Outlook

U.S. stock markets have been a relative haven in 2015. The largest drawdown during the year reached 12%, while developed markets outside the United States reached a drawdown of 17%, and emerging markets witnessed a maximum correction of 27%. Investor concern this year has been focused on economic growth, including whether the drop in commodity prices is a worrisome signal about future demand or mostly a reflection of over-supply.

Recent upset in the high yield bond market has also raised concerns about the state of the expansion. In addition, markets have been wrestling with conflicting messages from both the Federal Reserve and the European Central Bank (ECB)—both central banks seem too reactive to market pressures. The last month has also seen terrorist-linked attacks in Paris and California, raising the question of future political response in reaction to increasing voter concerns.

While we continue to have muted expectations for economic growth, we don’t expect a material slowdown from current levels. The U.S. labor markets are showing signs of resiliency, and European growth is withstanding the further slowing of emerging markets. We believe weakness in commodity prices (the Bloomberg Commodity Index is down...
24% year-to-date) is importantly attributable to increased supply, and probably isn’t signaling a future major growth disappointment for the global economy. The ECB disappointed investors, despite significant new stimulus, as market sentiment ran ahead of ECB President Mario Draghi’s ability to deliver. The Fed’s decision to finally raise interest rates is an important step toward an interest rate normalization that we expect to be very measured.

Financial markets, like history, are more likely to rhyme with the past than repeat it. Recent interest rate cycles have shown the ability of financial markets to digest central bank interest rate hikes, as long as they’re within market expectations. Financial markets are currently expecting the Fed to raise rates roughly three times during the next year—a pace that we believe is too aggressive. The key to market performance increasingly is the real economy, as investors are tiring of stimulus-led financial returns. With the Fed and the Bank of England (BOE) the only major central banks likely to tighten policy in 2016, we expect continued appetite for U.S. dollar assets and some headwinds for emerging-market assets to persist.

### Developing Momentum

**Developed markets have had better economic momentum this year.**

Emerging-market economies continued to show modest momentum at year-end. Countries more reliant on domestic consumption, such as India and to a certain extent China, are showing relatively better growth. Meanwhile, counties dependent on commodity exports, such as Brazil and Russia, are struggling. The addition of the renminbi to the International Monetary Fund’s Strategic Drawing Rights allocation is further confirmation of China’s increasing role in global trade, but is unlikely to have a material impact on its financial markets or economy. Chinese authorities are likely to continue easing monetary policy to stabilize the economy, which could be a first step toward increasing investor interest. However, emerging-market equities may need both economic momentum and clarity on the scope of potential Fed rate hikes before regaining sustained momentum.

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<th>Mark Composite PMI (percent)</th>
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**Developed Markets**

**Emerging Markets**

Note: PMI - Purchasing Managers’ Index; data is seasonally adjusted

Sources: Northern Trust, Bloomberg
Rooting for a Hike?

*Stock markets have rallied alongside increased expectations for a rate hike.*

By observing the correlation of U.S. stocks to expectations regarding the first interest rate hike in nine years, it’s clear that the market is viewing the increase positively. Economic growth remains relatively sluggish, but the start of monetary policy normalization signals the Fed’s confidence that the economy is ready to begin standing on its own. With a little luck, that confidence will penetrate through to corporate America, potentially kick-starting sorely missed capital investment, providing the fuel for longer-term growth. With the market and the Fed seemingly on the same page with the timing and magnitude of rate increases, and U.S. corporate earnings due to inflect positively next year, we expect 2016 to be a better year for stocks.

Sharing the Benefits

*Oil prices have fallen precipitously, even in euro terms.*

European equity market bulls have much to point to in the current environment. Growth is beginning to gain momentum, with eurozone real gross domestic product (GDP) growth finding a steady base and purchasing managers’ indexes solidly in expansion mode. Additionally, the price of oil has supported the consumer — even when priced in the weakening euro, oil prices have fallen by nearly 50% since last summer. These fundamentals are underpinned by continued accommodative ECB policy. What’s not to like? A few things have kept us slightly underweight. Currency expectations make U.S. dollar-denominated assets still our preferred investments. Meanwhile, emerging-market growth (from which European companies derive a material portion of their revenues), and geopolitical and regulatory concerns all make the European equity outlook a bit less constructive at present.
What Recession?

Despite economic struggles, Japanese stocks have been strong in 2015.

Reading the headlines, one could be forgiven for believing that Japanese equities were a bad place to be in 2015. Despite several government stimulus programs and large amounts of monetary accommodation, Japanese growth has stalled and inflation remains stubbornly subdued. However, it’s been a different experience for Japanese corporations, where corporate reforms — including more outsider presence on executive boards — have helped improve profitability and push share prices higher. Even in U.S. dollar terms, Japanese stocks are up nearly 10% (vs. negative returns in U.S. and European equities). Corporate reforms are constructive, but will peter out unless supported by a better performing economy. The Japanese government remains committed to the cause through its Abenomics program, but major demographic headwinds and entrenched inflation expectations will make this a long battle.
Looking for a Foundation

Real assets are having difficulty finding a base.

