HFS WEALTH MANAGEMENT

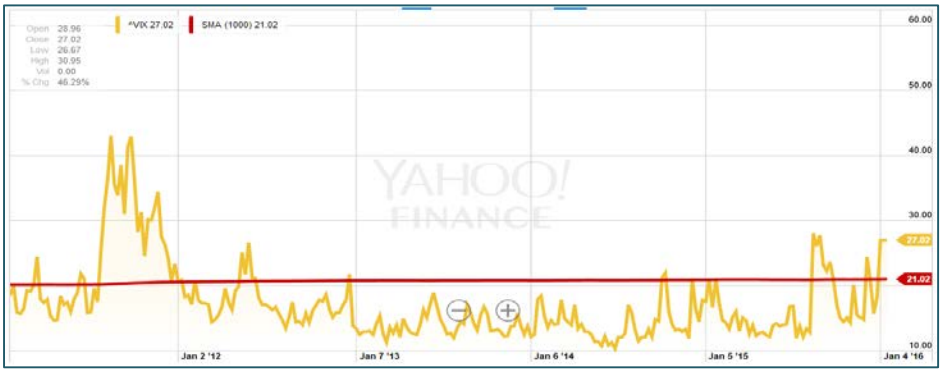
TO: HFS CLIENTS

FROM: HFS

SUBJECT: MARKET UPDATE

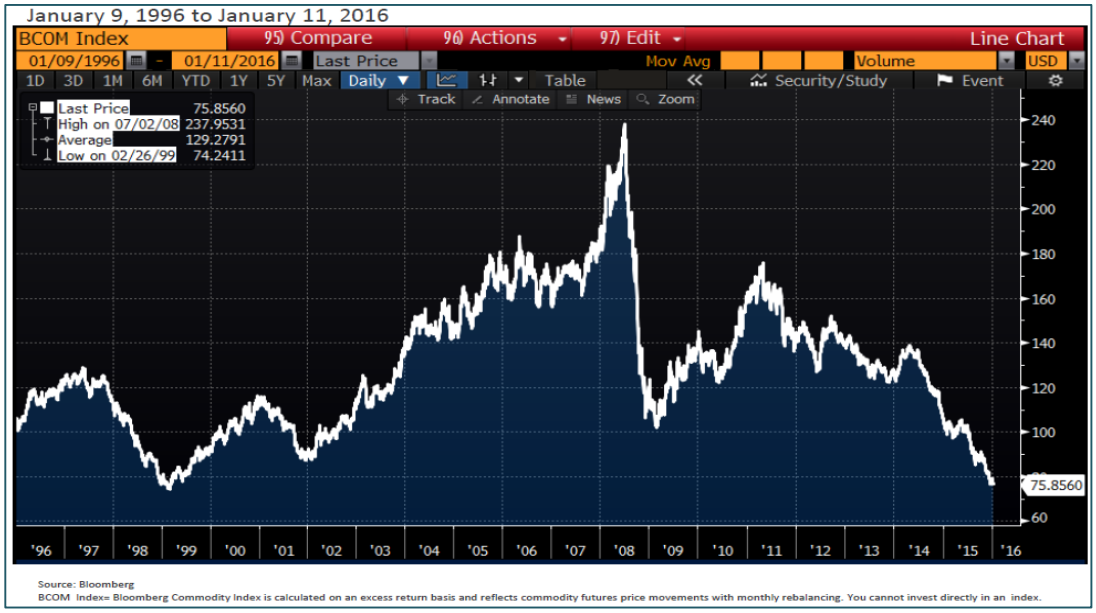
DATE: JANUARY 18, 2016

Several years of below average market volatility has been replaced by volatility levels last experienced in 2012. Items forefront in the financial media today as causes of the heightened volatility include China, the commodity price crash, higher US interest rates and widening credit spreads. These concerns are anecdotal to the broader overriding issue which is the risk of slowing global growth and the related difficulties. Below is a quick update on several of these factors.

