale production, not a recession, and market forces will bring prices to a more balanced long-term level soon. The recent bounce in oil prices lends some credence to our view.

We explore many of these topics in more detail below.

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Low Oil Prices Are Worsening Fears of a Global Economic Recession

As discussed above, we believe the oil downturn is mostly due to unabated production rather than weakening demand. Over the past 18 months, OPEC has made clear its intention to drive out higher cost producers in a monopolistic fashion. OPEC views these upstart producers, such as the U.S. shale producers, as threats to its global market share of production. Therefore, OPEC, which is primarily driven by Saudi Arabia, has been willing to withstand rock bottom oil prices for over a year in order to drive out newer higher cost producers. Additionally, Iran is bringing an additional one million barrels of oil each day back into production after the international community lifted years of economic sanctions. Meanwhile, U.S. oil producers continue to defy expectations by maintaining production despite deeply slashed capital expenditure budgets and employee headcounts.

Despite the prolonged downturn, we expect oil prices to climb back to a range of $50-$60 per barrel in the medium term. Fifty-one U.S. oil and gas producers have declared for bankruptcy since the beginning of 2015. Capital expenditures, employees and shareholder dividends have already been cut significantly by the surviving U.S. oil producers. Large producers are not fully replenishing production capacity with new drilling as prices remain depressed. All of these factors will eventually lead to significantly lower production and higher prices.

Most importantly, both OPEC and non-OPEC sovereign oil producers are struggling with oil prices in the $25-$40 range. While the cost of production for an OPEC nation like Saudi Arabia is very low, these nations rely on much higher priced oil – in the $40-$50 range – to bring in sufficient revenue to balance their sovereign budgets. Weaker OPEC nations like Venezuela need much higher oil (closer to $100) to come close to a balanced budget to fund their massive entitlement states. Thus, as energy prices persist in a low range, these nations will need to engage in austerity measures with respect to benefits paid to the general populace. This will be a very difficult endeavor for countries in regions that are no stranger to civil unrest. We believe that these factors will also tend to support oil prices over time.

However, the path to higher oil prices is likely to be rocky. U.S. oil inventories remain at the highest level in 80 years and those expecting that OPEC will agree to a production freeze at a meeting in mid-April could be disappointed, particularly because Iran and Libya likely will not agree to a freeze. In the first quarter, persistently low oil prices began to have a significant impact on overall investor sentiment. As the downturn has persisted, investors have increasingly speculated that low demand for oil, notably from China, is contributing significantly to the depressed prices. This fear has supported the argument that a global economic recession is increasingly more likely, led by economic weakness in China.

Despite all of the economic damage caused by the commodity downturn, we view a global economic recession as unlikely in the near term under current economic conditions. For all of the recession speculation recently, it is important to remember that the U.S. grew at a 2.4% annual rate in 2015 (identical to 2014), China grew at a 6-7% rate and Europe grew at a 1.5% rate. Nearly all of the economic weakness around the globe is focused on emerging markets that are vulnerable to low commodity prices and China, which is engineering a decades-long shift from a manufacturing to a service-oriented economy. Nevertheless, depending on the extent to which one fully believes the official government data from China, the economy there grew at least twice the rate as the U.S. Last, while corporate profits are clearly weaker over the past year, the earnings picture has been skewed by energy sector profits, which declined 60% last year. Thus, we believe the fear and panic over a recession is unfounded currently, and largely a byproduct of transitory economic impacts caused by market volatility in China and the intentional actions of OPEC (led by Saudi Arabia) to suppress oil prices and protect its financial interests.

Bank Stocks Hurt by Persistently Accommodative Interest Rate Policy

A significant byproduct of global recession fears has been the increasingly likely "lower for longer" path of interest rates in the United States. Recent comments by Federal Reserve officials including Janet Yellen indicate that the Fed will be very cautious in its rate increases this year. Prior to 2016, the Fed planned to raise interest rates four times during the year, with rates ultimately increasing by 0.5% by the end of 2016. However, given the economic uncertainty abroad and low oil prices, the Fed has backed off that more aggressive path and at most two rate hikes is now more likely.

