Economic and Market Overview

Fourth Quarter 2015

IRONWOOD
Investment Counsel, LLC
A Registered Investment Advisor

Economic and Market Overview

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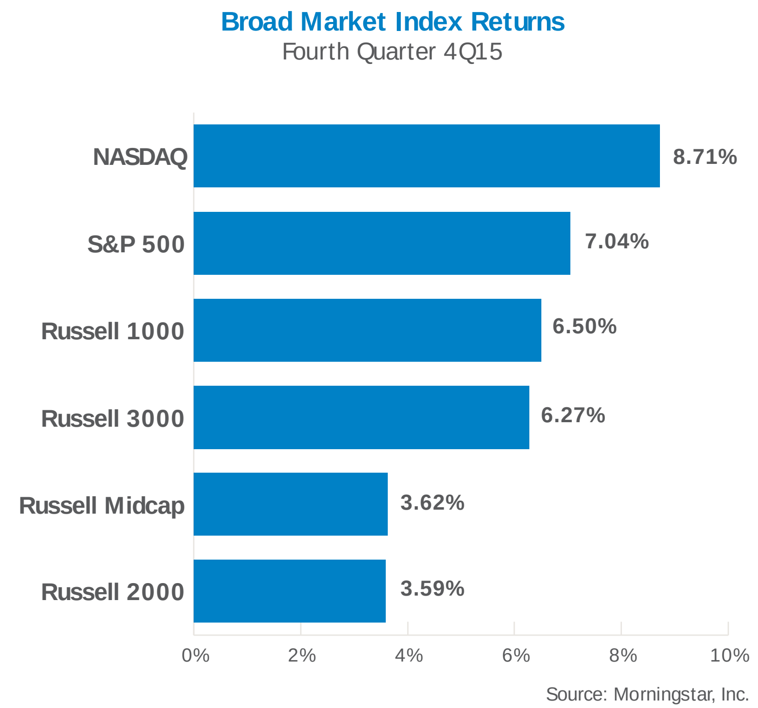
The Economy

The domestic economic landscape continued to be positive in the fourth quarter of 2015, highlighted by ongoing improvement in the labor market. The quarter was generally quiet, highlighted by the Federal Open Market Committee's (FOMC) decision to begin raising interest rates for the first time in nearly 10 years. The Bureau of Economic Analysis's third estimate of gross domestic product (GDP) for third quarter 2015 was +2.0%, in line with the prior estimate, but lower than the second quarter's +3.9% reading. The employment situation remained strong, with an average of about 218,000 jobs added each month. The unemployment rate declined to 5.0%.



Global economic growth remained tepid due to several factors, including the ongoing decline in commodity prices, below-trend growth in China and the flow of refugees from the Middle East and Africa. The European Central Bank (ECB) indicated it would maintain an aggressive monetary policy to provide adequate stimulus to promote accelerated growth. The Eurozone has overcome several impediments in recent quarters, including questions about its viability and tension pertaining to member countries' policies. With economic growth beginning to improve, analysts are encouraged by the region's outlook.

In China, growth was below historical averages, but remains robust relative to other emerging and developed economies. Policymakers maintained an accommodative monetary posture in an effort to meet the country's economic growth target of 7%.

At its most recent meeting in December, the Federal Open Market Committee (FOMC) initiated the long awaited "lift-off" of rates. The move increased the target fed funds rate by 25 basis points to a range of 0.25% to 0.50%. The FOMC indicated that additional rate increases will be gradual, with the committee focused on allowing economic data (and the impact rate increases have on financial markets) to drive the decision.

