Palouse Capital Management, Inc.

Investment Commentary

1Q 2016

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MARKET OVERVIEW

“All’s well that ends well.” The stock market took on the aspects of a Shakespearean play during the first quarter. It was like a tragedy in the first half of the quarter, yet it ended well with a big rally in the second part of the quarter. While the Standard & Poor’s 500® Index (SPX) ended up with a small gain, this was the first quarter since 1933 in which the market declined ten percent and yet closed higher. This appears to be a time period in which investor perceptions changed faster and more often than the underlying fundamentals. In looking at the scorecard for equity market drivers we outlined in the January strategy letter, nothing much has changed from our year end outlook. It may be helpful to list the primary drivers again and update what has changed in our forecast for the stock market for this year:

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

A resumption of earnings growth - First quarter earnings will be coming out soon (estimates are for a nine percent decline compared to last year’s first quarter), and if the US dollar stays where it has been the past nine months this may be the last quarter of declining year over year earnings. The strong dollar has been a headwind for companies doing business overseas as it has been estimated that absent the dollar strength earnings would have been up five percent in 2015. Since equity valuations do not appear to be cheap, the best opportunity for stock price gains may reside in a resumption of earnings growth starting in the second quarter and continuing through year end. Watching the dollar will help determine the upside to earnings and likely the amount of upside to the market for 2016. Energy earnings may continue to be a negative, but we are approaching the bottom in year over year comparisons for crude prices as well. Energy earnings are likely to be lower in 2016, but stocks could benefit if total S&P 500 earnings can rise in 2016.

The FED raises rates at a slower pace - During the quarter the FED revised its projection of year end FED funds downward, resulting in a narrowing of the gap between the FED’s own projections and those of the market (as measured by the FED Funds futures contract). This event was one of the catalysts of the rally in the first quarter. Keeping interest rates lower for longer is a positive, but a much stronger economy and/or an acceleration in inflation could place the prospect of faster interest rate increases back on the table.

Economic growth continues, despite weakness overseas - After some weak economic reports, especially in the manufacturing sector, economic activity appeared to pick up later in the quarter. This allayed some of the fears that the economy was poised to enter a recession. China appears to have stabilized somewhat and the Emerging Markets had nice recoveries in their stock markets and currencies during the quarter. We anticipate 2016 GDP growth in the two percent range, which continues the trend we have seen over the past several years. This growth rate is lower than past recoveries, but one positive of slower growth could be a slower trajectory of interest rate increases by the FED.

Can we stay financially accident free in 2016? - The travails in the credit markets in the quarter have helped cool off the issuance of lower quality debt, so the risk of a financial accident may have decreased somewhat. One exception may be the energy companies, as the continued low price of oil may continue to stress these issuers. Still, a downturn in the economy could create a wave of financial difficulties for overleveraged companies.

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MARKET OVERVIEW CONT.

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; and any additional “wild cards” out there. Over the next few months, developments in the US election process may begin to have a larger impact on the markets.

If these key factors are resolved in a favorable manner then stock prices could rise in a path consistent with earnings growth, which could be in the five percent range. However, these uncertainties are likely to keep the market range bound at best over the near term. Which areas appear most promising for investment? In a potentially rising interest rate environment the **financial sector** could benefit since banks’ net interest margins have been squeezed by suppressed interest rates. Although, the financial markets will likely need to be satisfied that the banks have reserved adequately for their energy loans, which amount to approximately 2-3 percent of total loans for the largest banks. The **healthcare sector** had a correction in 2015 and was a poor performer in the first quarter, so this group could recover as investors look upon the demographic shifts which could increase demand for healthcare services and products. In addition, the political rhetoric has cast a cloud over the group, especially considering the pricing of drugs. This sector could do much better after the election uncertainties are resolved. **Technology** could also benefit from a recovery in corporate spending and new innovations in mobile and storage.

To summarize, equity market returns are likely to be dependent upon earnings growth, since valuations appear higher than long term averages. In the absence of solutions to the long term problems we face, the general market is likely to continue to have its ups and downs over the year. Our goal is take advantage of opportunities we may encounter during the various dips in prices we are likely to see over the next several months.

STRATEGY FOCUS [1]

Equity & Fixed Income Strategies

After a dismal start to the year, markets roared back in March, allowing the major indices to post positive returns for the first quarter. The S&P 500 gained across most sectors for the completed quarter with energy, surprisingly, leading the way. Healthcare was the poorest performing sector in the first quarter, though the sector began to perk up in the month of March.

Our strategies benefitted from the strong market returns of March, particularly our Diversified Income and Large-Cap Value Total Return Strategies. The Diversified Income Strategy led the charge, handily outpacing its corresponding index. The performance was driven by individual stock selection, particularly in the industrials and materials sectors. Within our Total Return Strategy the out-performance was attributed mostly to stock selection, particularly in the consumer discretionary and materials sectors.

While posting a positive return YTD, our Small/Mid Cap Value Strategy lagged slightly due to positions within the financial sector. For the Large-Cap Value Strategy, our overweight in the healthcare sector caused this strategy to under-perform modestly, though we feel the increased healthcare exposure positions us well as we move into the second quarter. The same can be said about our increased financial/bank exposure in the Small/Mid Cap Value Strategy.

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

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