HBK Wealth Management
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WEEKLY MARKET COMMENTARY

A Candid Look into the Current State of the Markets

February 2016

"Making a positive impact on as many lives as I can." Please contact me if you have friends and family who would enjoy receiving this newsletter!

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In This Issue

Weekly Market Commentary | Week of February 15, 2016

KEY TAKEAWAYS

- Down 8.8% though 29 trading days, 2016 is the third worst start for stocks over the past nearly 90 years.
- A comparison of market, sentiment, technical and fundamental indicators to prior bear market lows provides some encouraging signs.
- We do see several potential catalysts that could help stocks over the next several months, and a bear market may not necessarily be in the cards.

DATA-DRIVEN PERSPECTIVE ON A ROUGH START TO 2016

It has been a rough start to 2016 for the stock market. In fact, it's been one of the worst starts to a year in the history of the S&P 500. This week we look at how stocks have done historically after other similarly bad starts, compare current fundamental and technical conditions to prior bear market lows, and discuss some potential catalysts that could help turn stocks around. While recession odds have risen (we place the odds at about 30%), we do not expect the S&P 500, down 12.5% from 2015 highs, to enter a bear market.

Down 8.8% though 29 trading days, 2016 is the third worst start for stocks over the past nearly 90 years. Going back all the way to 1928, the S&P 500 Index (and its predecessor S&P Index) has been down at least 5% on the 29th trading day of the year 19 other times. So what has happened the rest of the year? The good news is that after a bad start, for the rest of the year the S&P 500 has averaged a gain of 5.3% (the median is also 5.3%), and the rest of the year has been positive 58% of the time. The best rallies after bad starts were 49% in 1935 and 36% in 2003. Going back 40 years, the S&P 500 has been down 5% or more after 29 trading days 10 other times besides this year. The rest of the year was down more than 10% only once, in 2008. That year saw a 33% drop from the 29th trading day until the end of the year. In other words, a sizable drop from here for the rest of the year would be extremely rare [Figure 1].

View Figure 1, A Big Drop Early in the Year Is Not Necessarily a Bearish Signal.

HISTORICAL PERSPECTIVE

With stocks down about 9% year to date and 12.5% lower than 2015 highs (and everyone wondering where the bottom is), we compare technical, sentiment, and fundamental indicators today to levels at prior bear market lows to assess the likelihood stocks may have bottomed. Generally, these indicators provide some comfort that the sell-off may be near its end and highlight relatively better fundamentals [Figure 2].

View Figure 2, Comparison of Market, Technical, and Fundamental Indicators at Recent Bear Market Lows.

Market-based indicators suggest bonds have priced in more bad news than stocks. Credit spreads are wider than they were at the October 1998 and March 2003 stock market lows, and close to August 2011 spreads, even though stocks have not corrected as much as they did in August 2011. But stock valuations are well above 2009 and 2011 troughs, and in-line with the March 2003 lows. On the surface, these comparisons suggest more potential near-term downside for stocks; however, given the economic cycle is in its latter stages, we think stock valuations are fair, and envision a scenario where credit markets may stabilize before stocks begin a sustained move higher.

Sentiment and technical measures show the bulls have been largely washed out. Stock market bulls have become extremely scarce. Based on two popular investor surveys (American Association of Individual Investors [AAII] and Investors Intelligence), bulls are as rare as they were at the March 2009 lows. Extreme levels of pessimism have historically provided accurate signals of market bottoms. The VIX measure of stock market volatility is calmer than we would expect, suggesting perhaps more volatility is needed to wash out more bulls; however, we could also interpret this to mean that markets were already positioned defensively coming into the year. Sentiment in the options market is similarly negative compared with levels at these prior major lows.

Fundamental picture offers some encouraging signs. Fundamentally, the current economic environment compares favorably to the last three major lows. Although this economic expansion has been lackluster, we continue to forecast 2.5% gross domestic product (GDP) growth in 2016. Leading indicators are supportive, job gains have been steady, and the service economy remains healthy (case in point: Friday's strong January retail sales report, pushing total sales to an all-time high). All of this suggests, in our opinion, that the U.S. economy should avoid recession, and hopefully, help the S&P 500 avoid a bear market. The lack of earnings growth is concerning, as is the related softness in the Institute for Supply Management (ISM) Purchasing Managers' Index (PMI). These indicators are at levels consistent with prior bear market lows and mild recessions, and also suggest stocks may have a bit more downside.