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Highlights and Perspectives

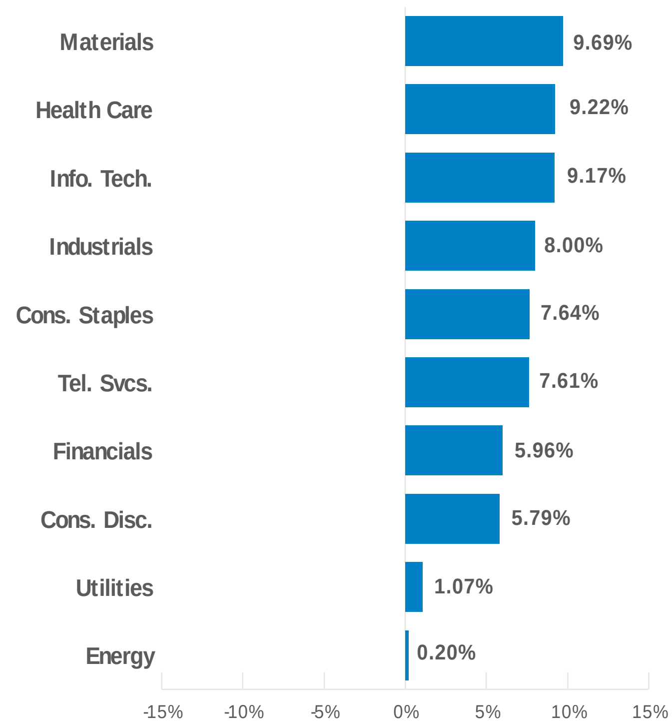
GROSS DOMESTIC PRODUCT (GDP)

The Bureau of Economic Analysis's third estimate of real GDP for third quarter 2015, reflected a seasonally adjusted annualized rate of +1.98%, down from the +3.9% annualized growth of the prior quarter, and in line with the previous estimate of +2.1% growth. The results demonstrated sluggish economic expansion, with inventory accumulation acting as a drag. Exports were also a detracting factor, as the strong dollar continued to hamper exports while encouraging imports. Analysts also cited the decline in oil process as another inhibiting component, but believe it should be short-lived. On the positive side of the ledger, consumer spending remains resilient, and efforts undertaken by Chinese authorities to stabilize their economy should bear fruit in 2016. In addition, the markets seem to have weathered the Fed's first rate increase in almost 10 years. Corporate profits dropped by -1.6% (not annualized) after a +3.5% advance in the prior quarter. As with the previous quarter, low energy prices kept inflation in check, with the personal consumption expenditures (PCE) index of prices rising +1.3%, following a +2.2% climb in the prior quarter.

HOUSING

The housing segment suffered somewhat of a setback. Existing home sales for November (the latest monthly data available) advanced at an annualized rate of 4.76 million units, down nearly -10.5% from the 5.32 million unit rate reached in October, and down almost -4% from November 2014. The inventory of existing homes remained relatively loose, with about 5.2 months of supply. Existing home prices in November were up slightly from August, and higher by about +6.6% from year-ago levels. In the new home segment, the NAHB Housing Market Index (a measure of homebuilding activity) ended the quarter at 61, in line with the reading of the prior quarter, and close to its highest level in the last decade. All regions except the South lost ground from the prior month. Analysts cite several factors supporting their contention that housing should continue to gradually improve in 2016: resilient job growth, moderate economic growth, and growing new home demand.

U.S. Equity Market Returns by Major Sector
(GICS Sectors in S&P 500, Fourth Quarter 4Q15)



Source: Morningstar, Inc.

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EMPLOYMENT

The employment situation remained relatively robust in the fourth quarter, and the continued modest growth was a key factor in the Fed's decision to initiate a "lift-off" in interest rates. Employers added 211,000 jobs during November, in line with consensus expectations. In addition, the gains for each of the prior two months were revised higher. The three-month moving average was 218,000, slightly higher than the average for the period ending in August, and also above the levels of each of the prior two months. Payroll gains were broad across industries, with segments such as leisure/hospitality, healthcare and retail trade leading the way, adding 39,000, 32,000 and 31,000 jobs, respectively, for the month. November's employment rate was 5.0%, below the 5.1% posted in August, and the same level as the prior two months. Average hourly earnings increased 2.3% in the past 12 months, a rate indicating a somewhat tightening labor market. Analysts expect the employment gains to average approximately 250,000 through 2016, and many expect the economy to reach full employment by the middle of the year.

