Palouse Capital Management, Inc.

Investment Commentary

4Q15

2026 N. Washington St., Spokane WA 99205 (509)624-5591 (800)624-3833 (509)624-7215 fax clientservices@palousecap.com

MARKET OVERVIEW

At the beginning of 2015, we felt that stock market gains would reflect potential earnings growth of 6-8 percent during the year, as PE ratios appeared already on the high side and were unlikely to expand further. Unfortunately the strong US dollar had a negative translation effect on US multinational companies' overseas earnings. This factor, combined with a large decline in energy company earnings, will most likely result in a year over year decline in S&P 500® companies' aggregate 2015 earnings.

The combination of declining earnings in addition to a number of other macro uncertainties kept the stock market range-bound throughout most of the year, which ended mostly flat. Except for a handful of large company stocks, the average stock fared far worse.

What should investors look for in 2016 as key drivers for the equity markets?

(1) **A resumption of earnings growth**. There have been estimates that if the effects of the strong dollar and energy prices were excluded, S&P 500 earnings could have been up 7 percent in 2015. The trade weighted dollar has been mostly flat the past several months, so if the dollar remains stable in 2016 a significant headwind that has existed for earnings growth could be reduced. Energy earnings are likely to lower in 2016, but stocks could benefit if total S&P earnings can rise 5 percent in 2016.

(2) **The FED raises rates at a slower pace**. The FED's own projections plus those of a number of economists project 3-4 rate increases in 2016, with a year-end FED Funds rate of 1.375 percent. However, the market (as measured by the FED Funds futures contract) is projecting a year end FED funds of .63 percent. If the domestic economy continues to grow at a subdued 2-3 percent rate then the FED may not raise interest rates as quickly as many expect, which could be a positive for the stock market.

(3) **Economic growth continues, despite weakness overseas**. There was widespread concern that the weakness in China could spread to other countries and eventually affect growth in the US. This issue was one of the primary reasons the US stock market had its first 10 percent correction in 4 years in the summer of 2015. Usually the size of the US economy more than offsets weakness in other countries, but many are concerned that weakness in China and the Emerging Markets (countries that primarily have exported commodities to China) could be enough of a negative to pull the US into recession. The poor performance by US manufacturing and other cyclical stocks suggests that the risks of recession have risen in the eyes of investors.

(4) **Can we stay financially accident free in 2016**? The suppression of interest rates by the US FED and other central banks have provided incentives and opportunities for companies to borrow money at cheap rates, thereby increasing debt levels. Debt levels in the energy industry have risen, and ready access to abundant and cheap borrowings have helped trigger many mergers and acquisitions. A downturn in the economy could create a wave of financial difficulties for overleveraged companies.

(5) **Other recurring and unresolved issues** could continue to affect markets, including: unrest in the Middle East, weakness in China and Emerging Market Countries, potential terrorist activity, potential escalation of tensions with Russia, the upcoming US election, plus any additional "wild cards" out there.

If these key factors are resolved in a favorable manner then stock prices could rise in a path consistent with earnings growth. However, we feel that there are uncertainties that are likely to keep the market range-bound at best over the near term. Which areas appear most promising for investment? In our opinion,

Industrial and cyclical stocks appear to be at low valuations as it appears the market seems to be pricing in a recession. If a recession does not occur, these stocks could enjoy nice rebounds from current depressed prices. In a potentially rising interest rate environment the **financial sector** could benefit since banks' net interest margins have been squeezed by suppressed interest rates. The **healthcare sector** had a correction in 2015, so this group could recover as investors look upon the demographic shifts which could increase demand for healthcare services and products. **Technology** could also benefit from a recovery in corporate spending and new innovations in mobile and storage.

We are asked often about the energy sector. We reduced our exposure to minimal levels earlier in 2015 as it appeared to us that Saudi Arabia's action to increase production and depress oil prices had a political, not just an economic agenda. US crude production has risen sharply and the Saudis appear to fear losing control of the market. However they may have misjudged the new drilling technology in terms of its cost structure and the ability of these US producers to quickly ramp up production. A number of oil companies sold varying amounts of their production forward in the futures market, so in 2016 as these hedges roll off there could be more difficulties in the energy sector. At some point the energy sector may look promising, but we prefer to remain on the sidelines at this time.