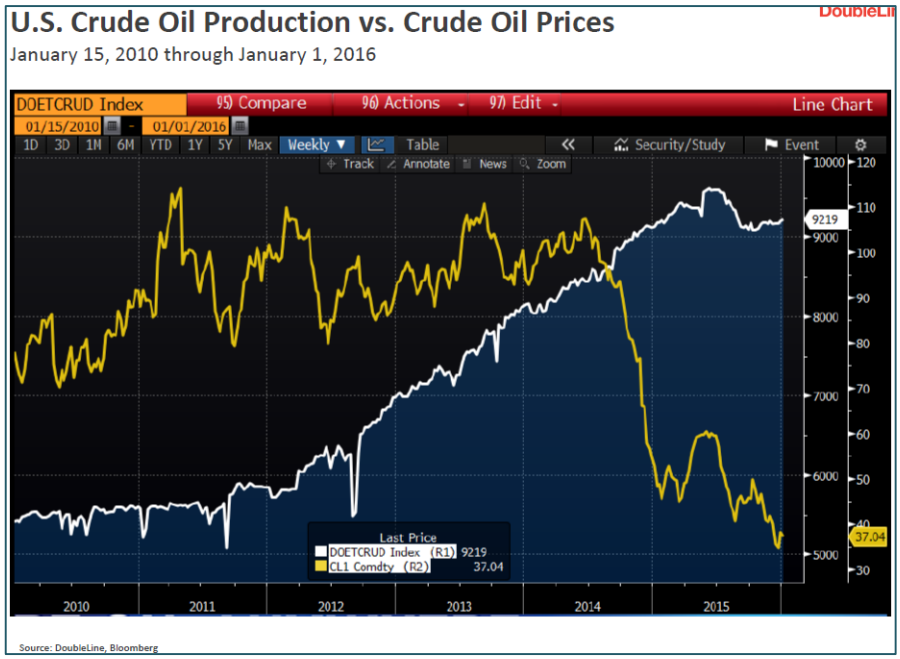


Commodities – Oil, et al

Commodities, broadly speaking, have been in a declining trend since 2011. A broad basket of commonly followed commodities is trading at levels last seen in 1999. Crude oil, like other commodities, recently traded at much higher levles. The price of crude has tumbled to below $30/barrel from over $100/barrel in 2014.



Commodities, over time, are priced by supply and demand dynamics. A question concerning declining commodity prices, and oil specifically, is whether the recent declines are supply or demand driven. A price decline because of excess supply is commonly indicative of industry specific factors compared with demand driven declines being indicative of broader economic problems.

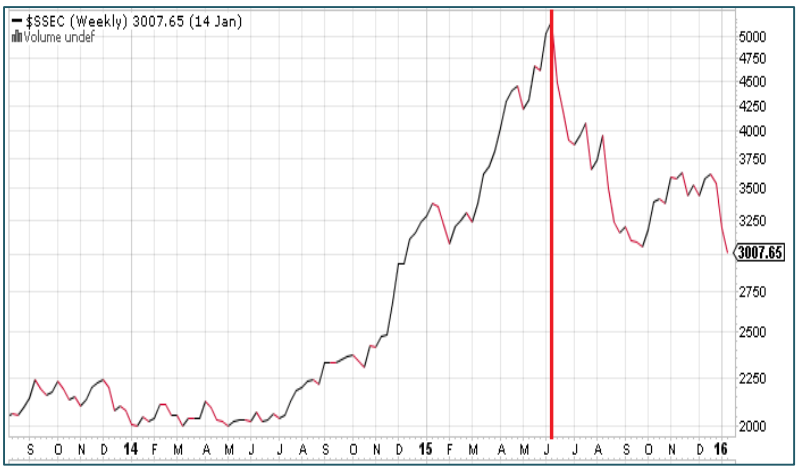


It appears the most significant driver of the oil price decline is excess supply. Simply stated, there is too much oil production to support higher prices. Increased production of crude oil in the US and around the world has caused a surplus to build and, thus, put negative pressures on the price of crude oil.

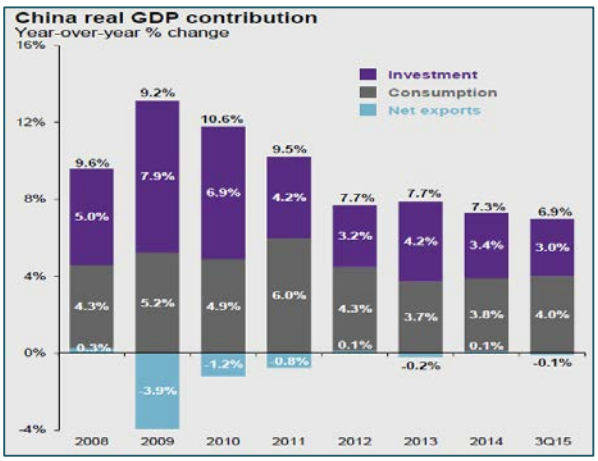
In time, market forces will calibrate the supply/demand mismatch that currently exists in global crude markets. Crude production levels are declining domestically and expected to do so further. Very few places in the world can economically produce oil for $30/barrel. Uneconomic drilling will lead to reduced production, followed by price stability and ultimately price recovery.