FED POLICY

The FOMC ended its highly anticipated recent December meeting by raising its target range for the fed funds rate by 25 basis points to 0.25% to 0.50%. The move had been expected, and analysts contend that it should have little impact on consumers, as it already had been discounted by financial markets. The committee's statement noted that it expects gradual increases in the fed funds rate. Some analysts are expecting 25 basis point increases at alternate meetings in 2016, for a total of four hikes in 2016. The FOMC indicated that future rate hikes will be driven by economic data, meaning it has not pre-determined the course interest rates will take. In addition, the FOMC maintained its reinvestment program, which will keep its balance sheet at existing levels, at least for the present. The Fed projects that there will be 100 basis points of increase in rates in 2016, and the median estimate for where the fed funds rate will end 2017 was 3.3%

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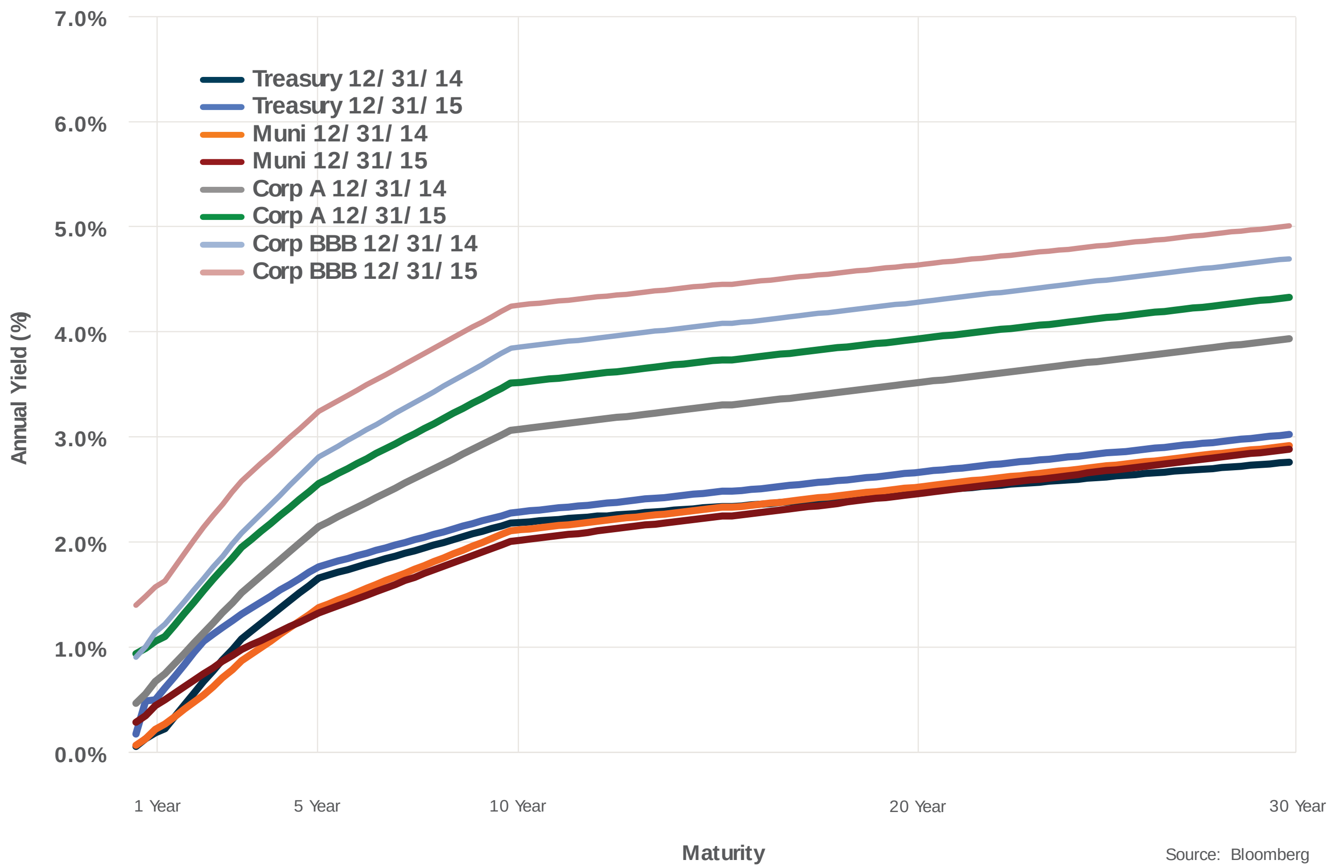
INTEREST RATES

In the fourth quarter, prices of fixed-income securities were driven primarily by anticipation of potential FOMC action on interest rates at its December meeting. After declining to begin interest rate policy "lift-off" at its September meeting, the FOMC confirmed at its December meeting the widespread investor expectation that the Committee would initiate the first increase in the fed funds rate in almost 10 years. Not only did the FOMC raise rates by 25 basis points, it also projected additional increases in 2016 amounting to 100 basis points. However, in its statement accompanying the rate increase, the committee indicated that further increases would be gradual.