Putting this all together, stocks may have some more downside; but if so, we see perhaps a further decline of

5% rather than 10%. That said, we cannot completely discount the possibility that the S&P 500 finds an eventual intermediate-term bottom near 1820 depending on catalysts that may emerge.

WHAT MIGHT TURN STOCKS AROUND

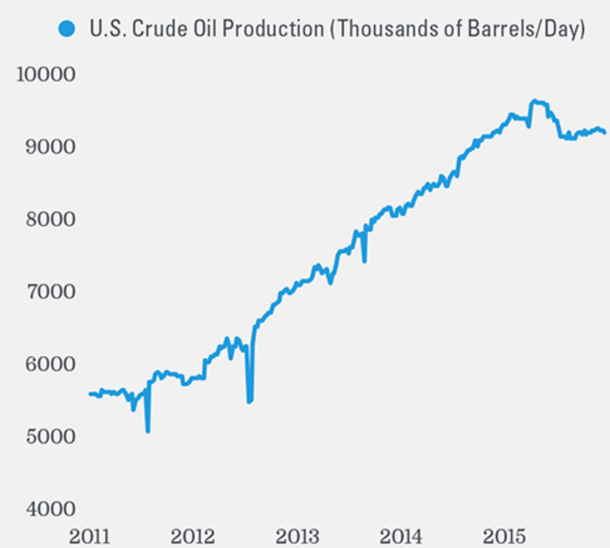
We see potential for stocks to get a boost from the following potential catalysts, although admittedly timing is very difficult to predict:

Oil price stability. Stocks have become increasingly tied to oil, making oil prices a potential catalyst for stocks. For example, on Friday (February 12), speculation of an OPEC agreement to cut supply helped drive oil up 12% (no, that is not a typo), the biggest one-day jump since 2009, which helped drive Friday's 2% rally in stocks. Default fears in the energy sector remain a big concern for both equity and credit investors. Cuts to capital spending by oil producers have reverberated through the manufacturing industry and industrials sector (capital expenditure reductions by the S&P 500 energy sector are expected to approach $50 billion in 2016 according to FactSet-tracked consensus estimates). Concerns have spread to banks, where energy loan defaults are rising. Default fears are not limited to the U.S., as counterparty risk among European banks has become a bigger concern in part due to energy lending.

What We Are Watching: More progress toward reducing U.S. production [Figure 3] to recalibrate supply and demand or Saudi production cuts.

Estimated Timetable: 2-6 months.

