POLARIS
WEALTH ADVISORY GROUP

The Polaris Perspective

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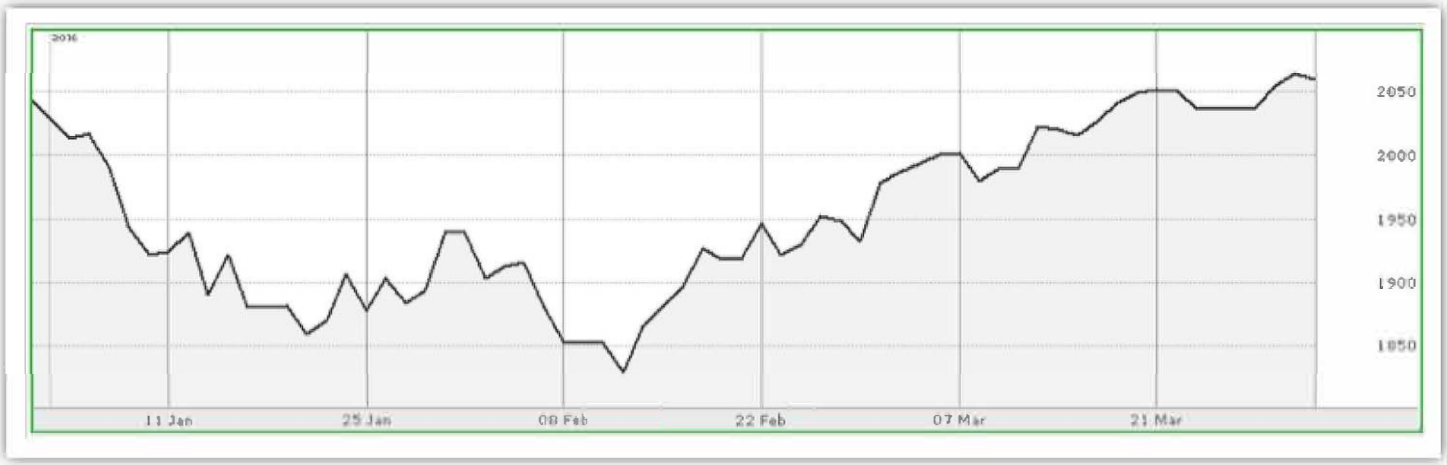
First Quarter 2016 Review

The S&P 500 squeaked out a scant 0.77% return for the first quarter of 2016. This performance data did not reflect the turmoil that most people endured over the first three months of the year, as the markets took investors on a complete roller coaster ride. The first two weeks of the year ushered in the S&P 500's worst start to any year in its 89+ year history. By February 11th, the benchmark had hit a 22-month low, falling 10.51% from the end of 2015 and 14.06% below the all-time highs experienced in July of 2015. This was the second time in three quarters the S&P 500 experienced a drop over 10%. At the same time, West Texas Intermediate (WTI) spot prices dropped to levels not seen since March of 2003. Remarkably, the S&P 500 shook off the sentiment driven decline and finished up 0.77% for the quarter, as you can see from the chart below.



Here are some highlights and interesting facts for the first quarter in the markets:

- Gold had the top performance of any major asset class, up 16.54% for the quarter. This was gold's best quarter since 3rd quarter 1986.
- The S&P Goldman Sachs Commodity Index (GSCI) gained 3.78%, due mainly to a surge in oil prices after Saudi Arabia and Russia agreed to freeze production on February 17th.
- Q1 2016 saw the dollar drop 4.15%, its worst quarter since 3Q10.
- Bonds had a remarkable quarter as investors sought safety during the downturn. Treasury bonds were up 8.15% and the Barclays Capital U.S. Aggregate Bond Index was up 3.03% for the quarter. Remarkably, bond inves tors maintained their rally as the stock market recovered due, in large part, to the negative interest rate policy found in several major economic regions.
- The S&P 500 was up 0.77% for the quarter.