China

In June 2015, the Shanghai Exchange began a precipitous fall after rising ~150% from the end of 2013. This move in the Chinese market reignited concerns about an accelerating slow-down in the Chinese economy. The Chinese economy is certainly slowing as the government tries to engineer a transition from a manufacturing-based economy to a consumer/services-based economy. The Communist government's reluctance to allow free-market forces to facilitate this transition has created instability and uncertainty in its financial markets. While all numbers out of China should be taken with a grain of salt, much of the slowdown that is reported does not portend an imminent collapse of their economy.



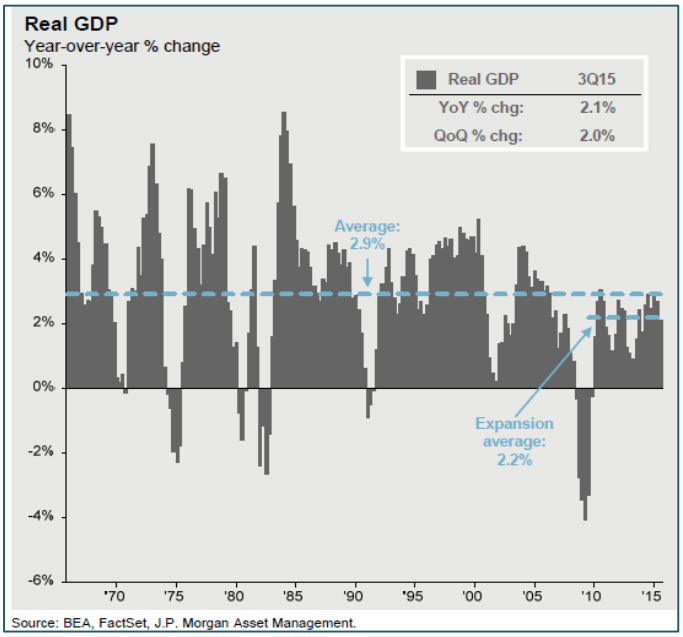
(Source: StockCharts.com)

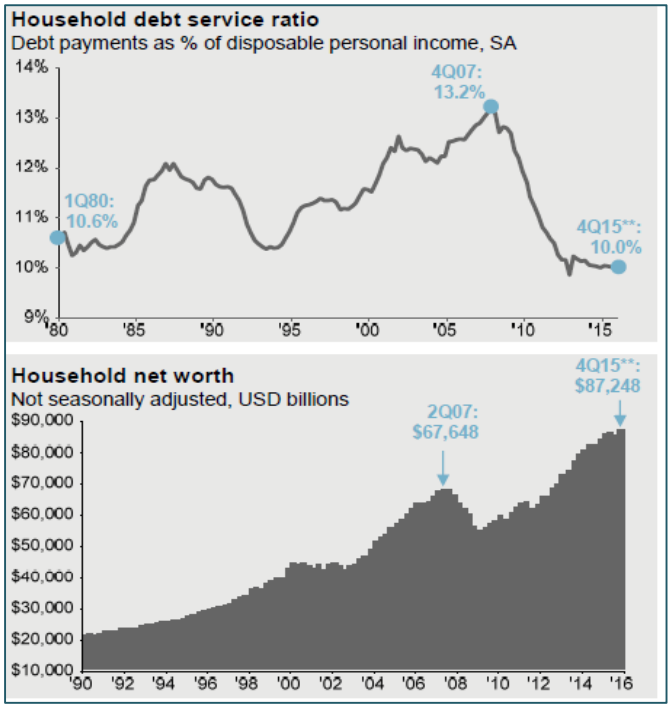


(Source: CEIC; JPMorgan)

US Growth

Much of the world, including the US, has experienced below average GDP growth. Even though growth has been below average, households have been able to reduce outstanding debt and household net worth is at all-time highs.



