News from China — its stock market’s wild ride, economic slowdown, and slow transformation — dominated financial markets in 2015. In the early part of the year, Chinese stocks rose in spectacular fashion only to see the bottom fall out over the summer. From June 12 to August 26 the Chinese stock market dropped 43 percent and took stock markets around the world with it. As panic spread among retail investors, unsuccessful attempts by Chinese authorities to prop up the market and the devaluation of the Chinese currency further dented investor confidence. The Chinese economy has been slowing down for some time and is transforming from investment spending to consumer spending. China is the largest importer of commodities and this transformation hit commodity demand hard and caused prices to collapse.

In 2015, oil prices fell 30.5 percent ending the year at $37/barrel. That is more than 62 percent below its peak price in 2014. Despite a slight decline in U.S. oil production, global production rose as OPEC and other countries around the world chose to defend market share and hoped that low prices would eventually cause many smaller and weaker shale oil producers in the U.S. to go bankrupt. This did not happen in 2015, but even lower prices in 2016 may indeed lead to that result.

Lower oil and commodity prices along with a slowdown in China hurt stocks of global energy, commodity, and industrial companies and commodity exporting countries such as Brazil, Canada, and Australia, leading to a negative year for the MSCI World Stock Index.

STOCKS: DIFFICULT YEAR FOR U.S. INVESTORS
Following strong gains since the recession of 2008, the Standard & Poor’s 500-stock index, including dividends, delivered a meager total return of 1.4 percent. Slumps in oil and commodity prices were major drags on the stock market. Energy stocks were down 21.1 percent for the year while the Basic Materials sector fell 8.4 percent. Consumer, health care, and technology companies delivered solid earnings growth and those sectors were largely responsible for a mildly positive year for stocks. Outside of energy, Freeport-McMoRan, the world’s largest copper and gold miner, fell 71 percent due to slumping commodity prices. China’s crackdown on corruption hit Macau, a major gambling hub. Wynn Resorts, which has casinos in Macau, was down 53 percent for the year. Meanwhile, technology companies like Netflix, Amazon, and Activision were some of last year’s best performers — up 134 percent, 118 percent and 92 percent respectively.

Large company stocks continued to outperform stocks of smaller companies, suggesting that the bull market is maturing. In 2015, the Russell 2000-stock index of small companies fell 4.4 percent. Many international markets fared well in 2015 in terms of local currencies but not in dollar terms because of the rally in the U.S. dollar. The MSCI All-Country World Index ex-U.S. fell 14.9 percent for the year. In local currencies, Eurozone stocks rose 8.0 percent with Italy leading at 12.7 percent and Japan gaining 9.6 percent.
**BONDS: FALLING OIL PRICES HIT HIGH-YIELD SECTOR**

U.S. shale oil production growth has been driven by many small companies financed by bank loans and high-yield securities, also known as “junk bonds.” The low interest rate environment and high oil prices over the last several years were supportive of this growth. However, as oil prices fell below $40/barrel in 2015, it became likely that many of the weaker companies would default on their debt. This prompted investors to sell bonds of energy and commodity companies. High-yield bonds were down 4.4 percent for the year while those in the energy sector fell 24 percent.

The Barclays U.S. Aggregate bond index was relatively flat and returned 0.6 percent in 2015. Within the broader market, mortgages did the best — up 1.5 percent for the year. Strong demand from domestic and overseas institutional investors helped support Agency Mortgage Backed Securities. Banks have added over $120 billion of these securities this year after being net sellers in 2014. Bonds of investment grade corporates felt the negative effects of the high-yield energy sector and were down 0.8 percent in 2015. On the other hand, investment grade municipal bonds outperformed all sectors of the bond market, as investors took advantage of their premium yields relative to U.S. Treasurys. Municipal bonds also benefited from moderation in new supply as the majority of issuance in 2015 was to refinance existing debt, rather than issuance of new debt.