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Additional highlights and interesting facts for the first quarter in the markets:

- The top sectors in the S&P 500 during this quarter were Telecom, Utilities, and Consumer Staples, up 15.10%, 14.51%, and 4.85% respectively. Unfortunately, the Telecom and Utilities sectors each represent less than 3% of the S&P 500, making their contribution to the S&P 500's performance slight, at best.
- The worst performing sectors in the S&P 500 this quarter were Health Care, Financials, and Consumer Discretionary. Their performance was - 5.93%, - 5.60%, and up 1.20% respectively.
- The Russell 2000 (small-cap companies) was down 1.9% in the first three months of the year.
- The NASDAQ lost 2.75% of its value in the first quarter.
- The ACWI (All-Countries World Index) fell 2.02% in local currency, as renewed concerns about a global recession pushed down most international regions.
- Canada and Emerging Markets had the best returns, up 3.03% and 2.40% respectively in their own local currencies.
- Japan and Europe ex-U.K. had the worst returns, dropping 13.41% and 7.46% respectively in their own local currencies.

What Caused This Quarter's Correction & Rebound?

Much of the weakness that we experienced during the first quarter was due to issues carried over from 2015, namely: China's slowing economy, the European Central Bank's monetary policy, a weak European economy, Federal Open Market Committee (FOMC) monetary policy, and falling oil prices.

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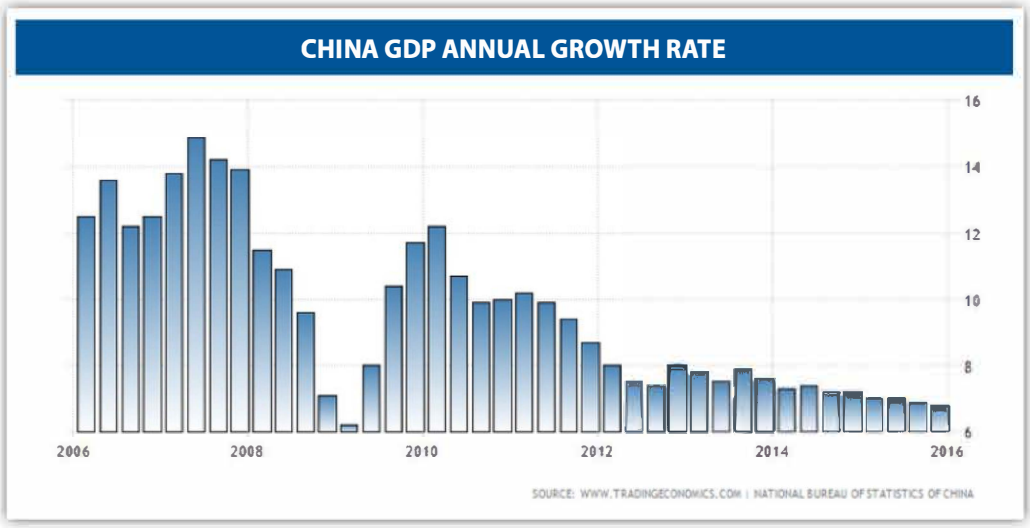
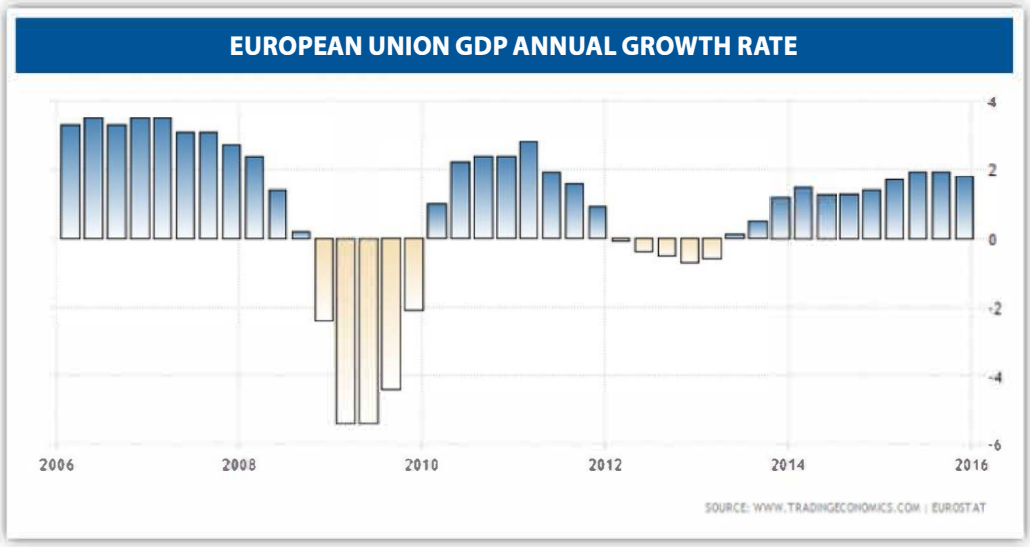
China: Albeit 60% the size of the United States economy, China's economy represents the second largest economy in the world, according to the International Monetary Fund. More than forty countries consider China to be their top export partner. The Chinese economy has been slowing for some time. Its GDP, after recovering from the Great Recession rebounded up to an 11.9% annualized growth rate before slipping below 7% at the end of last year.