STRATEGY FOCUS [1]

Equity & Fixed Income Strategies

With our much hoped for "Santa Claus" rally not occurring, the S&P 500 declined 1.75 percent in December, pushing the index into negative territory for the year, albeit only 0.73 percent. The S&P 500 Total Return completed the year with a positive return of 1.38 percent. While one would see this as a flat year, it doesn't mask the extreme volatility experienced across the winners and losers. As we look at the year-end data, we see that 137 issues moved at least 25 percent – some up over 25 percent, but the majority of this figure falling at least 25 percent.

[1] PCM obtains all financial/performance data cited herein from Bloomberg, S&P Dow Jones Indices, and Russell Investments, as applicable.

Another key aspect for 2015 was the disparity of returns of Growth over Value. For 2015, the Russell 1000® Growth Index returned 5.67 percent. The Russell 1000®Value Index posted a return of negative 3.83 percent. This carried over to the smaller cap indexes as well, with the Russell 2500™ Growth Index posting a negative 0.19 percent and the Russell 2500™ Value Index returning negative 5.49 percent.

Looking at our strategies on a quarter and year-end basis, our Small/Mid Value Strategy finished the year strongly. Benefiting again from individual stock selection, this strategy out-performed for the quarter and the full year, and now has strong relative returns over the last four year period.

Our Large-Cap Value Strategy closed 2015 slightly lagging the index on a quarter and year-end basis. Primary under-performance was due to consumer discretionary individual stock selection. Our Large-Cap Value Total Return Strategy finished the year in-line with the Russell 1000 Value, and lagging the S&P 500. Aiding performance was our under-weight in energy and stock selection in materials. Stock selection within industrials was a performance detractor. This theme continued within our Diversified Income Strategy, where individual positions in consumer discretionary and industrials had a negative impact on overall performance.

DISCLOSURES

Past performance is not a guarantee of future results and there is no assurance that any predicted results will actually occur; actual events and results may differ materially from those discussed herein. The opinions expressed are those of Palouse Capital Management, Inc. (PCM), and are based upon information available at the time of the printing of this report, and subject to change. Furthermore, these opinions are not the opinions of your custodian or broker. The information provided in this report should not be considered a recommendation to invest in a particular security, strategy or purchase or sell securities in a particular industry or sector. There is no assurance that securities or securities within the sectors mentioned in this report will be in a client's portfolio. Holdings are subject to change. This information is not intended to be used as the primary basis of investment decisions nor should it be construed as advice designed to meet the particular investment needs of any specific investor. Approved for investment professional and client use. Small-cap investing typically carries more risk than investing in well-established large cap companies since smaller companies generally have limited product lines and financial resources and a higher risk of failure. Historically, smaller companies' stocks have experienced a greater degree of market volatility than the average stock. PCM's Small/Mid Value Strategy may not be suitable for everyone. The income generated by the securities held in PCM's Large-Cap Value Total Return and Diversified Income strategies may decline. Generally the prices of fixed income securities decline as interest rates rise. The Diversified Income strategy may include investments in lower quality, higher yielding fixed income securities which may be subject to great price fluctuation than higher quality fixed income securities. Index returns and other historical data were gathered from resources believed to be reliable; PCM does not guarantee their accuracy. The performance of the indices may be materially different from the individual performance attained for a specific client. The S&P 500 is a capitalization-weighted index of the prices of common stock of the 500 leading companies representing the leading industries of the US economy, which are actively traded in the United States on the New York Stock Exchange or the NASDAQ. The Russell 2500 Value Index measures the performance of the small to mid-cap value segment of the US equity universe. It includes those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values. The source for all market data is Bloomberg, S&P Dow Jones Indices, and Russell Investments. Information regarding the services provided by PCM is available in Form ADV Part 2, which is available upon request or on PCM's website at www.palousecap.com.

Approved for investment professional and client use.

Strong Values-High Integrity-Exceptional Service Since 1994

Palouse Capital Management, Inc., a boutique asset management firm, founded in 1994, providing active asset management nationally to high net worth individuals, foundations & endowments, corporations, and public funds. The firm's fundamental "value" philosophy is consistently applied across the core equity strategies; Large-Cap Value, Large-Cap Value Total Return and Small/Mid Value. The firm also offers a Diversified Income Strategy for those clients seeking income from diversified asset classes, which may include fixed income, equities, preferred stock, REITS, and other income producing securities.

