

January, 2016

2015 Fourth Quarter Update and 2016 Outlook

Review: Domestic large cap equities rallied 7.0% in the fourth quarter, reversing the negative returns of the third quarter. This enabled the S&P 500 to post a positive yearly return of 1.4% including dividends. International equity markets once again lagged behind the U.S. as economic growth remained flat to negative. Domestic bonds fell 0.6% for the quarter as interest rates rose ahead of the Federal Reserve's first rate hike in nine years. They did, however, manage to post a slightly positive return for the year of 0.6% as rates stayed low for most of the year and income offset principal loss.

Period	4Q15	3Q15	2015	2014
S&P 500	7.0%	-6.4%	1.4%	13.7%
EAFE*	4.7%	-10.2%	-0.8%	-3.6%
Emerging Markets	0.7%	-17.9%	-14.9%	-4.5%
Barclays U.S. Aggregate Bond	-0.6%	1.2%	0.6%	6.0%

*Europe, Australia, Far East

Domestic Economy: U.S. economic growth slowed to 2.0% in the third quarter (the most recent data available) after accelerating to 3.9% in the second quarter. Strength in consumer spending was unable to completely offset a drop in business investment in general and the energy sector in particular. Business hiring remained healthy with almost 300,000 jobs added in the month of December and a fourth quarter average monthly rate of 284,000. Wage growth, however, remained relatively muted at approximately 2.0% as businesses were able to contain labor costs even as hiring strengthens. Growing new household formation was instrumental in new housing starts rising 11% for 2015. Vehicle sales reached a new yearly high of 17.5 million.

Looking ahead, the U.S. economy should continue to grow modestly at 2.0- 2.5% for the year, boosted by rising employment, especially in the Services sector, which now comprises 70% of all U.S. economic activity. Cautious business capital expenditures will remain a headwind in general and for energy companies in particular as further investment cutbacks appear inevitable in the face of still weakening oil and gas prices. Wage growth should remain moderate and in line with GDP growth.

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International Economies: We remain concerned about the economic trends in both developed and developing economies. In Europe, the ECB has embarked on another round of stimulation to boost stubbornly anemic growth in its member countries. Emerging economies, still burdened in general by the excesses of the boom years, continue to face dual headwinds of weak commodity prices and a strong U.S. dollar with little relief in sight. China's economic growth and currency management in particular will be important.

Strategy: Equities remain more attractive than fixed income. Global interest rates remain at multi-decade lows and the Federal Reserve has initiated rate normalization. We continue to favor domestic over international equities with U.S. economic growth on the best relative footing. Returns may not match recent years because valuations have risen and are no longer at depressed level. Earnings gains may also moderate; however, dividend growth and stock buybacks will augment returns. Because growth will be relatively scarce, investors will be willing to pay a premium to get it, leaving some company stock multiples at lofty levels for those that can justify it, but punishing those that fall short. As such, volatility will remain elevated and stock selection will continue to be critical.

Rising interest rates in the U.S. will be a headwind not only for domestic bonds but also dollar-based international bonds. Lower quality issue spreads will remain under pressure, especially in the below investment grade sector, for both the taxable and tax-exempt markets.

Certain investment themes will continue to influence sector attractiveness. Ongoing rapid technology innovation, especially internet-based, will favor the Information Technology sector. Growing demand from aging demographics, plus still rapidly rising investment in healthcare research and development, will make the Healthcare sector attractive.