The Chinese economy is now at levels experienced in 2008, giving cause for alarm about the impact this will have on companies and countries reliant on China as a major revenue source.

Europe: The European Union, a politico-economic union of 28 European countries, now has an economy that is slightly larger than the United States. The European Central Bank (ECB) has been trying to stimulate their economy through several quantitative easing packages. As you can see to the right, its economy has been sluggish at best.



Concern that Europe would slip into a similar recession that they experienced in 2012 has put pressure on the global markets. Many investors believe the European economy would have slipped into a recession without the ECB stimulus packages that have been introduced over the past several years.

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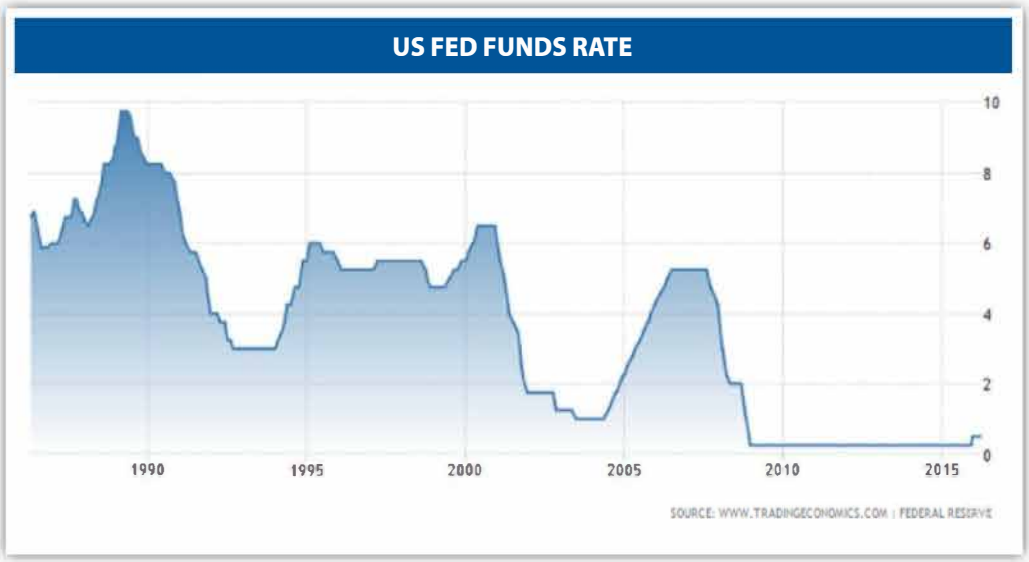
The Fed: Janet Yellen and the Federal Open Market Committee (FOMC) raised rates in December for the first time in seven years. The end of ZIRP (Zero Interest Rate Policy) was significant. As you can see to the right, fed fund rates have been held at near zero for an unprecedented amount of time.



The FOMC had publically mapped out a plan to "normalize" fed fund rates slowly over time. Their goal was to raise rates each quarter until rates reached 1.25% by the end of 2016. They wanted to continue to raise rates to 2.50% by the end of 2017, and to raise rates up to 3.50% by the end of 2018. For the first time since its creation in 1907, the Federal Reserve isn't raising rates to combat inflation; they are raising rates to re-set one of their most important levers to combat recessions.

Raising fed fund rates can have other unintended consequences. Raising rates can slow the economy. Typically, raising rates can impact the value of the dollar. If the FOMC is raising rates while our trading partners leave their rates alone, the dollar will strengthen. This makes our products more expensive in foreign lands and their products cheaper here. Currently, Japan, China, and the European Union are all trying to stimulate their economies by making their currency cheaper in various ways. The FOMC's decision to raise rates while three of the world largest economies are lowering rates made investors fearful that the United States might fall into a recession. Fed Chairwoman Yellen reversed her stance on raising rates throughout the year at her press conference after the March 15-16 FOMC meeting. According to the CME Group, there is almost a 50% probability that the FOMC will leave rates alone for the rest of the year. If the global economy stabilizes, the FOMC's future moves should not have a material or negative impact on the U.S. economy.

