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**FIRST QUARTER 2016 REPORT**
**FOR BROKERAGE ACCOUNTS**

Stocks took investors on a rollercoaster ride during the first quarter of 2016, with the S&P 500 reaching a low of 1,829 of February 11th, a decline of 10.5% from the beginning of the year as stocks moved in lockstep with oil prices. On the same day as stocks bottomed, West Texas Intermediate crude hit its bottom at $26 per barrel, its lowest point in nearly 13 years. Prices bounced off their lows and a series of improving economic data helped sustain a rally that brought most indexes into positive territory by quarter's end. Much of the recovery in stocks was driven by the highest dividend paying sectors, including utilities and telecommunications, as the Federal Reserve appeared increasingly reluctant to raise interest rates and investors sought out yield. Oil prices also rallied through the end of the quarter, reaching the mid $30 level per barrel.

Increased appetite for risk on better economic data also drove money into what are generally considered higher risk asset classes. Emerging market stocks were the best performing asset class, returning 5.7% for the quarter, followed by high yield bonds, which were up 4.1%. Reduced expectations for Fed interest rate hikes helped drive interest rates lower, spurring investment grade bonds to a 2.2% return on the quarter. Strength in energy prices and the rally in gold helped the Bloomberg commodity index finish the quarter in positive territory after a nearly 25% decline during 2015. Small capitalization stocks were the only U.S. index down for the period due to heavy exposures to financial services and health care, particularly biotech, the worst performing sectors over the past several months.

| *Major Stock & Bond Indexes (Total Return)* | | *Lipper Mutual Fund Indexes (Total Return)* | |
|---|---|---|---|
| | 1Q 2016 | | 1Q 2016 |
| S&P 500 Index | 1.4% | Large-Cap Core Funds | 0.3% |
| Dow Jones Industrial | 2.2% | Large-Cap Growth Funds | -2.8% |
| Russell Midcap Index | 2.2% | Large-Cap Value Funds | 0.3% |
| Russell 2000 | -1.5% | Mid-Cap Core Funds | 1.5% |
| MSCI EAFE (USD Gross) | -2.9% | Small-Cap Core Funds | 0.6% |
| MSCI EM (USD Gross) | 5.7% | International Large-Cap Core | -2.2% |
| NAREIT U.S. Real Estate Ind. | 5.8% | Emerging Markets | 4.0% |
| Barclays US Agg. Bond (3-5yr) | 2.2% | Core Bond | 2.7% |
| Bloomberg Commodity | 0.4% | High Yield | 2.3% |

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## Q1 ECONOMIC ACTIVITY:

Following several months of slowing economic activity and heightened concerns over a potential recession, the U.S. economy showed signs of acceleration through March. Manufacturing data indicated improvement as the Institute for Supply Management (ISM) Index posted its first expansionary reading since August 2015. Excess manufacturing and trade inventories that built through last year are starting to fall, meaning factories will need to start producing more goods. Although growth in the services sector have slowed a bit, data still shows positive growth.

Jobs continued to grow at a very healthy rate throughout the quarter. In March, the U.S. economy created 215,000 jobs, bringing the quarterly total to 608,000. In order for the unemployment rate to stay stable, it is estimated that the economy needs to create 85,000 jobs per month. Unemployment hit 5.0% in March; although a slight uptick from the 4.9% level in February, this was due to an increase in the labor participation rate. Goldman Sachs estimates that without the 0.6% gain in labor force participation over the past six months, unemployment would now be at 4.0%. There has been much discussion about "slack" in the labor force since 2009, referring to potential workers who were under-employed or not employed at all as they were discouraged from the job seeking process. Recent data indicates that this slack is being removed and the number of labor non-participants that say they are seeking employment has fallen to levels consistent with other cyclical lows. With strong employment, consumer spending should continue to drive economic growth. The consumer is roughly two-thirds of GDP and the reason for an upward revision to fourth quarter GDP growth.

## THE PRESIDENTIAL ELECTION:

Presidential elections do not typically have a significant impact on financial markets as change happens very slowly in Washington D.C. Stocks historically have rallied or sold off a little bit depending on whether the Republican or Democratic candidate is performing better in the polls, with the Republicans generally seen as more business friendly. Once the new president takes office, markets return to normal and focus on economic and company data with little concern for Washington.

This election cycle is shaping up to be one of the most unusual in a very long time and could have a bigger impact on markets than the typical election. Of the top four candidates, Hillary Clinton and Bernie Sanders on the Democrat side and Donald Trump and Ted Cruz on the Republican side, only Hillary Clinton is considered a mainstream candidate. The remaining three candidates have positions that could prove more disruptive to current policy.

