The Longer View
COMMENTS AND OUTLOOKS FROM LONGER INVESTMENTS INCORPORATED

January 4, 2016

Market Update

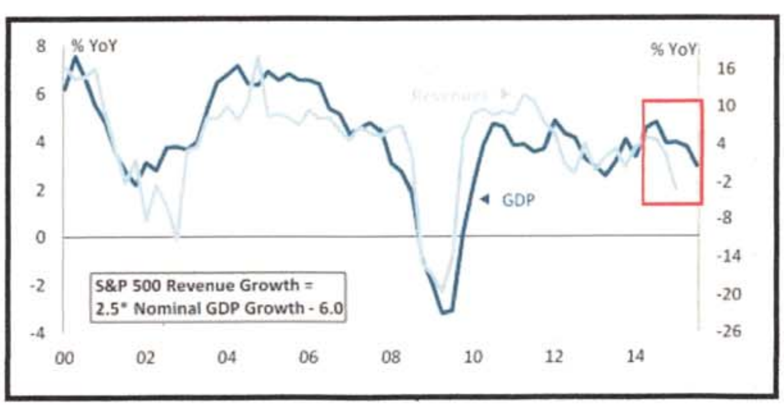
We saw significant volatility in the markets in the first week of 2016. The concerns we expressed in our September 18 newsletter (enclosed) are still valid, so in the interest of timely reporting, we will briefly update that information here.

The market traded in a "violently flat" pattern all of 2015, within a range of 15,370 and 18,350. It ended the year down 2.23% on the Dow Jones Industrial Average (DJIA) and down 0.73% on the S&P 500. Other indices fared worse. The Dow Jones Transportation Index was down 17.85%, and the Russell 2000 small-cap stock index was down 5.71%.

Please refer to the enclosed September 18 newsletter for a wider discussion of the bullet points that we update below:

- **The Dow Theory nonconfirmation:** The Dow Theory nonconfirmation has continued since the Transportation Index violated the August lows in 2015. An equivalent move by the DJIA would mean a violation of 15,350. (The DJIA currently stands at 17,150.)
- **The unusually high valuation, or P/E multiple:** Valuation did not improve in 2015. Earnings will be flat to slightly lower for the year, and the market closed slightly lower. Earnings are projected to be flat to +3% in 2016. Without either greater earnings growth or lower stock prices, the valuation applied to earnings (P/E multiple) will not improve.
- **Pressure on operating margins:** The pressure on operating margins continues. Rising labor costs and a rising dollar both have negative effects on the margins of multinational corporations.
- **Sluggish revenue growth:** The sluggish revenue growth we discussed in July and September has persisted. The year-over-year revenue trend for the third quarter yielded a -3% result. With revenue growth sluggish and operating margins contracting, earnings cannot grow. Revenue growth depends upon improved domestic and international economic growth. As this is written, domestic growth remains sluggish (the preliminary 2015 figure is 2% real GDP growth; 2016 GDP growth is expected to be 1.5% to 2%). International growth is stagnant. China's growth is slowing, Japan returned to recession in the fourth quarter, and Europe continues to struggle. (See Chart A.)

Chart A **S&P 500 Revenues vs. U.S. Nominal GDP**



Source: S&P, BEA, Haver, and RBC Capital Markets

- **The end of easing:** In December, the Federal Reserve increased the Fed funds rate by 0.25%. Although this increase sounds trivial, it has already had an impact on the currency markets. Because most of the world (for example, the European Central Bank, the Bank of Japan, the People's Bank of China) is moving toward greater easing, the U.S. action sets us apart. The interest rate increase strengthens the dollar relative to the euro, the yen, and the yuan. This puts pressure on commodities, on emerging economies, and on the growth outlook — and therefore on revenue and the earnings outlook.

As this update is written, we remain defensively postured. We will enter the equity markets only at strategically important levels of support, using close stop-loss disciplines to protect portfolio value and flexibility in volatile markets with potential for lower prices. This is how we protected portfolio value and accumulated purchasing power for opportunities during previous disruptive markets in 2000-2002 and in 2008-2009. Many variables are in play today — Fed policy, China policy, foreign growth outlooks, geopolitical risks, and presidential politics. What all of this means to earnings and to the valuation applied to those earnings is yet to be determined.

We purchased a position in the Dow Jones Industrial Average ETF as the market approached support at 17,000 on the DJIA. When that level was violated on the new year's first day of trading, we left that position, taking a slight loss to return to cash. Cognizant of the risks and uncertainties we face, we will continue to tactically watch for opportunities to reestablish positions in companies that we left at higher levels.

In short: We fully expect that with recent violations of 17,000 on the DJIA, and with weakness in commodities, the transportation index, and foreign currencies, we will see a retest of the August low (15,350). After 2015 fourth-quarter earnings are reported in January, we will have a better understanding of how corporate America closed the year and how corporate management views 2016. Until the outlook for revenue growth (economic growth) and earnings growth improves, the markets will struggle. As the markets adjust to a muted outlook for 2016, with its rising political and geopolitical risks, we believe we will be able to buy stocks at better valuations. In the meantime, we will protect portfolio value and flexibility, and we'll capitalize on opportunities as they arise.

We wish all of you and your families a happy, healthy, and prosperous new year. We appreciate the trust you have placed in us. We seek to honor that trust in the work we perform daily to manage your financial assets. Please feel free to send us your questions or comments. Your views are always welcome.

Elaine Longer

The information provided herein is illustrative only. It should not be construed as a formal recommendation by Longer Investments Inc.

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