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Oil: Most people think that low oil prices are a good thing. For most Americans, lower gas prices have provided them more flexibility with their discretionary spending. There is a point, however, where low oil prices can be negative for our economy. Here are a couple of reasons why:

According to the International Energy Agency, the United States surpassed Saudi Arabia as the world's largest oil producing country. This is due to the expanded use of fracking, a process used to extract oil trapped in shale formations. The extraction of oil has different costs, depending on where and how it is extracted. According to Rystad Energy, countries like Saudi Arabia produce oil for only $9.90 per barrel. It costs the average U.S. producer $36 per barrel. Forty percent of U.S. oil production is from fracking. Using this technique, oil extracted from shale formations costs between $40 and $70 per barrel, depending on the location.

As you can see from the chart above, oil prices plummeted over 46% in 2014, and lost over 30% in 2015. Oil dropped from $37.04 a barrel at the start of the year to a low of $26.21 on February 11th, a 20% loss. From its high in 2014 to its lows in 2016, oil prices fell more than 75%.

The biggest fear that ripped through the markets was that U.S. oil producers were no longer able to produce oil at a profit. If they were unable to produce a profit, the risk of oil producers defaulting on the debt they took to expand their production (during the good times) would increase. If oil producers started defaulting on their debt, the impact would be felt by the financial industry which lent them the resources to expand.

Another fear was that low oil prices would create political unrest in places like Russia, Saudi Arabia, and other Middle Eastern nations. These nations are reliant on their profits from oil production to fund their government spending needs. While still profitable compared to U.S. producing companies, low oil prices have cut dramatically into these countries budgets and spending.

