The Longer View

COMMENTS AND OUTLOOKS FROM LONGER INVESTMENTS INCORPORATED

April 7, 2016

Market Update

The stock market volatility we've been writing about since the summer of 2015 continued into the first quarter of 2016. By early February, we saw a decline of about 9% in the S&P 500 and in the Dow Jones Industrial Average (DJIA). The decline from mid-2015 highs was about 15.5% in the blue chip indices (S&P 500 and DJIA). The small-cap indices fared worse, with the Russell 2000 small-cap index hitting a February low 14.4% below its closing value at year-end 2015, and 27% below its mid-2015 high. The markets rallied at the close of the quarter, ending flat to slightly positive.

As dramatic as this U.S. volatility seems, it pales in comparison to the volatility of the international markets:

International Markets:

2016 Through the February 2016 Low	
EAFE index (MSCI Europe Australasia Far East Index)	-13%
India	-14%
China	-20%
Emerging	-15%

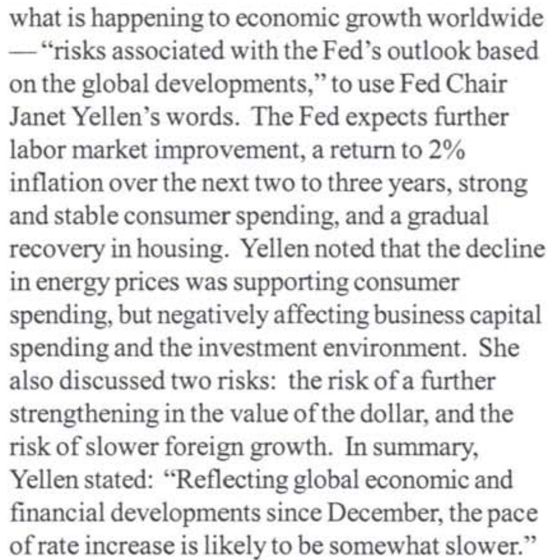
Mid-2015 High Through the February 2016 Low	
EAFE index (MSCI Europe Australasia Far East Index)	-23%
India	-30%
China	-46%
Emerging	-37%

The Stock Market

We have been cautiously postured since mid-2015, when we wrote the June newsletter. We reinforced our defensive posture in September and again at year's end. We discussed our being at the low end of asset allocation to equities allowed in investment policies and our holding of large cash balances. As the equity market declined in January and February, we increased exposure to domestic and international equities. We used our cash reserves to buy stocks that meet our valuation standards, show strong balance sheets, and offer a good dividend yield. We also deployed equity capital into the beaten-down foreign markets by selectively purchasing foreign market exchange-traded funds (ETFs). Years ago, we held a consistent 15% to 20% equity exposure in international stocks. We left international stocks in the fourth quarter of 2011, believing that U.S. markets presented greater values at that time. Since then, the S&P 500 has dramatically outperformed the EAFE international market index: 88% to 22%. This was our first move back into international stocks for our general equity client base since the fourth quarter of 2011. We have now allotted about 20% of equity exposure to international investments. This has proved to be an attractive asset class so far this year, as we caught a good bounce off the lows in the first quarter. Having deployed cash into domestic and foreign equity assets during the early-year dips, we ended the quarter with a larger overall equity allocation than we had at year-end.

The Bond Market

For the first time in 10 years, the U.S. Federal Reserve raised Treasury bond rates at its December meeting. The Fed declined to raise rates further in March. I can sum up this section of the newsletter in three words: "The Fed blinked." It may seem inconsequential that the Fed opted not to raise interest rates another 25 basis points (or 0.25%). But that decision spoke volumes about the Fed's sensitivity to



what is happening to economic growth worldwide — "risks associated with the Fed's outlook based on the global developments," to use Fed Chair Janet Yellen's words. The Fed expects further labor market improvement, a return to 2% inflation over the next two to three years, strong and stable consumer spending, and a gradual recovery in housing. Yellen noted that the decline in energy prices was supporting consumer spending, but negatively affecting business capital spending and the investment environment. She also discussed two risks: the risk of a further strengthening in the value of the dollar, and the risk of slower foreign growth. In summary, Yellen stated: "Reflecting global economic and financial developments since December, the pace of rate increase is likely to be somewhat slower."

This helped to move the dollar lower relative to the yen and the euro, which created a floor under commodity prices and foreign currencies and supported dollar-sensitive emerging markets. Market expectations have moved from two to three Fed rate increases in 2016 to an expectation of one or two increases.

As we discussed in our third-quarter and fourth-quarter newsletters, a stronger dollar could threaten the revenue growth and profit margins of larger U.S. multinational companies selling goods abroad. The lower dollar unleashed a stock market rally post-Fed meeting that approached last year's high. The S&P 500 and DJIA are about 3% short of reaching new highs. We will be unwrapping first-quarter earnings in April. The market participants will be looking at the quality of earnings. Did the earnings result from revenue growth, and/or improving margins? Or were they a function of reduced shares outstanding and accounting department tricks to reduce tax rates? A confident outlook by management during future quarterly earnings conference calls will be critical to help the rally maintain its momentum and to instill confidence in investors.

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

Summary

In summary, we are well positioned in domestic and international equities to participate in any further rally in stocks. Although we are not willing to say that the market is totally out of the woods, it was oversold in February to a degree not seen since 2009, as measured by several technical indicators we follow. We have realized the gains on long-maturity bonds we owned in February. We have booked the gains we achieved in gold this quarter. We anticipate that the stock market rally may fade or back and fill as we enter the May/June period; we'll therefore continue our policy of downside protection for new purchases. We had a fast rally off the February lows, and we face what looks like a tumultuous election season. If recent levels of support do not hold, we may return to a more defensive position. We will write more about that in our mid-summer newsletter.

We wish all of you a joyful entry into spring. We appreciate your trust and thank you for the special role you allow us to occupy in your lives, your families, and your business. Please feel free to call anytime you have questions or would like to schedule a meeting.

LONGER INVESTMENTS INCORPORATED

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