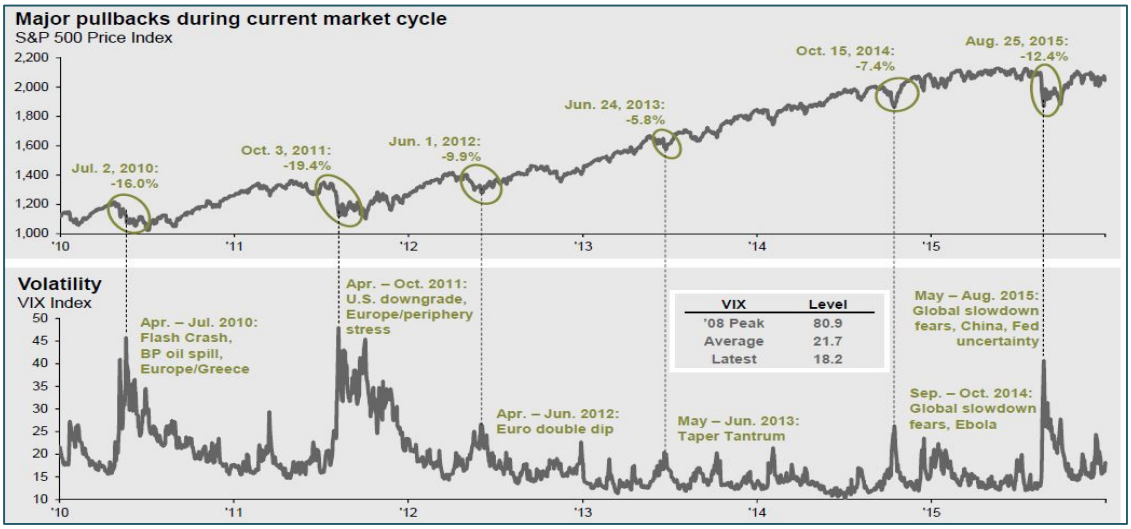


(Source: JPMorgan)

US corporate profits (earnings) have fallen since their highs of 2014, but much of this is explained by the headwinds presented from the energy sector and the strong dollar. The dollar has appreciated significantly to most other currencies making goods and services produced here more expensive in international markets. Many market analysts believe the strong dollar advance is nearing an end or at least slowing. Oil producers would be a beneficiary of a weaker dollar as the value of oil and the dollar tend to move in opposite directions. Until then, oil consumers will benefit from the lower prices.

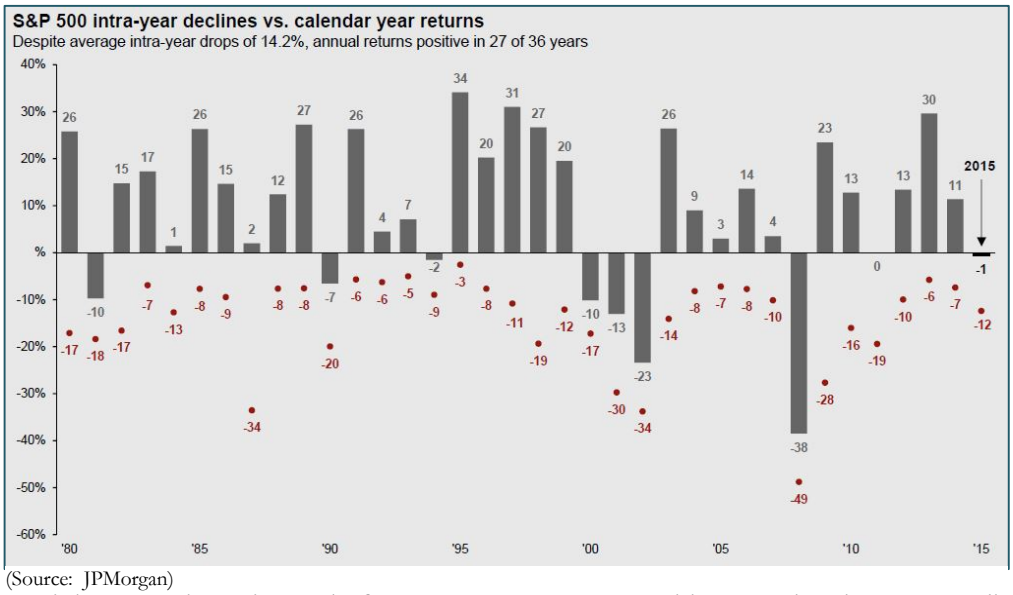
Market Implications

Declines like we are currently experiencing have been observed before and will most certainly be observed again. Corrections (declines of 10%) and bear markets (declines of 20%) are not uncommon.



(Source: FactSet; S&P; JPMorgan; CBOE)

Over the last 36 years, the S&P 500 averaged a 14% intra-year decline per year yet still provided positive returns in 27 of the 36 years. Until late 2015, the S&P 500 hadn't experienced a decline of more than 10% in over four years. This information makes market gyrations no less palatable, but it does provide context and reinforces understanding of the normalcy of market cycles.



(Source: JPMorgan)

HFS Positioning

The only way to completely avoid periods like this in the markets is to completely avoid the markets. As long-term investors, we understand periods of market stress are inherent to investing and often present great opportunities to patient investors. Client portfolios, in general, remain weighted towards equities in developed economies, with a tilt towards larger cap and dividend-focused strategies. Our fixed income positioning is focused on US investment grade bonds but with a shorter duration given that we are at the beginning of a tightening cycle. We continue to seek opportunities presented by the sell-off and would use further weakness as an opportunity to rebalance. Discipline to the plan, perseverance and maintaining a long-term perspective are integral to succeeding during periods of market distress such as today.