

HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

By William N. Hudson, Jr., David D. Burrows, William Hudson III, Evan Coppola, & Jeremy Hudson

We said three months ago that 2016 would be an anemic year for the markets. The first quarter did show us some volatile entertainment. But our outlook for the year remains what we stated in January and this market is best described as “fatigued”. We will feel gratified to end the year with some modest gains.

Some pundit once said: “Only two things matter in the stock market: earnings and interest rates.” We do not think that statement is always true. However, in 2016, it is pretty darn accurate.

The stock market will only gain traction if the “E” part of Price/Earnings ratio improves. Corporate earnings are not so pretty right now. The consensus view is that first quarter S&P 500 earnings will fall close to 9% from last year. It will mark the fourth consecutive quarter of year-over-year earnings decline. The basic reason is the sluggish global economy and its impact on the U.S. economy.

On the bright side, earnings are predicted to turn positive in the second half of the year. The reasons would be improved consumer spending and stronger U.S. exports tied to a weakening dollar. That outlook gives us the hope for modest equity gains.

But, then, we have to watch that other thing about interest rates. It was comments from the Federal Reserve and the European Central Bank which basically saved the market from a first quarter rout. In the words of one analyst: “The market is addicted to liquidity drips from the central banks.” That said, we are quite concerned how the market will react if the Federal Reserve does move toward higher rates in 2016. The sensitivity may be irrationally high – but it does clearly exist.

As always, we will be observing all these trends with the intent to protect and enhance our client portfolios.

MARKET TRENDS

The accompanying chart summarizes stock and bond market prices in the first quarter. The stock market was pounded in the early weeks, but rallied in March and ended essentially flat for the quarter. Meanwhile, U.S.

Volume 67

April 2016

Government prices showed renewed and curious resilience.

Equity Market: Stock prices were pounded in the first 6 weeks of the year over concerns about the global economy and corporate earnings. The S&P 500 reached a low point of 1810 in mid-February – down from 2042 at the beginning of the year. Then the markets were hugely calmed by announcements from the Federal Reserve and the European Central Bank about their cautious approach to any rate increases. The S&P rebounded and ended the quarter with a .8% gain. The Dow Jones Industrial Average also dipped and recovered and was ahead 1.5% for the quarter. In contrast the Russell 2000 index was down 1.64% for the quarter and the Nasdaq Composite Index was down 2.4%. These indexes were not able to totally recover from steep losses early in the quarter.

Fixed Income Market: Long-term U.S. Treasury yields posted their steepest quarterly decline in three years. Yields move inversely to prices. The yield on the 10-year Treasury settled at 1.78% at the end of March – down sharply from 2.27% three months earlier. Much of this trend was driven by global demand for U.S. bonds. At Hudson Advisors, we think buyers are not looking correctly at the risk of buying and holding bonds for the long term.

THE OUTLOOK

The Economy: The employment picture in the U.S. is basically good. Job growth has been consistently over 200,000 per month for the most of the last year. The unemployment rate is about 5% and could move lower. But the overall pace of economic expansion is less impressive. The GDP increased just under 2% in 2015 and is not expected to do much better in 2016.

MAJOR MARKET INDEXES

| | 1Q 2016 Return | 2015 Return |
|-------------------------------|-------------------|----------------|
| Dow Jones Industrials NR | 1.49 | -2.23 |
| S&P 500 Index PR | 0.77 | -0.73 |
| Russell 2000 Index NR | -1.64 | -4.79 |
| NASDAQ Index | -2.39 | 8.43 |
| EAFE Index NR | -3.01 | -3.30 |
| Barclays Aggregate Bond Index | 0.07 | -2.12 |

Much of the problem is rooted in corporate earnings – which are a leading economic indicator. And the problem is not just tied to the energy sector. For the first quarter, 7 of the 10 S&P macro sectors are expected to have earnings decline. Only consumer discretionary, telecommunications, and health care are expected to have earnings demand.

The biggest challenge to earnings is weak international demand. Europe remains stagnant and the Chinese situation seems uncertain. But the U.S. consumer has been something of a disappointment as well. We might have expected that consumers would be cheered by savings on energy costs. But the leading indicator of consumer confidence, administered by the University of Michigan, declined in February for the fourth consecutive month.