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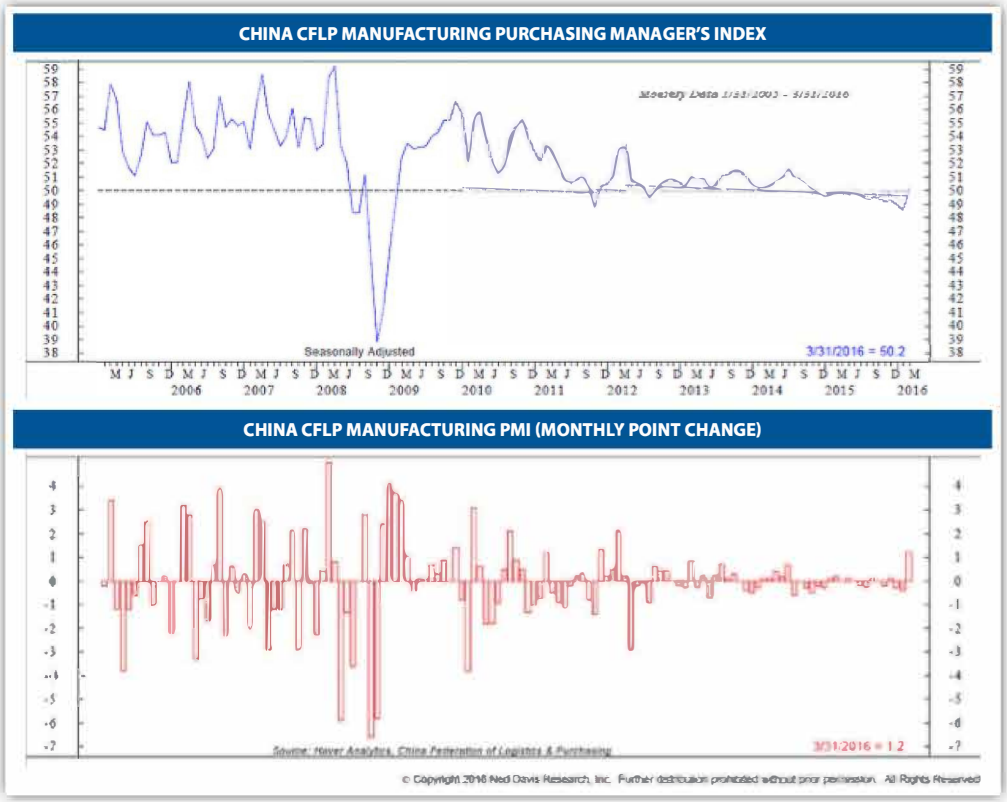
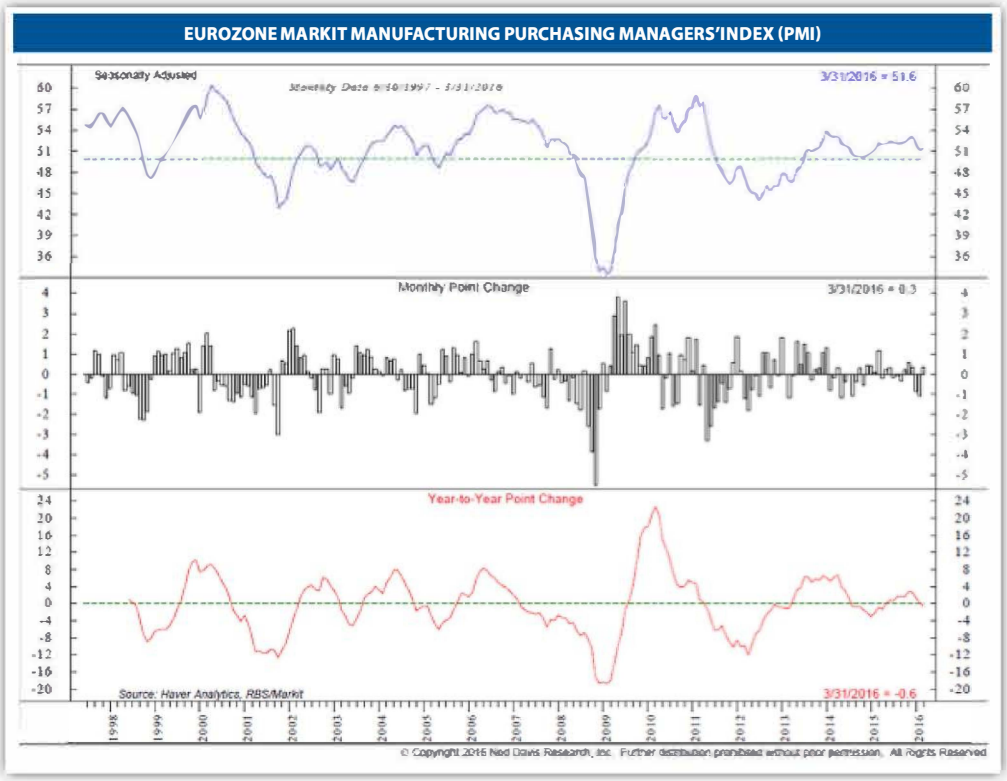
Where Do The Markets Go From Here?

Most of our research makes us believe that the majority of the negative news is behind us and that we will most likely see the S&P 500 drift higher from here and end the year higher than where we are today. Here is why I believe this to be true:



Europe's and China's economies have stabilized –

Purchasing Managers' Index (PMI) is often a good indicator to understand economic stability. As you can see to the right, China's manufacturing PMI just moved positive and the European manufacturing PMI remains sluggish but positive.