U.S. Treasury, Muni, and Corporate 30-Year Yield Curves



Source: Bloomberg

Within this environment, the yield curve rose, and its shape flattened, with yields on short-term maturities rising more than those in the intermediate- to long-term end of the spectrum. By the end of the quarter, the yield on the benchmark 10-year U.S. Treasury had risen to 2.27%, from 2.04% on September 30th. Yields climbed steadily during the quarter, as investors discounted likely action by the FOMC at its December meeting.

Yield changes along the yield curve reflected the FOMC's modified interest rate policy. Yields on the shortest maturities rose more than intermediate and longer term maturities, resulting in an upward shift and flattening in the yield curve relative to September 30th. The yield on the 3-month T-bill settled at 0.17%, up from -0.01% at the end of the previous quarter. The yield on the five-year Treasury surged, ending at 1.76%, compared to 1.36% on September 30th, and as mentioned above, the yield on the 10-year Treasury jumped to 2.27% from 2.04% over the same period. The yield on the 30-year Treasury also rose, ending at 3.02% from 2.86% during the quarter. Inflation expectations continue to be fairly well contained, with the Fed's gauge of five-year forward inflation expectations closing at 1.72% on December 31st, up from 1.65% on September 30th.

Fixed income securities generally delivered negative total returns this period. The Barclays Treasury 5-7 Yr. Index declined -1.3%, and the Barclays U.S. Corporate 5-10 Yr. Index shed -0.5%. High yield securities again performed very poorly, as credit spreads widened, dropping -2.1%. The Barclays Municipal Bond Index was one of the best performing fixed income asset classes, gaining +1.5%. Non-U.S. fixed income also gave up ground, as the Barclays Global Aggregate ex-U.S. Index posted a -1.3% return, and fell by -6.0% for the year. Emerging market bonds bucked the overall trend, with the JPM EMBI Global Index tacking on +1.6%.

EQUITIES

The fourth quarter of 2015 was generally positive for equities. Higher prices coincided with seasonal tendencies, in which stocks have fared well in fourth quarters of years past. However, this year was slightly different from the usual scenario, as gains were front-loaded in October. November was essentially flat, and there was no "Santa Claus" rally this year: stocks limped home with negative returns in December. As with the fixed income markets, one of the fundamental return drivers was anticipation over the FOMC's decision to begin raising interest rates. The S&P 500 Index finished with a gain of +7.0%, but posted a meager +1.4% for the full year. Excluding dividends, the index fell -0.7%, its first annual price decline since 2008.

The ten primary economic sectors generated significant disparities in performance, putting sector selection at a premium for active managers. Materials, healthcare and information technology were the strongest performers, delivering gains of +9.7%, +9.2% and +9.2%, respectively. The energy and utilities sectors were the poorest relative performers, posting gains of +0.2% and +1.1%, respectively.