**CURRENCIES: DOLLAR CONTINUED ITS RALLY**

The dollar continued its rally in 2015 as the Federal Reserve, which ended its quantitative easing program in October of 2014, raised rates for the first time in a decade. On the other hand, the central banks of other developed countries introduced additional easing or continued to hold rates at historically low levels. The Dollar Index rose 9.3 percent against a basket of major currencies. The euro fell 11.4 percent against the dollar while the yen was flat for the year. Emerging market currencies fell hard relative to the dollar. The Brazilian Real was down 49 percent and the Argentinian Peso fell an astonishing 52.9 percent.

**COMMODITIES: OIL PRICES CONTINUED TO TUMBLE**

WTI crude oil prices fell 30.5 percent in 2015, ending the year at $37.04 a barrel. U.S. benchmark crude has lost 62.4 percent over the last two years. This is because of the rapid growth in U.S. oil production over the past four years. In 2015, U.S. oil production slowed somewhat from 9.6 million barrels a day to 9.2 million barrels a day. However, global oil production grew 2.28 million barrels a day, or 2.4 percent, because countries whose economies depend on oil revenues produced more to make up for lost revenue and as a strategy to maintain market share and shake out the weaker U.S. shale oil producers.

Natural gas prices fell 19.1 percent along with crude oil, and gold was down 10.4 percent. The Bloomberg UBS commodity index, which tracks 22 commodities, fell 19 percent in 2015. This was the fifth straight year of declines for commodity prices.
OUTLOOK 2016
We expect U.S. economic growth in 2016 to accelerate from 2015 levels, boosted by low oil prices and an improving jobs market which should boost consumer spending. We also expect the Federal Reserve to gradually raise interest rates this year. On the other hand, the European Central Bank and the Bank of Japan are expected to continue on their paths of easing monetary policy. The dollar, which has strengthened significantly since 2014, should continue to rally modestly relative to other currencies.

We expect short-term rates to drift higher as the Fed raises rates. Muted inflation and low rates overseas should prevent long-term rates from rising as much. Fixed income portfolios whose durations are neutral relative to an investor’s benchmark should benefit. Corporate bonds, both investment grade and high-yield, are attractively valued. Since our best case scenario is that the U.S. will not enter a recession in 2016, these bonds should outperform government securities.

The equity bull market is entering its seventh year and we expect muted results for U.S. stocks. The Fed raising rates, a strengthening dollar, high valuations, and peak margins all pose challenges. We believe international equities, particularly Europe, should do better in their local currencies. Valuations are cheaper than the U.S., and the European Central Bank remains accommodative. Within the U.S., since the Fed is raising rates, stocks of large companies should do better than small companies. Technology, healthcare, and consumer sectors should benefit from stronger growth in jobs and wages, lower oil prices, and secular trends from the Affordable Care Act. Emerging market stocks, currencies, and local bonds have been hurt by a stronger dollar, weak commodity markets, and slowing growth and we are not expecting a turnaround except in select countries. Over the long-term, emerging market stocks offer some of the best risk-adjusted returns.

A stronger dollar, slowdown in China’s economy, and excess supply are not great for commodities. China’s economy is slowly transforming from investment spending to consumer spending, which will continue to be a headwind for commodity prices. Low oil prices may be with us for a while. While U.S. output is down a little, it has been more than replaced by increased pumping from OPEC and other oil producing countries. Oil inventories remain high and prices should remain contained until capacity is removed.

KEY RISKS

**China** — a hard landing in China poses one of the biggest risks to stocks and other risk assets.

**Federal Reserve** — if forced to tighten at a rate that is faster than what the market expects.

**U.S. Presidential Elections** – the uncertainty of the outcome is often a cause of volatility and puts a lid on market gains.

**Geopolitical Risk** - emanating primarily from the Middle East, but also Russia and North Korea.

Sources: Wall Street Journal, Bank of America Merrill Lynch, Goldman Sachs, Northern Trust, Bloomberg, Factset, Morningstar