PRAETORIAN GUARD℠

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TAX CHANGES FROM THE PATH ACT OF 2015

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2015 MARKET REVIEW AND DISCUSSION

2015 saw the first negative stock returns for most major indices since 2008 with the S&P 500 (Large Cap), 400 (Mid Cap) and 600 (Small Cap) all finishing the year with negative returns (excluding dividends) over the 12 month period. U.S. markets made a strong effort to recover from the August correction but ended the year a bit short. Internationally, both developed and emerging markets were also in the red as slow growth in Europe and the impact of a slowing economy in China weighed heavily in the latter half of the year.

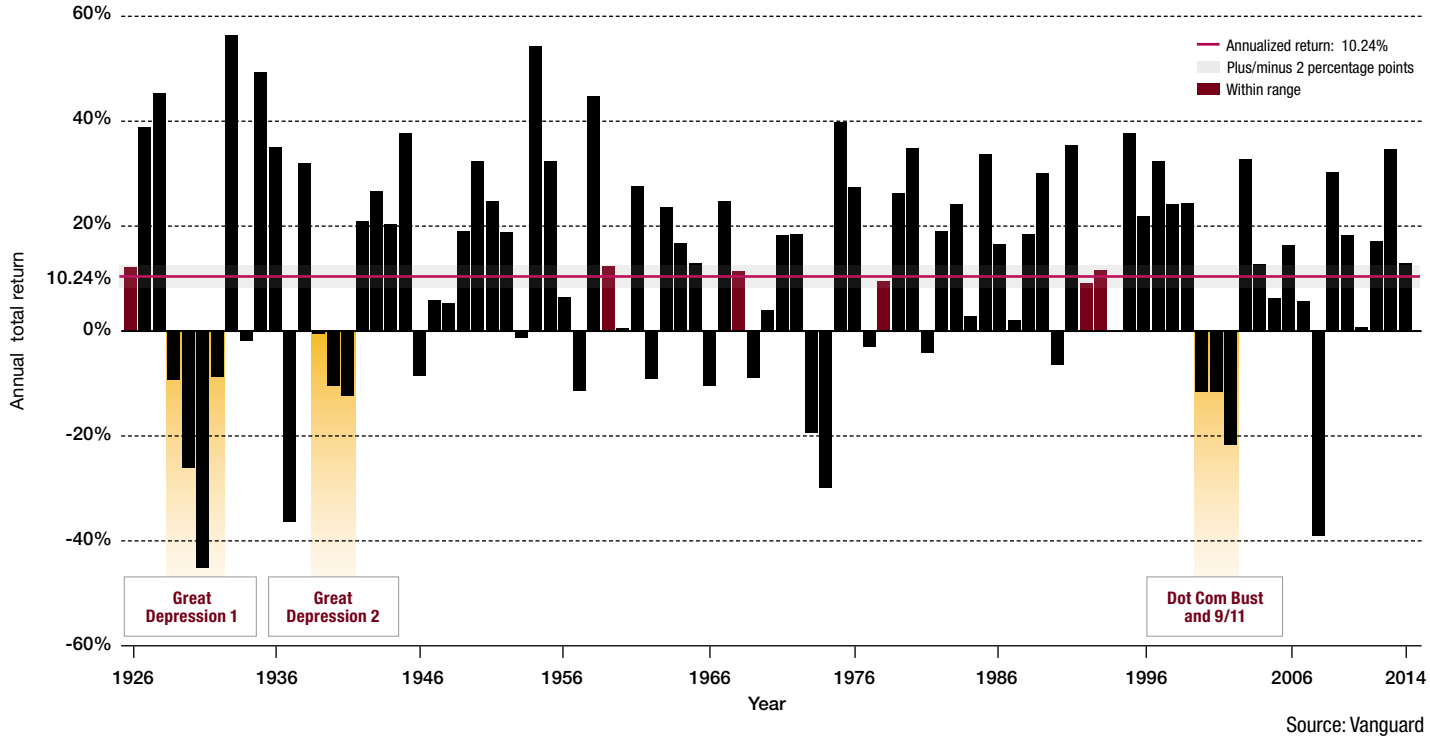
	S&P 500 Large Cap	S&P 400 Mid Cap	S&P 600 Small Cap	Developed International	Emerging Markets
2015	-0.73%	-3.71%	-3.36%	-3.30%	-16.96%

Source: MSCI & Yahoo Finance

What conclusions can we draw from this experience? First, after six consecutive years of positive returns, the "Law of Averages" was bound to reassert itself. Second, while investors who remain fully invested (in up and down market periods) earn the long-term "average" return, it is rarely the case they earn *that* return in any single year. The chart below shows the S&P 500 annual total return from 1926 to 2014 (including reinvested dividends). The annual average return was 10.24%. Yet in those 89 years, there were only six (the red bars) that were within +/- 2% of that EXACT return. Finally, there are few (which is not to say none) periods of consecutive, multi-year negative returns. Clearly noticeable on the graph is the only 4 year losing period (1929-1932) as well as the two 3-year losing periods (1939-1941 just prior to WWII and 2000-2002 with the Dot Com Bubble Burst/9-11 Terrorist Attacks). Markets are resilient as the S&P 500 reflects the state of the U.S. economy, which remains the largest and most adaptive wealth creation machine ever designed.