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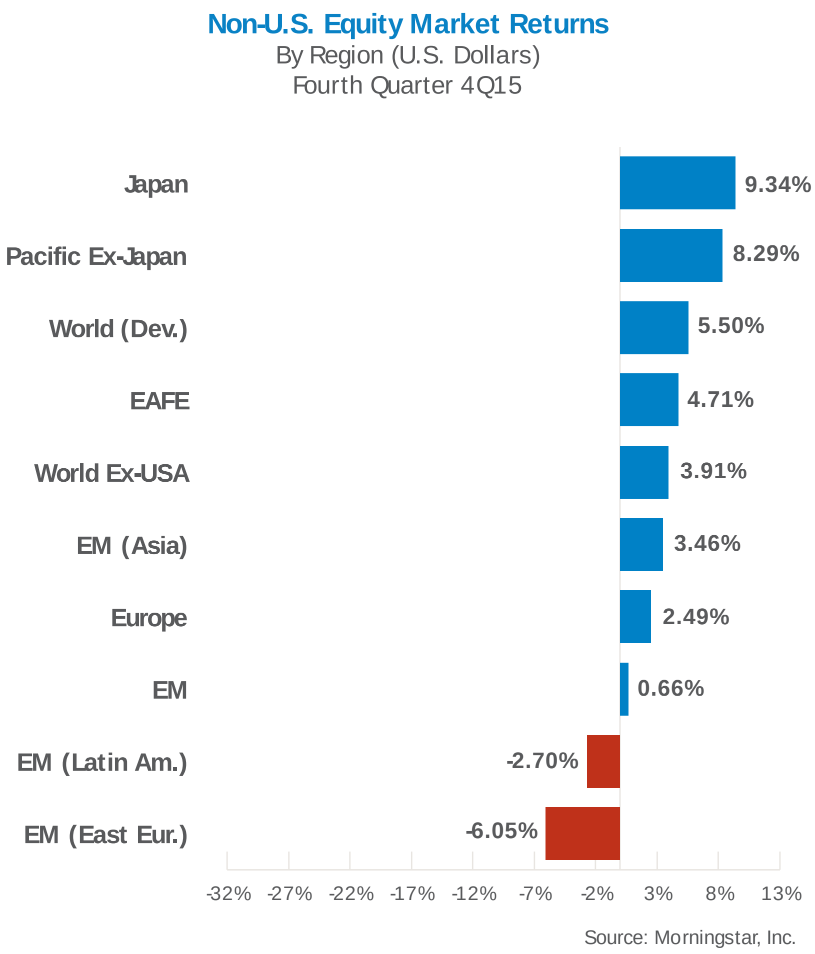
The Russell 1000 Index of large cap stocks generated a +6.5% total return. Within the large cap segment, value stocks outperformed growth stocks. Small cap stocks, as represented by the Russell 2000 Index, underperformed large caps, ending with a total return of +3.6%, and capping off a difficult year in which the index declined -4.4% Once again, value significantly underperformed growth within the small cap universe. The Nasdaq Composite, dominated by information technology stocks, generated solid gains, ending up +8.7%, and advancing +7.0% for the year. The Dow Jones Industrial Average of 30 large industrial companies gained +7.7%, and eked out a meager +0.2% return, when dividends were included, for the full year.

Real Estate Investment Trusts (REITs) also participated in the market's positive trend, even though interest rates were generally higher. The DJ US Select REIT Index produced an advance of +7.5%. Commodities continued to disappoint, with the Bloomberg Commodity Index sinking -10.5% for the quarter ended December 31st. The index plunged almost -25% for the full year, and has declined at an annualized rate of more than -17% for the past three years.



International stocks did not fare as well as U.S. equities, despite assertions by the European Central Bank (ECB) that it would be aggressive in providing stimulus to the Eurozone's recovery. Many investors are anticipating improved performance from European equities in 2016, largely because of the accelerating pace of economic growth and support of the ECB. However, Eurozone leaders also are also trying to grapple with an influx of refugees from the Middle East and Africa, which has the potential of causing increased tensions among member countries. International stock indices were mixed, but generally gained ground. The MSCI ACWI ex-USA Index, which measures performance of world markets outside the U.S., climbed +3.2%, but declined -5.7% for the full year of 2015. The MSCI EAFE Index of developed markets stocks rose by +4.7%, but gave back -0.8% for the year. Regional performance was a mixed bag with significant disparity. Japan and the Pacific region were the strongest performers, posting advances of +9.3% and +8.3%, respectively. Eastern Europe and Latin America were the poorest relative performers, with the MSCI EM Eastern Europe and MSCI Latin America indices suffering losses of -6.1% and -2.7%, respectively. Emerging markets performance was essentially flat, once again a result of the collapse in commodity prices. The MSCI Emerging Markets Index posted a modest gain of +0.7% for the three months, but sank -14.9% for the year.

Outlook

The domestic economy enjoyed a solid year in 2015, and economists continue to be optimistic about its prospects in 2016. Fueling the economy's gains has been the employment situation, with employers adding more than 200,000 jobs a month on average. Some analysts note that sustaining this trajectory would put the U.S. economy at full employment by around the middle of 2016. Economists expect about 3 million jobs to be added next year, roughly the same as both this year and last. Such a stretch of job gains hasn't been experienced since the late 1990s. The improving job market is also resulting in higher wages, one of the elements the FOMC considered in deciding to raise interest rates in December. The FOMC indicated that rate increases will be gradual, as inflation is not yet an issue, despite firming wages. The FOMC also will assess the impact the rate increases have on financial markets. The global economy outside of the U.S. wasn't quite as strong as it was domestically in 2015, but analysts expect it to strengthen in 2016 and into 2017. Emerging markets economies suffered from the plunge in commodity prices, which was keyed by a slowdown in demand from China and a rising U.S. dollar. Analysts expect a modest recovery for commodities, including the energy sector, in 2016. Potential risks to the global economy include how the financial markets deal with the transition in U.S. monetary policy, with some analysts expecting heightened volatility in coming quarters. In addition, China's credit bubble could pose an issue if policymakers mishandle its unwinding. Finally, geopolitical risks such as the refugee situation, potential flare-ups in the Middle East and tension between Russia and the West could create financial market volatility and cloud the economic outlook.