There are counter veiling trends. Corporate earnings are expected to improve in the second half of the year. Several forces could drive this improvement. Oil prices will remain low. This situation could turn consumer confidence more positive. Corporate spending on technology is gaining strength. The lower price of the U.S. dollar may help international demand. In fact, most analysts expect profits to turn positive in the third quarter with the possibility of an overall annual profit growth of 2% for the year.

The Market: We are encouraged by the prospect of better earnings. But our forecast for equity performance remains modest. Stocks are highly priced right now. The S&P 500's price/earnings ratio is 18.2 – compared to the 10-year average of 15.8. It will take more than 2% earnings growth to bring stock prices closer to their historic levels.

Also, we think the uncertainty of Federal Reserve policy hangs over the market in a dominant way. The Fed obviously has backed off its earlier movement towards a program of regular rate increases. But it is quite likely that we might see at least one, possibly two, rate hikes this year. We worry the market will react negatively and somewhat irrationally.

So, we stand by our prediction of three months ago. We will be fortunate to see 5% growth in the major indexes this year. We would not be surprised to have neutral year-end results.

OUR STRATEGIES

Asset Allocation: For clients investing new money, same as last quarter, we recommend 55% allocation to equities and the remaining portion to cash, bonds with maturities under two years, and alternative investments. We stagger the time period in which we reach that 55% level. For fully invested clients, we recommend to trim equities to 55-65% depending upon time horizon and objectives.

Preferred Equities: We remain focused on large cap companies with strong balance sheets, sustainable cash flows, and credible business models. Companies that pay attractive dividends are central to our strategy. Some of the sectors we like are similar to those indicated last quarter:

- **TECHNOLOGY:** Despite the 1Q performance, we expect technology to show strength – especially those companies that appeal to consumer interest in new and imaginative devices. Business spending on technology should pick up.
- **HEALTH CARE:** We are attracted to some pharmaceutical companies because of new products coming to market.
- **ENERGY:** Despite the overall problems in this sector, some companies are interesting such as those involved in propane distribution. Overall, there is upward potential in the sector.
- **CONSUMER DISCRETIONARY:** We expect consumer spending to improve and there is opportunity here.

Fixed Income: Our repeated aversion to bonds with long maturities remains firm. We are surprised the Treasury prices spiked in the quarter. The risk of a sharp decline in bond prices is too great a risk for our clients. We prefer to find alternatives such as municipal tax liens.

| Dow Jones U.S. Sectors | | | |
|--|--------------|---------------------------|--------------|
| (Percent Change for YTD, Ending March 31, 2015) | | | |
| Oil & Gas | 3.55 | Consumer Services | 1.16 |
| Basic Materials | 4.24 | Telecommunications | 15.42 |
| Industrials | 4.69 | Utilities | 15.66 |
| Consumer Goods | 4.54 | Financials | -3.77 |
| Health Care | -6.04 | Technology | 1.90 |

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Top 25 Stock Returns for US Listed Stocks with a market cap greater than \$500 Million

