Investment Tally & Perspective

Investment Overview

Running in Place, Running on Empty

A snapshot of where the financial markets stood at year-end 2015 compared to the end of the 2016 first quarter would suggest not much has changed, yet this would grossly underemphasize the degree of global market volatility in recent months. A brief summary of related points and our thoughts going forward follow.

Economic & Monetary Policy

From a basic economic standpoint, little has changed for major economies - the United States continues to show strength and resilience, while China and select emerging markets continue to show uneven economic results and prospects. U.S. job growth has maintained a methodical pace as the economy posted 1.4% growth in the fourth quarter of 2015. While low historically, it appears relatively strong compared to a 2016 first quarter growth estimate of 0.4% (Atlanta Fed).

One particular data point we are following closely is inflation, which is a strong factor in Fed decisions on interest rates and related monetary policies. The graph (page 3) displays the year on year change of the core Consumer Price Index (CPI) which is designed to track inflation or, more specifically, changes in the cost of living in the U.S. (less food and energy). As shown, inflation pressures are trending higher and, when coupled with a full labor market, our primary concern is that "wage" inflation pressures escalate and paint the Fed into a box that lacks a positive resolution. Recall that since the Fed began its ZIRP (zero interest rate policy) over seven years ago, past attempts to "normalize" interest rates have resulted in financial markets "rioting" (sharp selloffs) which generally caused the Fed to back off and change course once again. So while rising interest rates to more historically normal levels is desirable and, perhaps, inevitable, it will likely involve a re-pricing of assets that may catch many by surprise.

(Continued on Page 3)

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MAJOR INDUSTRIALIZED COUNTRIES

	2016 Est. GDP	Unemployment	Consumer Prices	Budget Balance (as % of GDP)	Int. Rate 10-Yr Gov't
Britain	2.0%	5.1%	0.7%	-3.6%	1.54%
Canada	1.6%	7.3%	1.6%	-1.4%	1.23%
France	1.3%	10.2%	0.4%	**-3.5%**	**0.48%**
Germany	1.5%	6.2%	0.6%	**0.4%**	**0.16%**
Italy	1.1%	11.5%	0.4%	**-2.5%**	**1.22%**
Japan	0.8%	3.3%	0.4%	-6.2%	-0.09%
Spain	2.7%	20.5%	-0.1%	**-3.4%**	**1.44%**
Switzerland	1.1%	3.4%	-0.6%	0.3%	-0.39%
United States	2.0%	4.9%	1.2%	-2.5%	1.85%

Note: Interest rates in bold are Euro currency rates.

Data from The Economist, April 2, 2016

MARKET INDEX RETURNS

Fixed Income	1st Qtr. 2016	1 Year	3 Year	5 Year
Citi Treasury Bill 3 Month	0.05%	0.08%	0.05%	0.06%
Barclays US Aggregate Bond Index	3.03%	1.96%	2.50%	3.78%
Barclays Global Aggregate Bond Ex US	8.26%	6.69%	-0.32%	0.39%
Stock Indices				
S&P 500	1.35%	1.78%	11.82%	11.58%
Dow Jones Industrial Average	2.20%	2.08%	9.29%	10.27%
NASDAQ Composite	-2.43%	0.55%	15.63%	13.22%
MSCI EAFE Index	-3.01%	-8.27%	2.23%	2.29%
MSCI Emerging Markets	5.71%	-12.03%	-4.50%	-4.13%
Russell 2000	-1.52%	-9.76%	6.84%	7.2%
Other				
Bloomberg Commodity Index	0.42%	-19.56%	-16.87%	-14.15%
S&P GSCI Precious Metal Index	16.00%	2.70%	-9.83%	-5.49%

*Data obtained from Morningstar; period ending 03/31/16

*All figures are stated as trailing total returns, and returns over 1 year are annualized