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INDEX OVERVIEW

The **Dow or DJIA** (Dow Jones Industrial Average) is an unmanaged index of 30 common stocks comprised of 30 actively traded blue chip stocks, primarily industrials and assumes reinvestment of dividends. The **Nasdaq Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The **S&P 500 Index** is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The **DJ U.S. Select REIT Index** is a subset of the Dow Jones Americas Select RESI and includes only REITs and REIT-like securities (The Dow Jones U.S. Select Real Estate Securities Index (RESI) represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the U.S.). The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks prices of futures contracts on physical commodities on the commodity market and is designed to minimize concentration in any one commodity or sector. The **MSCI EAFE Index** is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia and the Far East. The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The **MSCI ACWI Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The **MSCI Emerging Markets (EM) Eastern Europe Index** captures large- and mid-cap representation across 4 Emerging Markets (the Czech Republic, Hungary, Poland and Russia) countries in Eastern Europe. With 52 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The **MSCI ACWI Ex-U.S. Index** is a market-capitalization-weighted index maintained and designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies. The **MSCI China Index** captures large and mid-cap representation across China H shares, B shares, Red chips and P chips covering about 85% of this China equity universe. The **Barclays Municipal Bond Index** is an unmanaged index comprised of investment-grade, fixed-rate municipal securities representative of the tax-exempt bond market in general. The **Barclays Global Aggregate ex-U.S. Index** is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented. Municipal bonds, and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The index includes Treasury securities, Government agency bonds, Mortgage-backed bonds, Corporate bonds, and a small amount of foreign bonds traded in U.S. The **Barclays U.S. 5-10 Year Corporate Bond Index** measures the investment return of U.S. dollar denominated, investment-grade, fixed rate, taxable securities issued by industrial, utility, and financial companies with maturities between 5 and 10 years. Treasury securities, mortgage-backed securities (MBS) foreign bonds, government agency bonds and corporate bonds are some of the categories included in the index. The **Barclays Capital US 5-7 Year Treasury Bond Index** is a market capitalization weighted index and includes treasury bonds issued by the US with a time to maturity of at least 5 years, but no more than 7 years. The **Russell 1000 Index** is a market capitalization-weighted benchmark index made up of the 1000 largest U.S. companies in the Russell 3000 Index (which comprises the 3000 largest U.S. companies). The **Russell 2000 Index** is an unmanaged index considered representative of small-cap stocks. The **Russell 3000 Index** is an unmanaged index considered representative of the US stock market and measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The **Housing Market Index** (HMI) is based on a monthly survey of **NAHB** members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months as well as the traffic of prospective buyers of new homes. The **JPMorgan Emerging Market Bond Index** (EMBI Global) tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes U.S.dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million.

DEFINITIONS

The **Federal Open Market Committee** (FOMC) is the monetary policymaking body of the Federal Reserve System. **Fed Funds Rate**, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **European Central Bank** (ECB) is the central bank for Europe's single currency, the euro. The ECB's main task is to maintain the euro's purchasing power and thus price stability in the euro area. The euro area comprises the 19 European Union countries that have introduced the euro since 1999. The **Gross Domestic Product** (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States. The **Bureau of Labor Statistics** (BLS) is a unit of the United States Department of Labor. It is the principal fact-finding agency for the U.S. government in the broad field of labor economics and statistics and serves as a principal agency of the U.S. Federal Statistical System. The **Bureau of Economic Analysis** (BEA) is an agency in the US Department of Commerce that provides important economic statistics including the gross domestic product of the US; a governmental statistical agency that collects, processes, analyzes, and disseminates essential statistical data to the American public, the U.S. Congress, other Federal agencies, State and local governments, business, and labor representatives. The **PCE (Personal Consumption Expenditure) Index of Prices** is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals.