

WEEKLY MARKET REVIEW

FEBRUARY 17, 2016

In This Edition

- *Questions to ask during this uniform market correction.*
- *What to make of the close stock and oil correlation.*
- *How to evaluate the jobs numbers.*



Market Performance

Stock Market	LAST WEEK	QTD	YTD '16
Total U.S. Market ¹	-0.94%	-9.54%	-9.54%
Domestic Large Cap Equity ²	-0.72%	-8.51%	-8.51%
Domestic Small Cap Equity ³	-1.34%	-14.31%	-14.31%
International Equity ⁴	-4.45%	-11.96%	-11.96%
Developed International Equity ⁵	-4.72%	-12.95%	-12.95%
Emerging Market Equity ⁶	-3.82%	-10.37%	-10.37%
Fixed Income	LAST WEEK	QTD	YTD '16
U.S. Bonds ⁷	+0.16%	+1.78%	+1.78%
Cash Equivalent ⁸	+0.00%	+0.02%	+0.02%

¹Russell 3000²S&P 500 Index ³Russell 2000 Index⁴MSCI ACWI ex-U.S. Index⁵MSCI EAFE Index
⁶Shares MSCI Emerging Markets Index ⁷Barclays Capital U.S. Aggregate Bond Index ⁸Barclays Capital 1-3 Month U.S. Treasury Bill Index

Week in Review

Last week, the markets continued to give investors a bumpy ride. The S&P fell 0.7%, and small-cap stocks sank 1.3%. International markets dropped 4.5%, while bonds rose 0.2% and commodities slid 0.2%.

Earnings for S&P 500 companies are down 4.9% this quarter. Most of the bad news was concentrated in energy stocks, materials, and industrials. Non-cyclical companies reported 4.3% earnings growth so far this quarter.

Corrections Happen

Apologies to those of you getting nervous. Since joining CLS in 1995, I've seen a lot of corrections, and I don't ever recall seeing one this uniform. I was only semi-joking with colleagues earlier this year when I said, "This is the best downturn ever!"

Perhaps the hardest thing about being an investor is seeing securities dart higher and slide lower while you have no control over their movements. If some investors overreact to a small interest rate increase, there is nothing you can do to stop the wave of sellers pushing prices lower. Because many of the corrections are only loosely based on fundamentals, predicting them is nearly impossible. Some investors "prepare" by making their portfolios more conservative, or by storing up cash. I haven't seen

many who jump back in at the right time. More common is for the cash to sit on the sidelines, missing out on potential gains.

Accepting corrections as a fact of life is freeing and allows us to focus on more important questions. One crucial question is, how well are our risk budgets managing risk? During this downturn, risk budgeting is performing very well. Nearly all of the broad asset classes we track at CLS are performing close to what their risk budgets would suggest. If the components are behaving as expected, then so are the overall portfolios.

A second crucial question is, what asset classes are winning and losing on the margin? Where asset classes are varying from expectations, that variance has been in line with our forecasts. Many CLS portfolio managers

have shared concerns about the valuation and extended performance of U.S. small- and mid-cap stocks. Large-cap stocks are outperforming the average of small and mid caps by more than 4% so far this year. Emerging markets are down less than both mid and small caps.

Another crucial question is, what's on sale? Chief Investment Officer, Rusty Vanneman's [January Market Review](#) covered that subject very well. If you didn't read it, I encourage you take a look.

Corrections like this one can be tough. Focusing on the right questions and accepting corrections as a natural part of investing can make them easier to navigate.



Scott Kubie, CFA
Chief Strategist

Scott Kubie joined CLS as a portfolio manager in November 1995. In March of 2002, he was given additional responsibilities as the Director of Research. In response to rapid asset growth at CLS, Mr. Kubie moved to the role of Chief Strategist in June 2005.

Mr. Kubie holds a Bachelor of Arts degree in Business and Economics from Trinity University in San Antonio, Texas, and a Master of Business Administration from the University of Nebraska at Omaha (UNO). He holds Series 6 and Series 65 securities registrations as well as the Chartered Financial Analyst (CFA) designation.

Stocks and Oil

In recent months, stocks and oil have looked like they are carpooling together. The chart below shows how closely stocks and oil have tracked each other since July 2015. Oil has been more volatile, but the two have zigged and zagged in similar directions most weeks.

Over the last 12 months, the weekly correlation between stocks and oil has been just above 0.5% – significant, but with opportunities for diversification. Since the end of November, when it had become apparent the Federal Reserve (Fed) would raise rates, correlations have shot upwards to just shy of 0.9%. Correlations that high imply very little diversification benefit.

What could this statistical relationship mean? If you have

taken a college statistics class, you have probably heard the phrase, “Correlation is not causation.” In other words, two things moving together doesn’t mean one is causing the other. For instance, each could be affected by a common third variable.

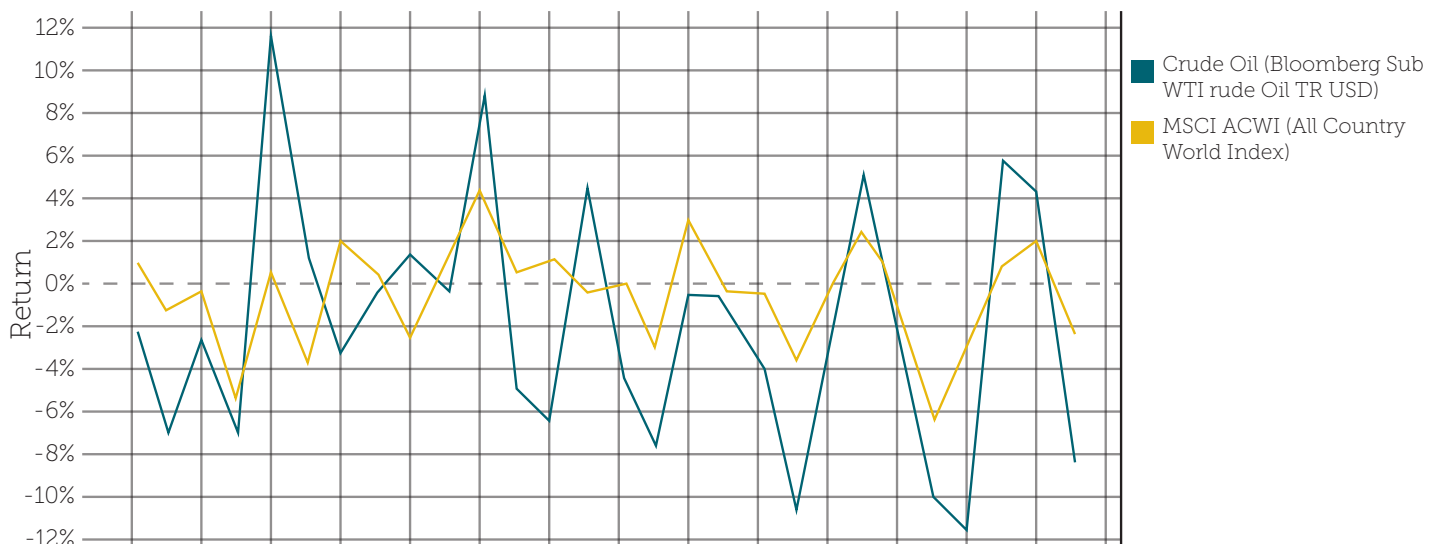
In the case of stocks and oil, Jeffrey Gundlach, manager of a bond ETF we use at CLS, believes concern about economic weakness is the common variable. Gundlach criticizes the Fed for raising rates when economic growth is declining. Investors are concerned that continued rate hikes will slow the economy in the U.S. while China’s demand for oil declines. When data shows signs of economic strength, stocks and oil rally. Stocks rally because it

means profits are more likely to increase, and oil rallies because demand is higher in a more robust economy.

Another potential idea (and both could be true) is the stock market is concerned about defaults in the high-yield and loan markets hurting investors’ appetites for risk and bank profits.

For now, stocks and oil are likely to move together. During this year, we expect some oil producers to reduce production by not drilling new wells to replace others. Because U.S. shale wells have the shortest life cycle, it wouldn’t surprise us if oil responds positively to production cuts and slight increases in demand.

Return of Stocks versus Oil



Keeping Score of the Jobs Numbers

Our economy is like a car trying to make it through bumper-to-bumper traffic on the freeway. The speed limit is 60 and we are going about 35. It is performing way under potential, yet we are making progress. The latest round of jobs numbers continues to support this comparison. Consider the following pairs of strong (+) and weak numbers (o):

- + **Unemployment Rate:** Dropped to 4.9% in January, falling below 5% for the first time since February 2008.
- + **Average Hourly Earnings:** Wages surged 0.5%, the second-highest growth we've seen during the recovery.
- + **U.S. Retail Sales:** Up 0.2% in January, reflecting ongoing consumer confidence.

- o **Jobs Added:** Employers added 151,000 jobs last month, below expectations and the weakest number since September 2015.


- o **Productivity:** Dropped 3% in the fourth quarter, while labor costs rose.

The numbers all reflect an economy with too many obstacles to get to full speed. New hires come with a high cost, relative to output, pushing productivity lower. Slower productivity gains make productive workers more valuable, pushing wages up. Because companies aren't getting as much out of recent hires, they may be slowing down hiring.

As long as two of the four statistics above are improving

and the other two are fairly stable, we'll keep chugging along. If the U.S. economy had an appointment with a strong recovery three years ago, it missed it because of traffic. But unemployment moving below 4.9% is a meaningful achievement and averaging 35 mph will eventually get you home.

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The S&P 500® Index is an unmanaged composite of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large cap stocks. The Russell 3000 Index is an unmanaged index considered representative of the U.S. stock market. The index is composed of the 3,000 largest U.S. stocks. The Russell 2000® is an index comprised of the 2,000 smallest companies on the Russell 3000 list and offers investors access to small-cap companies. It is a widely recognized indicator of small capitalization company performance. The MSCI EAFE International Index is a composite index which tracks performance of international equity securities in 21 developed countries in Europe, Australia, Asia, and the Far East. The MSCI All-Countries World Index, excluding U.S. (ACWI ex US) is an index considered representative of stock markets of developed and emerging markets, excluding those of the US. The Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Barclay's Capital 1-3 Month U.S. Treasury Bill® Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have \$250 million or more of outstanding face value. The Equity Baseline (EBP) is a blended index comprised of 60% domestic equity (represented by the Russell 3000 Index) and 40% international equity (represented by the MSCI ACWI ex US Index), rebalanced daily. An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. You cannot invest directly in an index.

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