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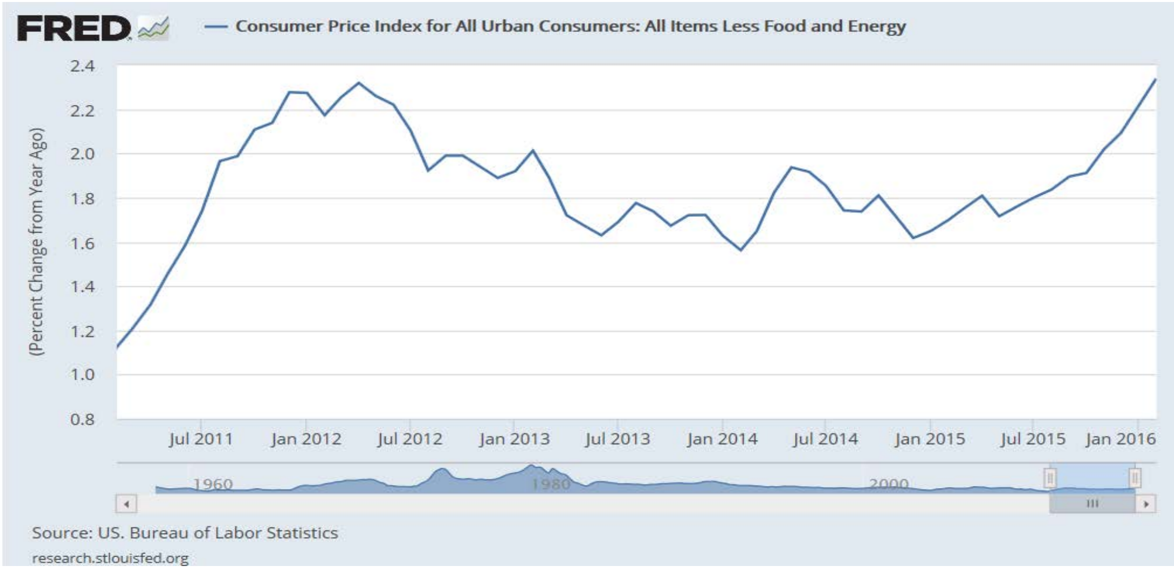

Financial Markets

U.S. stocks, as measured by the S&P 500 index, generated an average total return of +1.3% in the first quarter of 2016, while bonds (Barclays US Aggregate) posted a +3.0% total return. While these seem reasonable to a distant observer, markets were far from sanguine during the quarter, as the stock market began the year with a historic decline. As investors may painfully recall, the S&P 500 stock index declined over 10% in the first six weeks of 2016 with the average stock moving 20% or more below its highest price in the past year. What happened?

A combination of weak economic growth, a strong dollar and soft commodity prices led global financial markets to revolt until two major events caused markets to reverse direction. First, the Fed talked back their rate hike cadence, and, second, major oil producers began discussing production discipline. Concerns about weak global economic growth and market volatility were cited in Fed meeting notes as reasons to slow the plan for raising interest rates. In turn, the weaker dollar helped commodity prices and emerging markets stabilize and move higher, and gave support to domestic (U.S. based) company profits and exports. Firmer commodity prices relieved some of the stress seen in the high yield bond market. Rumors of a production freeze for major oil producers further boosted energy prices, as any semblance of discipline in the market would be an improvement to the recently irrational marketplace.

Where are global economies headed and what key points require consideration? Responses to these questions were addressed in a recent report by BCA Research:

1. Economic Outlook – The fact that global deflationary pressures continue to persist in much of Europe and Japan, with their economies bordering on recession is a vivid illustration that the effectiveness of unorthodox central bank policies – negative interest rates, aggressive asset purchase programs, and credit subsidy strategies – is exhausted and the need for bolder fiscal policy stimulus is paramount.

2. Dollar strength is a byproduct of U.S. growth outperforming the rest of the world which will keep U.S. Treasury bonds well bid (our paltry yields of 1% to 3% are quite attractive compared to negative-yielding German bunds and Japanese government bonds).

3. Deteriorating corporate balance sheets argue for resisting the temptation to chase U.S. high yield spreads lower.

4. Political risk remains elevated globally. Rising inequality of income and opportunity in advanced economies has sown the seeds of protectionist, populist sentiment and given rise to 'Trumpism' and support for Brexit (the term du jour for the upcoming referendum on Britain leaving the European Union), neither of which is likely to triumph ultimately, but both of which are sources of uncertainty for markets in the coming months.

Investment Strategy

With a preface that no one truly knows what will happen and that equity markets always have the capacity to surprise even the most seasoned investors, we are keeping client accounts invested, yet cautiously positioned. A major driver of equity performance has been the weaker dollar and underlying fundamentals do not call for further dollar weakness. As previously stated, most troubling is that the Fed's ability to continue its dovish posture may be diminishing, as inflation pressures and continued employment gains could force the Fed to raise interest rates pushing the dollar higher and, as collateral damage, cause equity and bond prices to decline.

In sum, the U.S. remains the strongest horse in the economic race, yet it is clear that the recent stock market rally is being fueled by rising liquidity and not rising profits. Money creation by global central banks must find a home somewhere and this flood of liquidity may extend the stock market rally further with prices overshooting fair value. If the declining trend in profit margins continues at the same time that inflation pressures begin to build, then the Fed may be forced to raise rates more than expected and the re-pricing of assets (stocks, bonds, real estate, and commodities) will accelerate and broaden. From a portfolio perspective, we continue to manage accounts with a long term view (years) combined with periodic, tactical (nearer term) changes. Given the sum of all these considerations, it seems prudent to gradually reduce equity exposure during this rally and become more defensive in these uncertain times.