3 SLOWING U.S. OIL PRODUCTION HAS BARELY PUT A DENT IN THE LONG-TERM TREND LINE

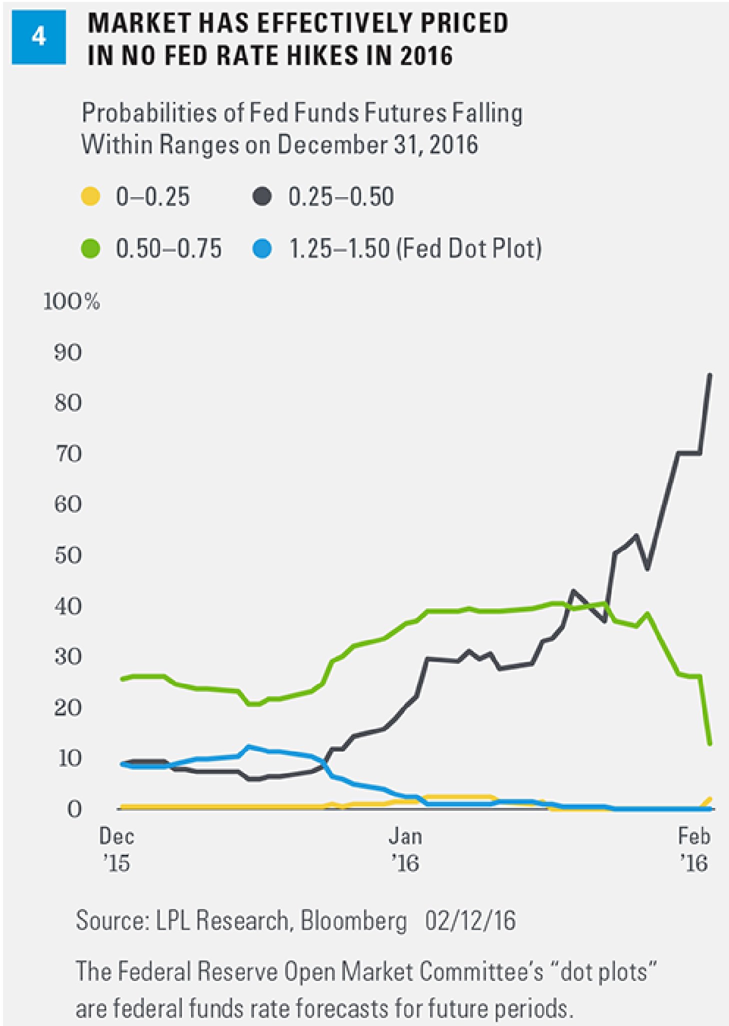


Source: LPL Research, U.S. Department of Energy 02/12/16

Evidence of a more pragmatic and global Fed. The Federal Reserve (Fed) appears to be more disconnected from markets than it has been in some time. Although Fed Chair Yellen has reiterated that the Federal Open Market Committee (FOMC) will be data dependent, she has given little indication that she expects less than the four rate hikes in 2016, which were conveyed in December 2015. The fed funds futures market has now effectively priced in no rate hikes at all this year [Figure 4]. The Fed and the market are seemingly too far apart for that gap to close soon; however, progress may start at the March 15-16 FOMC meeting and continue through subsequent FOMC meetings in April, June, and July.

What We Are Watching: Commentary from the Fed that closes the gap between its communications and market expectations.

Estimated Timetable: 1-5 months.



Improving credit markets. We put the odds of recession in the U.S. at about 30%. By contrast, financial markets are implying a probability closer to 50%. The energy-sensitive high-yield bond markets are sending a particularly negative signal with spreads near August 2011 levels, when markets were worried about the Eurozone breaking apart and the creditworthiness of the U.S.; they are even wider than the March 2003 bear market bottom following the 2001 recession and accounting scandals of 2002, although credit spreads had already bottomed in November 2002 and were already starting to recover.

What We Are Watching: Investment-grade and high-yield bond spreads to Treasuries. Until spreads stabilize and show progress toward sustained improvement, possibly with help from oil, the market's recession worries may continue. The timetable for this potential catalyst is likely a bit longer because energy defaults will take time to play out should low prices continue.

Estimated Timetable: 3-12 months.

Stability in Chinese capital flows and currency. Markets remain worried about the potential for China to sharply devalue its currency (the yuan), sparking Asian currency wars similar to 1998 when the Thai baht collapsed. China's foreign currency reserves have been falling by about $100 billion per month in recent months, largely because the central bank has been defending the yuan in the unregulated "offshore" market, although the Chinese central bank still has approximately $3.2 trillion in currency reserves. Until the market gets comfortable with the outlook for the yuan, which may be helped by better performance by the Chinese economy and a more dovish Fed, it may be difficult for U.S. stocks to sustain a meaningful rally.

What We Are Watching: Slowing Chinese capital outflows and controlled devaluation that leads to stability in the yuan currency.

Estimated Timetable: 3-12 months.

CONCLUSION

After one of the worst starts to a year for stocks, we do see some cause for optimism. Based on how stocks have historically performed after similarly bad starts to a year, the worst may be behind us. A comparison of market, sentiment, technical, and fundamental indicators to prior bear market lows provides some encouraging signs.

And finally, we do see several potential catalysts that could help stocks over the next several months. Although recession odds have risen, a bear market may not necessarily be in the cards.

Thank you to Ryan Detrick for his contributions to this report.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

All investing involves risk including loss of principal.

Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features.

High-yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

The credit spread is the yield the corporate bonds less the yield on comparable maturity Treasury debt. This is a market-based estimate of the amount of fear in the bond market. Bass-rated bonds are the lowest quality bonds that are considered investment grade, rather than high yield. They best reflect the stresses across the quality spectrum

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Institute for Supply Management (ISM) Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The Index of Leading Economic Indicators is a monthly publication from the Conference Board that attempts to predict future movements in the economy based on a composite of 10 economic indicators whose changes tend to precede changes in the overall economy.