U.S. Stock Market, 1926–2014

Returns fell within 2 percentage points of the annualized return of 10.24% in only 6 out of 89 years.



Source: Vanguard

President's Commentary

Regardless of whether the glass is half full or half empty, I am reminded of the fact it is refillable. We are in a period of immense global turmoil and the need for U.S. leadership is obvious. At home, our economy continues to grow at an excruciatingly slow rate. China's economic turmoil has, and will continue to, cause increased volatility and concern. Our nation's political discourse will only get louder in the months ahead but unfortunately there is not much hope it will improve in clarity or insight.

That said, I remain optimistic for the following reasons: domestically, despite large headwinds, the U.S. economy IS expanding. It can (and ultimately will) accelerate as long as we trust that individuals and businesses can decide for themselves how best to employ their resources. Internationally, Winston Churchill's words ring true: "You can always count on Americans to do the right thing - after they've tried everything else."

PEERING INSIDE THE U.S. ECONOMY IN 2016

The following is our assessment of where the U.S. economy is headed in the year to come based upon several critical areas.

Overall, we continue to see the United States economy growing at a slow but steady rate averaging 1.5% to 2.25% per quarter annualized with the overall year over year growth at 2%. Job creation will continue its generally positive posture of adding 200,000 jobs per month but we do not foresee acceleration much above that number. Therefore, the unemployment rate will remain steady at 5% as jobs created (and subtracting persons leaving the labor force) will just about absorb new entrants to the workforce. The labor force participation rate is more important to signaling the health of the U.S. jobs machine than the U-3 unemployment rate (officially recognized rate of unemployment). The U-6 unemployment rate (currently at just under 10%) is the more telling statistic and the one to watch closely. The U-6 rate includes the total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons (as a percent of the civilian labor force plus all persons marginally attached to the labor force).

U.S. corporate profits will grow approximately 5% year over year. In 2015, energy companies' profits fell significantly and pulled the overall S&P 500 down by 1.5%. That drop in profits was comparing 2014 to 2015 and the worst of the energy/oil decline is now behind us. The strength of the U.S. dollar has hurt exporters, but exports comprise only 12% of U.S. GDP. Therefore the services sector, which is much less sensitive to the currency impact, is more important.

Energy and oil will struggle for the first half of the year. It is too soon to know when and how much Iranian oil will return to the world market and how long the Saudis are willing to pump oil at full capacity. The impact of low oil prices were seen in the election results in Venezuela in December 2015 (not yet stolen back by Chavez' successor) and will continue to pressure those regimes needing the price per barrel at or over $100 to balance their domestic budgets.

The Federal Reserve has clearly signaled that the pace of rate hikes in the year ahead will be "slower for longer." We see, at most, four rate hikes in the course of the year and the Federal Funds Target rate ending up at 1.25%-1.50% at this time next year. That remains very accommodative monetary policy historically, thus the Fed's actions will not have a major negative impact on the economy. However, it will fill air time so you can expect to hear a lot about the smoke… but there will be no fire.

Globally, the big question will be China's economic health and growth rate. We believe 7% economic growth is the inflection point—much less than that number in the first six months will make the year very volatile. The China stock exchanges already have experienced halts, large declines and caused worldwide tremors. China will stabilize its economy and there will likely be two mid to long-term benefits for us: pressure for greater internal economic reforms and less willingness to support its client state of North Korea (the DPRK).

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TAX CHANGES FROM THE PROTECTING AMERICANS FROM TAX HIKES (PATH) ACT OF 2015

The closing days of December saw the most significant tax legislation since 2012. The good news is that many (not all) of the yearly tax extenders for businesses and individuals were made permanent, adding some certainty to tax planning going forward.

For individuals, these include state and local sales tax deductions—beneficial to those who live in no income tax states such as Texas or Florida. Charitable deductions up to $100,000 from IRAs for owners age 70 ½ or older. Computer and related technology equipment is now a qualified expense that can be paid for out of a 529 account for college students. The excise tax on high dollar health care plans (nicknamed the "Cadillac Tax") has been delayed for 2 years and we'd be surprised if it ever comes to fruition. Finally, ABLE Accounts (Achieving a Better Life Experience) are now eligible for rollovers from 529 plans (with some restrictions) so that assets for individuals with disabilities can be consolidated and used for their benefit in a more streamlined manner.

Businesses also benefited: Section 179 expensing of investments were permanently set at $500,000 with a $2 million cap, up from the levels of $25,000 and $200,000. This was one of the habitually passed extensions and its permanent status adds assurance that annual capital planning for businesses will be under a known and stable set of rules. In addition, there were multiple changes to depreciation schedules.

All of this "horse trading" comes at a cost—subsidies and incentives for wind and solar were kept alive again (Ronald Reagan's observation that "a government bureau is the nearest thing to eternal life we'll see on this earth" applies).

THE ONLY GOAL THAT MATTERS

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Closing Thought

In times like these, it helps to recall that there have always been times like these.

— Paul Harvey