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The dollar has stabilized –

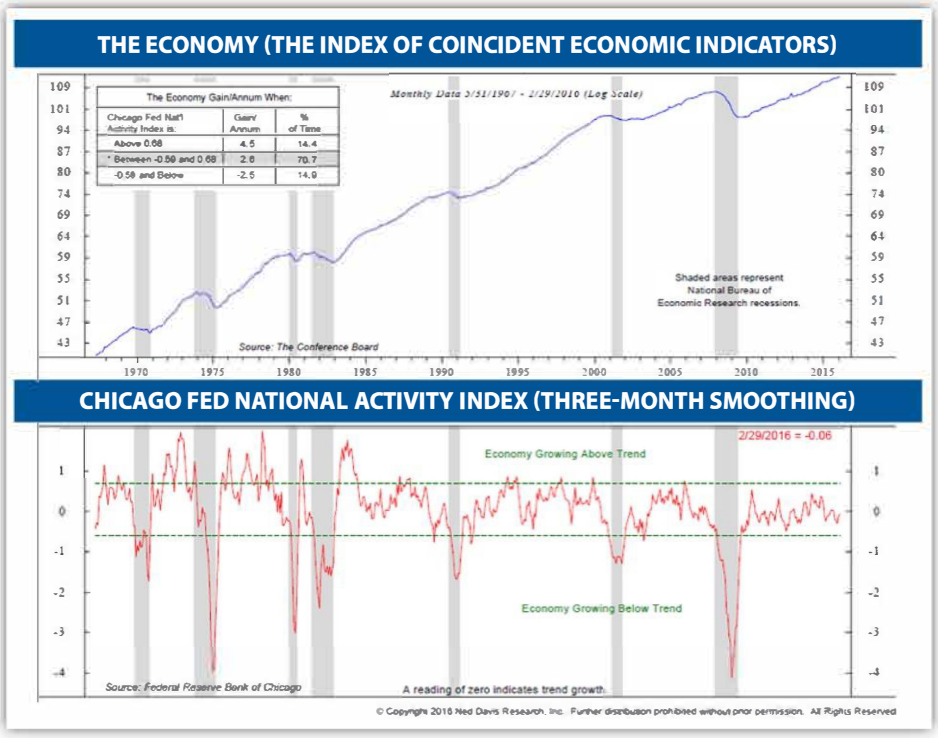
The graph to the right indicates euro to U.S. dollar rates. As the graph drops, the euro is weakening to the dollar. As you can see, the dollar strengthened to the euro at the end of last year, in part due to Fed action and continued easing in Europe. The euro is recovering which could positively impact earnings for U.S. based companies that derive some or most of their earnings abroad.

Don't expect oil prices to rise as quickly as they dropped –

We do expect oil prices to stabilize and slowly grow over time as economic stabilization continues in China and Europe. Increased demand should slowly force prices up over time. Oil prices won't go up substantially due to OPEC's strategy to continue high production levels. Their goal is to keep prices down and force the U.S. fracking companies to slow or stop production due to a lack of profitability. They are hoping to retake market share with this strategy. The removal of sanctions on Iran as well as record oil reserves should continue to suppress oil prices as additional oil is placed on the market.

U.S. economy is stable and growing –

As you can see from the Chicago Fed National Activity Index (top chart to the right), the U.S. economy is growing. The bottom chart shows a three month smoothed average (in red) of U.S. economic activity. Zero indicates average growth. Anything above 0.75 indicates inflation and anything below -0.75 indicates recessionary pressures. As you can see from the statistics to the right, we are experiencing average growth.



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Bond Prices Will Drop – Long and intermediate term bonds saw an incredible run during the downturn in the stock market, as investors flocked to safer investments. More remarkably was how well bond prices held in during March as the stock market rallied. This was mainly due to the continued quantitative easing going on in Europe and China, and the negative interest rate environment in Japan. We do not expect prices to remain at these levels and expect a normalization of bond prices this quarter.

What is Polaris Wealth Doing?

All of Polaris Wealth's proprietary strategies are managed in a dynamic and tactical manner. Our investment ideology is based on understanding the risk we believe is found in the markets. We assess this risk by applying our proprietary four pillars of investing: technical analysis, macro-economic analysis, fundamental analysis, and sentiment analysis. If we assess high risk, we will lower our exposure to the stock market in all of our strategies and favor bonds or cash. If risk is low, we will take from our bond or cash holdings to overweight equities.

We are currently under-weighting the equity markets in all of our strategies with extra cash (instead of bonds) poised to invest in the equity markets. Our current feeling is that we may soon overweight our equity holdings, if evidence of economic stabilization occurs in Europe and Asia. Please keep in mind that this may be a short lived investment, as our belief is to never be "married" to any investment. We might be required to "trade" rather than "invest," if the markets remain turbulent. We will continue to remain short to intermediate in duration with our bond investments, and underweighted fixed income to our benchmark, regardless of their short-term strength. The FOMC is expected to raise fed fund rates in the near future. This will negatively impact intermediate and long-term bonds. Investing is often like playing a game of chess. You sometimes have to be willing to give up a piece or two in order to win the match. We refuse to invest in an area that we are confident will show long-term weakness.

I hope this helps you further understand the dedication and vigilance we take in the management of your portfolio. Your Polaris Wealth advisor will be happy to review all of our strategies with you to ensure you are invested appropriately.

As always, I welcome your comments and questions.

Sincerely,

Jeffrey J. Powell
Managing Partner

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