Those looking for an eventual supply response to deteriorating commodity prices may need to wait a little longer. Despite broad agreement that current oil prices aren’t economically supported longer term, production continues. Most recently, the Organization of Petroleum Exporting Countries (OPEC) maintained production levels at its annual meeting, continuing the market share battle against non-OPEC producers. It now looks as though the supply-demand balance will take at least into the second half of 2016 to normalize. We remain overweight. Global real estate and global listed infrastructure also faced headwinds in 2015 in the form of lower equity prices, volatile interest rates and widening credit spreads. We continue to recommend strategic weightings in these cash flow asset classes, attracted to the superior dividend yield but aware of the continued interest rate volatility to which these asset classes are exposed.

Diminishing Bonds

Falling U.S. Treasury issuance should provide some support to bond prices in 2016.

According to estimates by primary dealers who are required to bid at Treasury auctions, net issuance of Treasury notes and bonds is projected to fall to its lowest levels since 2008. As the United States continues to reduce its budget deficit amid higher tax revenue, the need for long-term funding has slowly diminished. Additionally, the Treasury has shifted its focus to issuing shorter-dated T-bills as regulatory changes have caused investors to seek high-quality short-term debt. The decrease in net issuance of Treasury notes and bonds could cause long-term yields to remain in check when the Fed begins to raise rates and may contribute to a flatter yield curve going forward. We expect the Fed to hike rates more slowly in 2016 than the market does, which also should support bond prices.
Quite a Spread!

Spread differentials have reached new cycle highs.

High yield credit spreads have widened 19 basis points since October 2. However, the range of spreads by rating category has widened significantly. This has been particularly true for CCC-rated bonds. Since October 2, the spread differential between B- and CCC-rated securities has widened 200 basis points to 654 basis points. Since January 2010, this differential has been 297 basis points. The 220 basis point differential between BB- and B-rated securities is wider than the average of 132 basis points since January 2010. However, this has widened only 32 basis points since October 2. Demand for high yield market exposure remains, but risk tolerance within the market is low. The CCC segment of the market holds a large portion of distressed energy, commodity and retail issuers. We expect opportunities to develop in the CCC category in 2016, but capitalizing on this will require careful credit selection.

Note: CCC-B spread represents OAS difference between CCC-rated and B-rated High Yield securities. B-BB spread represents OAS difference between B-rated and BB-rated High Yield securities.

Sources: Northern Trust, Bloomberg
Conclusion

Growth in the United States, while not spectacular, is supported by solid labor markets and good credit growth. The European economy continues to expand, despite slowing emerging markets, as domestic demand has helped offset some weakness in export markets. Japanese growth continues to vacillate between moderate contraction and expansion, while emerging-market growth has suffered this year from a sharp slowdown in global trade. The economic impact of the drop in commodity prices has so far been mostly negative, as energy and mining capital expenditures have been slashed. Changes in energy prices have historically had a lagged effect on overall economic growth, so 2016 could see some benefit from improved consumption.

We don’t expect much movement in the interest rate markets during the next year, as central bank policy expectations are well entrenched. U.S. futures markets are pricing in roughly three rate hikes during the next year, while German futures markets still expect negative rates out to three-year bunds in one year’s time. We expect the Fed to hike rates more reluctantly than this, while the ECB has already announced an extension of its bond buying program into 2017. As important as changes in the policy rates will be the accompanying language. Recent communications from the Fed and ECB have been confusing to the markets, increasing volatility in both bonds and stocks.

Our positioning remains overweight U.S. dollar-oriented assets (such as U.S. equities and high yield) and underweight those hurt by dollar strength (such as emerging-market equity and natural resources). We view the recent sell-off in the high yield market as more of a microeconomic signal (distress in energy, materials and certain retailers) than a sign of a macroeconomic problem. Our primary risk case has been the outlook for Chinese growth, and recent data on growth starts to support the case for stabilization. It’s now up to the Fed to clearly communicate its monetary policy plans, giving the financial markets a chance to discount the likely path of short-term interest rates during the next year, and rebuild confidence that the Fed has a clear vision and isn’t hostage to the financial markets.
From the Managing Director

Dear Clients,

It is no secret that 2015 was a volatile year for the markets, and it looks like we’ll be in for another interesting ride in 2016. While our global neighbors are experiencing great fluctuations and uncertainty in their economies, the fundamentals of the U.S. economy remain strong. This is not always evident in the behavior of the stock market and investor sentiment, as seen in the first weeks of trading this year. In spite of this turmoil, our philosophy towards our investment approach remains the same. We are long term investors with a long term view of the markets. As we structure your portfolio, our priority is to keep your goals in mind so that we can help protect your financial health. We are committed to you and never take for granted the trust you’ve placed in us. Our staff is composed of very qualified financial professionals with a long track record of success and relationship management. As always, we encourage you to call us if you are feeling uncertain about the markets and need reassurance on current economic events.

As we usher in the New Year, we’re excited about a number of positive changes that are on the horizon at Enterprise Investment Advisors. We’ll be sharing some announcements in the coming months via this newsletter, your monthly statement and other communications. Stay tuned!

On behalf of everyone at Enterprise Investment Advisors, I would like to thank you for your business and wish you success in 2016.

My best,

Rosalin Acosta,
Managing Director

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