| RIC | Company Name | Market Capitalization (USD, Millions) | Total Return, YTD (Simple) (%) |
|---------|----------------------------------|---------------------------------------|--------------------------------|
| AJGH.PK | AJ Greentech Holdings Ltd | \$ 3,285.68 | 380.77% |
| CDE.N | Coeur Mining Inc | \$ 857.59 | 126.61% |
| TRHF.OB | TRHF Company Ltd Inc | \$ 12,000.00 | 113.22% |
| X.N | United States Steel Corp | \$ 2,350.04 | 101.75% |
| CLF.N | Cliffs Natural Resources Inc | \$ 540.33 | 89.87% |
| AKS.N | AK Steel Holding Corp | \$ 736.56 | 84.38% |
| DDD.N | 3D Systems Corp | \$ 1,724.10 | 78.02% |
| MUX.N | McEwen Mining Inc | \$ 520.49 | 77.83% |
| RMR.OQ | RMR Group Inc | \$ 775.31 | 73.56% |
| TROX.N | Tronox Ltd | \$ 739.65 | 69.82% |
| JCP.N | J C Penney Company Inc | \$ 3,394.14 | 66.07% |
| TUMI.N | Tumi Holdings Inc | \$ 1,807.53 | 61.27% |
| SPXC.N | SPX Corp | \$ 628.69 | 60.99% |
| CENX.OQ | Century Aluminum Co | \$ 613.62 | 59.50% |
| QUOT.N | Quotient Technology Inc | \$ 872.04 | 55.43% |
| OCLR.OQ | Oclaro Inc | \$ 599.65 | 55.17% |
| FCX.N | Freeport-McMoRan Inc | \$ 12,944.13 | 52.73% |
| ATSG.OQ | Air Transport Services Group Inc | \$ 982.61 | 52.58% |
| PLCE.OQ | Childrens Place Inc | \$ 1,596.41 | 51.21% |
| ELLI.N | Ellie Mae Inc | \$ 2,688.61 | 50.49% |
| NEM.N | Newmont Mining Corp | \$ 14,065.11 | 47.89% |
| HL.N | Hecla Mining Co | \$ 1,052.40 | 47.22% |
| IIIN.OQ | Insteel Industries Inc | \$ 568.61 | 46.27% |
| ERII.OQ | Energy Recovery Inc | \$ 537.17 | 46.25% |
| ATI.N | Allegheny Technologies Inc | \$ 1,775.27 | 45.60% |

Bottom 25 Stock Returns for US Listed Stocks with a market cap greater than \$500 Million

| RIC | Company Name | Market Capitalization (USD, Millions) | Total Return, YTD (Simple) (%) |
|----------|-----------------------------------|---------------------------------------|--------------------------------|
| PBYI.N | Puma Biotechnology Inc | \$ 954.14 | -62.54% |
| PTLA.OQ | Portola Pharmaceuticals Inc | \$ 1,149.79 | -60.35% |
| ALKS.OQ | Alkermes Plc | \$ 5,153.86 | -56.93% |
| LCI.N | Lannett Company Inc | \$ 656.97 | -55.31% |
| ADRO.OQ | Aduro Biotech Inc | \$ 826.47 | -54.48% |
| EGRX.OQ | Eagle Pharmaceuticals Inc | \$ 633.27 | -54.33% |
| ENDP.OQ | Endo International PLC | \$ 6,255.01 | -54.02% |
| ANAC.OQ | Anacor Pharmaceuticals Inc | \$ 2,397.67 | -52.69% |
| NK.OQ | Nantkwest Inc | \$ 673.47 | -52.57% |
| RLYP.OQ | Relypsa Inc | \$ 586.87 | -52.19% |
| SCTY.OQ | SolarCity Corp | \$ 2,406.70 | -51.82% |
| DATA.N | Tableau Software Inc | \$ 3,401.22 | -51.32% |
| RVBHF.PK | RVB Holdings Ltd | \$ 7,058.31 | -50.00% |
| NLNK.OQ | NewLink Genetics Corp | \$ 525.23 | -49.99% |
| SRPT.OQ | Sarepta Therapeutics Inc | \$ 891.41 | -49.40% |
| LNKD.N | LinkedIn Corp | \$ 15,102.74 | -49.20% |
| RDUS.OQ | Radius Health Inc | \$ 1,352.37 | -48.91% |
| FIT.N | FITBIT INC | \$ 3,272.50 | -48.80% |
| HDP.OQ | Hortonworks Inc | \$ 639.75 | -48.40% |
| ITCI.OQ | Intra-Cellular Therapies Inc | \$ 1,201.31 | -48.32% |
| RH.N | Restoration Hardware Holdings Inc | \$ 1,700.46 | -47.26% |
| TYMI.PK | Tyme Technologies Inc | \$ 530.05 | -46.22% |
| OPHT.OQ | Ophthotech Corp | \$ 1,490.11 | -46.17% |
| ETE.N | Energy Transfer Equity LP | \$ 7,449.34 | -46.03% |
| XLRN.OQ | Accelaron Pharma Inc | \$ 978.97 | -45.88% |