Despite a late surge by Bernie Sanders, Hillary Clinton appears to have a commanding lead for the Democratic nomination, having secured 1,756 of the required 2,383 delegates for the nomination. Remaining delegates available are mostly in states with high non-white populations, moderate conservatives, and seniors, demographics where the former Secretary of State has been performing well. The Republican side is more interesting with Donald Trump leading the

delegate race at 743, although unlikely to reach the 1,237 delegates necessary to secure the nomination. This would lead to a "contested" convention that is not likely to go in Mr. Trump's favor. The rules are complex, but if a candidate does not win the nomination on the first vote, most delegates are free to vote for whoever they like. It is unlikely that delegates would voluntarily vote for Donald Trump which leaves Senator Cruz in a relatively good position headed into the convention. Even John Kasich is a still a possibility. While there has been discussion about an outside candidate getting the nomination, though possible under the nomination rules, this outcome would be much less likely.

As crazy as the election has been, it still appears there is a chance that the November presidential election will be decided between two mainstream candidates, with Hillary Clinton on the Democrat side and an unknown Republican. This would come as a relief to markets, and stocks would likely rally coming out of the Republican convention on July 21st. If the Republicans do nominate Donald Trump or Ted Cruz, neither would likely defeat Hillary Clinton in November according to current polls. Markets would likely take this in stride as long as Hillary Clinton maintains her lead in the polls. The biggest risk to stocks would be if two outside candidates were to win the nominations. Though it now appears unlikely, a general election contest between Bernie Sanders and Donald Trump would be viewed very negatively by investors and increase market volatility. There is speculation that Donald Trump could run for president as an independent candidate, however given the extremely long odds against an independent candidate winning a general election, this would likely have little impact on markets.

## GREAT BRITAIN AND THE EUROPEAN UNION:

On June 23rd, Great Britain will hold a referendum to decide whether Britain should remain in the European Union. Britain originally joined the EU in 1975 after a referendum vote to join, although it has maintained its own currency, the British Pound. In the last election, the UK Independence Party won a meaningful number of votes on the platform of leaving the EU. The main concern with those wanting to leave is the free movement principal making immigration easier. Prime Minister David Cameron was able to negotiate a number of changes to its membership, largely related to immigration, that should lessen some of these concerns. Recent polls show the country evenly split between staying or leaving.

The impact of Britain leaving the European Union, or "Brexit" as it has been called, is not completely understood. Because Britain never changed to the Euro currency, an exit would be much less disruptive than other countries leaving. The argument for leaving is that economic growth would accelerate and jobs would grow if the country were free of increased regulations by the Union. However, most businesses are in favor of staying as it makes trade and movement of workers much easier. There are also concerns that the European Union would collapse without Britain's membership as the remaining northern countries would not be able to support the debt of the south. It is also unclear what would happen to the value of the pound and London's place as a global and European financial center.

Certainly the best outcome for markets would be a vote to reject the referendum and stay in the Union. This would keep the status quo, and the future would be far more certain. If Britain votes to leave, the uncertainty would likely trigger a selloff in global stocks following the vote. As this is not a situation like Greece that would involve a currency change and debt defaults, any real impact on the global economy would likely take much longer to play out. If the referendum is approved, we don't see an immediate risk to the U.S. economy as we do not export much to Europe. However, volatility is likely to increase particularly if polls show support for the referendum over the next several weeks.

**OUTLOOK:**

The U.S. economy appears to be fully recovered from the growth scare experienced in late 2015 and early 2016, which should provide confidence for investors. Stock prices are down slightly over the prior year, however valuations on a price-to-earnings ratio look slightly richer, the result of falling corporate earnings. The two main culprits to lower earnings have been lower energy prices and a rising dollar. The energy sector reduced S&P 500 earnings by about 10% as profits at energy companies dropped with falling oil prices. Although volatility in energy prices may continue, there does appear to be some stabilization and prices are very unlikely to fall by the same magnitude in 2016 as they did in 2015. Also, dollar strength that has crimped corporate profits over the past several years appears to be abating, with the U.S. dollar losing ground to our largest trading partners over the past several months. The first quarter of 2016 could be another weak quarter for profits, although comparisons get easier and growth should start to reaccelerate in the second quarter. With a strong March, investors will be closely watching earnings guidance for the rest of 2016 to determine confidence in economic conditions through the remainder of the year. Stocks in the U.S. and abroad appear fundamentally setup for a good rest of the year, although political risks in Britain and the U.S. could provide some negative surprises.

**COMMUNICATIONS FROM HC FINANCIAL ADVISORS, INC.**

We want to meet with you at least once a year to review and update any changes in your goals and objectives, cash requirements or asset allocation targets. If we don't hear from you, we will be calling to schedule a meeting. We want you to understand the decisions we are making on your behalf and be comfortable with your asset allocation. Please call us with any questions or concerns.

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