The VIX is a measure of the volatility implied in the prices of options contracts for the S&P 500. It is a market-based estimate of future volatility. When sentiment reaches one extreme or the other, the market typically reverses course. While this is not necessarily predictive, it does measure the current degree of fear present in the stock market.

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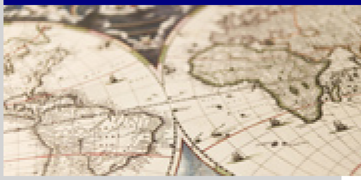


Weekly Economic Commentary | Week of February 15, 2016

KEY TAKEAWAYS

- European integration has been increasing steadily since the end of WWII.
- The U.K. is renegotiating its membership in the EU.
- The U.K. leaving the EU--the "Brexit"--would support anti-EU sentiment in other countries.

POLITICS, ECONOMICS, AND THE BREXIT: TWO SIDES OF THE SAME COIN

Heads or tails, politics or economics? Politics and economics are separate, but related disciplines, like two sides of the same coin. In an attempt to ensure that the continent would never suffer another major conflict after World War II, Europe embarked on a movement toward both political and economic integration. At times there have been disagreements, but as a whole, the European experiment--viewing Europe as a single economic and political entity--has moved forward. The United Kingdom has negotiated changes to its membership in the European Union (EU) that will be voted on by EU member nations on February 18, 2016. As early as June of this year, the U.K. will hold a referendum on whether it should leave the EU, an act referred to as the "Brexit." Other populist anti-European movements are growing and will no doubt be influenced by the EU's response to the U.K.'s request and the proposed June referendum.

THE MOVE TO INTEGRATE

The movement toward European integration began after World War II. After two major wars in three decades, European leaders were determined not to allow a third. In addition, the beginning of the Cold War and the creation of NATO (North Atlantic Treaty Organization) in 1949 required western European countries to focus their attention on the Soviet Union. In 1951, the first pan-European organization, the European Steel and Coal Commission, was created to coordinate steel production. French Foreign Minister Robert Schuman said this would make war between France and Germany "not merely unthinkable but materially impossible."

The next wave for European integration was focused on economics. Over several decades, common trade policies were created, most importantly the creation of a "customs union" in 1968. In a customs union, not only is there unfettered trade within the member countries, but the countries agree on a common tax regime for goods coming in from outside the region. This move has significant political ramifications as countries give up a major right of sovereignty, the ability to control all trade at their borders, not just trade from members.

Though the U.K. first applied for membership in 1961 in what was then called the European Economic Commission, it was not granted membership until 1975, after the U.K. held a referendum following its request for concessions from the other members. The current negotiations are not the first time the U.K. has sought exemptions from certain EU provisions.

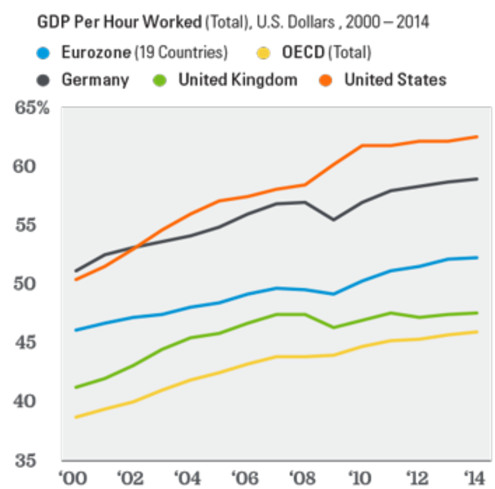
Whether due to language, culture, or simply the amount of time the U.K. spent outside of the EU, the political culture in Britain never embraced "Europe" as a political entity. Though the English Channel is only 21 miles wide, to the British it must look like an ocean. This skepticism is not just a function of geography or history; Scotland is far more pro-European than Britain.

The other major economic milestone for political Europe is the creation of the euro, and the removal of national currencies. This is perhaps the ultimate surrender of national sovereignty. With two exceptions, all members of the EU must ultimately accept the euro; currently 19 of the 28 EU members use the euro (collectively known as the Eurozone). Six of the remaining nine are Eastern European nations deemed not ready for adoption. The U.K. and Denmark negotiated an exception to the mandatory use of the euro. Sweden refuses to accept the euro on what amounts to a technicality, though the EU has allowed this to go largely unchallenged.