As interest rates remain near historic lows, bank stocks will continue to face headwinds. A rising rate environment is generally beneficial for bank profitability, as banks can increase interest rate spreads on loans and deposits. However, a very gradual interest rate path, as the Fed has foreshadowed recently, would tend to dampen expectations for profit growth within the banking industry. Our view has been that the Fed is very reluctant to damage the economic recovery with aggressive rate hikes, particularly when economic conditions abroad are weaker and central banks abroad (i.e. Europe, Japan) are embarking on far more accommodative monetary policies with massive stimulus plans. This disparity between monetary policy in the U.S. and abroad has caused the U.S. dollar to strengthen significantly recently, which is a headwind for profits in U.S. multinational corporations with sales overseas that report their financial results in U.S. dollars. The Fed clearly will err on the side of caution regarding the path of interest rates and would rather risk being slightly behind the curve on the timing of rate hikes than being overly-aggressive in raising rates and damaging the economy.

Therefore, we expect the Fed to continue to recognize the improvement in the U.S. economy, particularly with respect to the unemployment picture, yet hold off on aggressive rate hikes for some time. We were skeptical of the Fed's prior forecast of four rate hikes in 2016, given the implications for the dollar in the face of weakening currencies abroad and persistently low inflation. While banks may not benefit from quickly rising rates in the U.S. in the near term, the trend is clearly for higher rates over the long term, which will ultimately bolster the financial sector for investors with longer time horizons.

U.S. Presidential Election May Create Uncertainty and Hurt Pharmaceuticals

A hotly contested primary season foreshadows what is likely to be a highly contentious presidential campaign leading into November's elections. While extreme positions are often a normal part of presidential primary rhetoric before candidates retreat into more mainstream positions later, a more enduring concern for investors should be the focus on pharmaceutical industry profits and drug pricing. Indeed, the healthcare sector was battered in the first quarter due to the concern that pricing restrictions effectuated through regulations or through Medicare reimbursement policy could put a lid on corporate profits in the sector. We are concerned about the toll that such aggressive rhetoric could take on healthcare sector stock prices, particularly for large biotech companies. When biotech companies develop novel drugs that provide a benefit for patients above older drugs, the fact that the price per pill is higher than the older regimen does not by itself indicate that abusive pricing is taking place. In such a scenario, we do not believe the government would have much of a leg to stand on to restrain pricing, so long as the total cost to the patient of treatment or cure is lower. Nevertheless, once a sector becomes a political target, as in the case of banks after the 2008-09 recession, it can take years for investors to regain confidence. Therefore, we will be closely watching the results of the presidential election for its impact on regulatory policy as applied to the healthcare sector.

A final note regarding the upcoming presidential election: between now and November, undoubtedly the media will be saturated with market predictions based on historical presidential election trends. Over the past 100 years, there have been only six presidential elections where there was no incumbent in the race due to the end of a two term presidency. The average equity return for the last year of the six two-term presidencies is -1.2%. Therefore, we expect to see commentary that presidential election dynamics could lead to weaker equity performance in 2016 and beyond. It is important to note, however, that six data points are not statistically significant such that we can reliably project how the markets will perform in 2016. Further, 2008 clearly skews the average due to the historic Great Recession that caused markets to plummet that year by over 30%. We generally avoid drawing conclusions based on anecdotal evidence of correlations between market performance and presidential campaign politics, and instead choose to analyze concrete policy proposals of candidates that have important ramifications for the economy.

Conclusion

We continue to favor equities over fixed income as the core portfolio asset class for most long-term time horizon investors due to the following fundamental reasons:

1) Interest rates remain near zero. While many argue that a rising rate environment is negative for stocks, we argue that most rising rate environments when stocks underperformed historically have been from a much higher rate starting point and usually coincided with an overheating economy. This is not the case in 2016 with sub-optimal GDP growth and very little inflation. Rising rate environments off of 0% interest rates, such as 2016, would be more of a concern for bond returns than stocks, all else being equal.

2) Economic fundamentals are improving. The U.S. unemployment rate is getting closer to full employment as time passes. While improvement in job quality (i.e. part vs. full time), productivity and labor force participation can still be achieved, 5% unemployment is a positive for the economy under any analysis. Additionally, for all of the panic over a looming recession in the first quarter, U.S. GDP growth in 2015 held constant with 2014, despite a significant hit from the energy sector and a stronger dollar. Last, a variety of other indicators in the housing sector, auto sector, etc. reflect continued economic improvement. While deterioration in other economies like China, Japan and Europe are a concern, policymakers there are aggressively taking action to stimulate their respective economies, much in the way the Federal Reserve acted in the U.S. over the past several years.

3) Stock valuations have retreated. Due to the aforementioned economic concerns over the past year, including the commodity collapse, stock valuations have declined. While it is clearly ideal to invest in equities when they are cheap, it is not common that the entire market is cheap at once. 2016 presents reasonable market valuations combined with opportunities for long-term investors in under-valued sectors such as energy and financials.