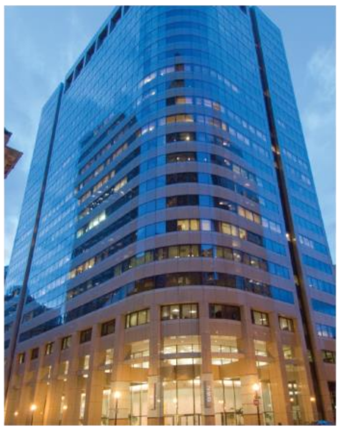
TFC FINANCIAL
The Financial Counselors

MARKET UPDATE
January 21, 2016

OUR VIEW



Market Meltdown: Correction or Start of a Bear Market?

U.S. Stocks Fall by More Than 8% to Start the Year

The S&P 500 Index fell by more than 2% last Friday, leaving the benchmark for U.S. large company stocks down 8% for the first two weeks of the year. International stocks fell even further, and mainland Chinese stocks approached bear market territory with losses of nearly 20%. Markets fell further this week, with some indices dipping into bear market territory.

It's natural to fear a repeat of the financial crisis and stock market collapse of 2008, and investors appear fearful of contagion from falling oil prices and slowing growth in China. TFC's view is that this market correction is an overreaction to current conditions rather than the start of a financial crisis or a long-lasting bear market.

Bear Markets Almost Always Coincide with Recessions

Bear markets, defined as a market decline of 20% or more, typically are associated with recessions. There have been bear markets that haven't coincided with recessions, such as in 1987 and 2011, but those bear markets reversed course relatively quickly.

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Recessions since 1970:

Dates	Primary Cause(s)	Economic and Market Impact
1973-75	Arab oil embargo, "stagflation"	Inflation rises to critical levels
1980-82	Inflation, real estate bubble, financial deregulation	Volcker Fed tightens monetary policy; significant rise in interest rates
1990	Saddam invades Kuwait	Oil price shock
2001	Technology bubble	Stock market plunge
2007-08	Real estate bubble, over-leveraged economy	Real estate collapse, financial crisis

We are looking for indications that a severe and long-lasting bear market in stocks is likely, assessing the likelihood of a recession or a banking crisis. We don't see signs of the imbalances that frequently cause recessions and severe market downturns, for a variety of reasons:

- *The slowdown in China is a concern, with the symbolic impact of their slowdown taking on outsized importance relative to the actual impact on the global economy*. We expect the industrial slowdown in China to continue, creating challenges not only for China but for commodity exporters throughout the world who previously benefited from China's seemingly insatiable appetite. We think the Chinese government has the motivation and the financial resources to keep the Chinese economy from falling into too steep a slowdown.

- *Energy and other commodity prices are severely distressed*, with no turnaround in sight. However, energy and commodities are much smaller contributors to the U.S. economy than real estate (in GDP and employment terms), so we don't see the downturn in oil and other commodity prices as a catalyst for another crisis for the economy. The oil bust and end to the boom in commodities is a negative for certain companies, regions and countries, but is a positive for consumers of oil and other commodities. In the words of Oaktree's Howard Marks, "I think low energy prices today will contribute to better economic growth tomorrow."

- *U.S. banks are stronger than was the case in the prelude to the financial crisis*, more than doubling equity capital since 2009, while significantly improving credit standards. We are, however, monitoring the troubling build-up of debt in the developing world.

- *Residential real estate, according to BCA Research, represents half the share of GDP that it had in 2005*. There is considerably less real estate-related leverage in the system, and delinquencies are not signaling a return to the systemic stress experienced in 2007-09. Although there may be some pockets of excess, real estate doesn't seem to be a threat to the health of the economy.

Overall, we think economic conditions will continue to provide a backdrop of slow growth. Despite all the negative headlines from recent weeks, there are significant bright spots in the economy.

- *The high yield market has been under pressure alongside falling oil prices since 2014*, pressure that increased since the closing of Third Avenue Management's distressed debt fund. Delinquencies and defaults are rapidly increasing among energy and commodities companies, but the rest of the high yield market is experiencing much lower levels of financial stress. In stark comparison with the collapse of the housing market in 2007, most high-yield debt is owned by non-leveraged investors, and the derivatives structure that served as an accelerant to the financial crisis is largely absent from the high yield market.

- *Liquidity* factors may be magnifying market movements. Sovereign wealth funds pressured by falling oil prices have reportedly been selling equities. Corporate stock buy-backs, which have been a meaningful source of support for markets in recent years, are precluded in the month before earnings are released. Resumption of buy-backs may provide some support to markets.

Overall, we think economic conditions will continue to provide a backdrop of slow growth. Despite all the negative headlines from recent weeks, there are significant bright spots in the economy. The employment picture is significantly improved in the U.S. and in Europe, monetary policy is still relatively "easy" in most parts of the world, and fiscal austerity has eased in most parts of the world. Despite contraction in the industrial economy, the services sector continues to be healthy in both the developed and developing world. We think this backdrop supports a slow, but still-growing global economy.

What We're Doing

In a quote commonly attributed to John Maynard Keynes, "When the facts change, I change my mind." We're constantly "testing" our investment point of view--reviewing whether we should alter our investment positioning. Among our areas of current focus are:

1. Corporate and economic data releases.
    a. *Global corporate earnings reports*: Early results are signaling slowing but still positive global profit growth, excluding energy and commodities-related companies.
    b. *Economic indicators*: We're looking for indications that problems in the oil industry will "infect" the consumer and compromise the outlook for consumer spending.

   c. *China*: We're looking at policy changes, stimulus efforts, and indications of consumer and business activity to assess whether China is stabilizing or deteriorating.

2. Geopolitics. Geopolitics often provides "sound and fury" that adds to investor concerns, but doesn't have a lasting impact on markets. There are issues on today's world stage that may run counter to our past experience, and may have a greater impact on our investment thinking. The rise of "ungoverned states" is one such issue, creating refugee issues and mounting concerns about terrorism. The growing popularity of anti-establishment candidates is another issue that was considered a distraction earlier in the U.S. presidential election cycle, but now has to be taken more seriously as Donald Trump and Bernie Sanders appear to be serious contenders for their respective party's nomination.
3. Validate our asset allocation weights. Our expectations for markets and economies have implications for our allocations to stocks and bonds, as well as global and regional weights within equities and fixed income. We continually validate our positioning relative to long-term objectives and assess whether any changes are warranted.
4. Review our current holdings. Some investments are better equipped than others to weather turbulent markets. We regularly monitor our mutual fund holdings, with special attention to those that have disappointed or may disappoint given our view of the market. Upcoming meetings with fund managers will inform our positioning and outlook.
5. Rebalancing and loss harvesting opportunities. We may rebalance portfolios to their target asset allocation weights, which in some cases implies adding to equity holdings that have declined in value. Where appropriate, we have reserved cash in client portfolios for anticipated withdrawals. We may also take advantage of the downturn in the markets to harvest losses.
6. Identify potential new holdings. As always, we're considering new investments to either enhance returns or better control risk.

Benjamin Graham, the "father of value investing," stated, "The day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment." Sentiment often swings between extreme optimism and extreme pessimism, and emotional swings are often disconnected from fundamentals. In our view, the plunge to start the year is more a function of sentiment than of an impending crisis in most of the global economies. We will continue to share our thinking and will update you when we make portfolio or fund changes.

Feel free to contact your advisor, or me directly, if you'd like to discuss this in more detail.

Sincerely,

Dan

Daniel S. Kern, CFA
Chief Investment Strategist

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