Where does this leave the U.K. economically? Two things stand out. First, the U.K. is less dependent on trade than any other major country in the EU [Figure 1]. Second, the U.K. lags the rest of Europe in terms of productivity when measured by gross domestic product (GDP) per hours worked [Figure 2]. U.K. politicians in favor of leaving the EU will often point to regulations foisted on its economy from the EU as limiting economic growth. That may be true, but it does not put the U.K. at a competitive disadvantage relative to other countries in the EU. The U.K. decided to retain its currency and a level of sovereignty. However, when compared to other higher economically developed economies in the EU, it appears that it may have forgone an economic benefit by not accepting the euro.

View Figure 1, Importance of Trade to National Economies.

2 THE UK LAGS OTHER EU COUNTRIES IN PRODUCTIVITY



Source: LPL Research, OECD 02/12/16

Data as of 12/31/14. Most recent data available. Past performance is no guarantee of future results.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

The Organization of Economic Cooperation and Development (OECD) brings together the governments of countries committed to democracy and the market economy from around the world to support sustainable economic growth, boost employment, raise living standards, maintain financial stability, assist other countries' economic development, and contribute to growth in world trade.

MORE THAN ECONOMICS

Whatever one thinks of the results of the economic integration of Europe, it is the political issues, especially those that involve national sovereignty, that are causing nations to consider reversing course. The most emotional issue involves immigration and the free movement of people within the EU borders. In fact, the U.K. Independence Party (UKIP) lists immigration first when it mentions "the issues of the day" on its website, before the economy, healthcare, and living standards.

In 1985, several European nations agreed to the Schengen Treaty, which allowed people to travel freely (without passports or further controls) with its region. This treaty was expanded over the years to become a core feature of the EU, to which all members must fully accede. Again, the U.K. (along with Ireland) was granted some exemptions from the requirements.

Immigration to the U.K. has averaged from 500,000 to 600,000* between 2006 and 2014. Official statistics are unavailable for 2015, but are probably near 700,000. The number of people coming to the U.K. from within the EU and those coming from outside of it are approximately equal. Refugees from the wars and political unrest in Syria, Libya, and other North African nations have been adding to the migration pressures. The U.K. wants greater ability to handle the immigration issues. This means limiting entrance, enforcing residency requirements before social services are offered, limiting citizenship by marriage to prevent fraud, and other similar measures. Current EU rules limit, if not expressly prevent, the U.K. from enacting these sorts of rules.

Though immigration tends to grab headlines, there are three other issues of contention, including:

- **Economic governance.** The U.K. is not part of the Eurozone, yet London operates as the European financial capital. The David Cameron government is concerned that countries in the Eurozone will pass regulations that will reduce the competitiveness of U.K. banks, and U.K. companies in general. It wants assurances that the countries not using the euro will not be discriminated against. In addition, it wants assurances that U.K. regulators will remain the primary regulator of U.K. financial institutions.
- **Economic competitiveness.** The U.K. would like to see a relaxed regulatory burden on all businesses. Though this seems a simple and obvious request, it is made difficult by the fact that the EU is comprised of 28 different nations. One nation's view of onerous regulation is another's guarantor of social harmony or environmental sensitivity.
- **National sovereignty.** EU and Eurozone nations have given up so much in the way of national sovereignty, most notably their currencies and the right to control their borders. Yet EU documents

still maintain an obligation to an "ever closer union." The U.K. would also like to see an increased role for national parliaments. Effectively, the U.K. would like a declaration suggesting that the period of integration has ended for the foreseeable future.

The European Council of national leaders has partially addressed the U.K. concerns. It is now up to both national leaders and the British people to decide if the compromises announced on February 2 are acceptable. Polling data in the U.K. suggest that support for the Brexit is growing, and may happen regardless of the results of this week's meeting.

Timeline of Events

- January, 2013. U.K. Conservative Party Prime Minister David Cameron promised to renegotiate the terms by which the U.K. is a member of the EU, and hold a national referendum on whether those new terms would be satisfactory.
- May 7, 2015. The U.K. held its general election. The result was a resounding victory for the Conservative Party, suggesting a high degree of support for the renegotiation, if not support for leaving the EU altogether.
- February 2, 2016. The European Council announced a draft renegotiation of the U.K.'s membership in the EU.
- February 18-19, 2016. Expected vote of European leaders on proposal.
- June 2016. Expected referendum in the U.K. on continued membership.
- October 2016. Spanish regional elections. Separatists in the Basque region look to the U.K. independence movement as granting legitimacy to their attempted devolution from Spain.
- 2017. Original time frame for U.K. referendum.

IMPLICATIONS OF A BREXIT

The implications of a Brexit are both political and economic, with little real consensus regarding a final conclusion. From a political perspective, the biggest implication would be the tacit support for other anti-EU movements across the continent. Figure 3 shows a map of the region, highlighting national movements that support increased autonomy for countries or regions.

View Figure 3, Regional Challenges to the EU.

The debate over the economic impact of a Brexit is highly partisan. However, some non-partisan groups have studied the matter in detail. A group from the London School of Economics suggests that the U.K. would suffer a loss of GDP between 1.1% and 3.1% due to a reduction in trade. In the long run, this group suggests that U.K. productivity would slow, which is particularly important given its economy is already less productive than peers (as shown in Figure 2). In addition, the U.K. would be forced to negotiate any further trade agreements on its own, rather than as part of the EU. This could leave the U.K. unable to further its interests. Of course, the UKIP and similar parties dispute these and similar viewpoints expressed by mainstream analysts.

Perhaps the biggest wildcard is what would happen to London as a banking center. One factor in the renegotiation is London's protection. If London is not safe given the U.K.'s current status, it must be considered less so should the Brexit occur.

CONCLUSION

"Europe" as a concept, rather than a just a place, is facing a critical test this week, and throughout this year. The benefits of economic integration appear clear. If anything, the data suggest that the U.K. might even benefit from increased economic coordination. However, politics matter in ways that do not show up neatly on national accounts and mathematical models. It is not for us to say how either side should decide the issues before them. That said, in our view, the possible reversal of a 75-year trend toward integration and harmony will have negative ramifications. We also cannot ignore the rising tide of populism, both in the U.S. and Europe, and question whether this tide will not overwhelm more sober economic calculation. At this point, it looks like both sides are flipping the coin hoping it lands on its edge, a most unlikely outcome.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

Focus on the Forest, Not the Trees, of Investing

"Chasing returns" by moving your money into whatever investment type or stock market sector happens to be doing well at the time rarely pays off in the long run.

It's a message worth repeating. Investing is a matter of focus. Despite recent disappointments in stock market performance, investors who are willing to assess the whole universe of investment choices may find that the market continues to offer new possibilities. And those who keep their sights set on long-term investment goals may find that a "forest, not trees" approach to investing offers the greatest potential for success.

Focus is especially important for retirement savers -- those who are still in the accumulation stage -- as well as for retirees who need to keep the potential for growth alive in their portfolios.

Are You a Micromanager?

As a retirement saver, your employer-sponsored retirement plan gives you the freedom to make your own investment decisions. And because you can easily change plan investments, you may find yourself becoming a micromanager. That's an investor who changes investments frequently because of daily market movements instead of focusing on the big picture -- a long-term investment strategy. But "chasing returns" by moving your money into whatever investment type or stock market sector happens to be doing well *at the time* rarely pays off in the long run.

The Unknowable Future

The problem with chasing returns is that it's virtually impossible to predict how long a particular investment or market sector will continue to be a top performer. Eventually, another investment or sector will probably take over the lead, and there will be little or no advance warning. That can leave you in the lurch if you changed the investment mix of your retirement plan account based strictly on recent performance.

The Solution: Keep a Long-term Perspective

You may be much better off by the time you retire if you use a "forest, not trees" perspective when you invest. Concentrate on your goal, and choose an investment mix with the potential to help you reach that goal over time.

Your retirement plan offers several investment options, allowing you to choose a well-diversified investment mix for your account. The idea behind long-term investing is to choose a mix that offers you a realistic opportunity to achieve gains while reducing the overall risk to a level you are comfortable with.

After you've chosen your investments, you shouldn't ignore market and economic developments. But you'll generally want to stay with your plan unless you decide that changes in your personal situation or risk tolerance make an adjustment necessary.

If you're a "forest, not trees" investor, you can be much less concerned with what the markets do on a day-to-day basis. You'll be free to switch your investments, but you won't feel compelled to make a move every time the markets zig or zag.

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