Economic and Market Overview

First Quarter 2016

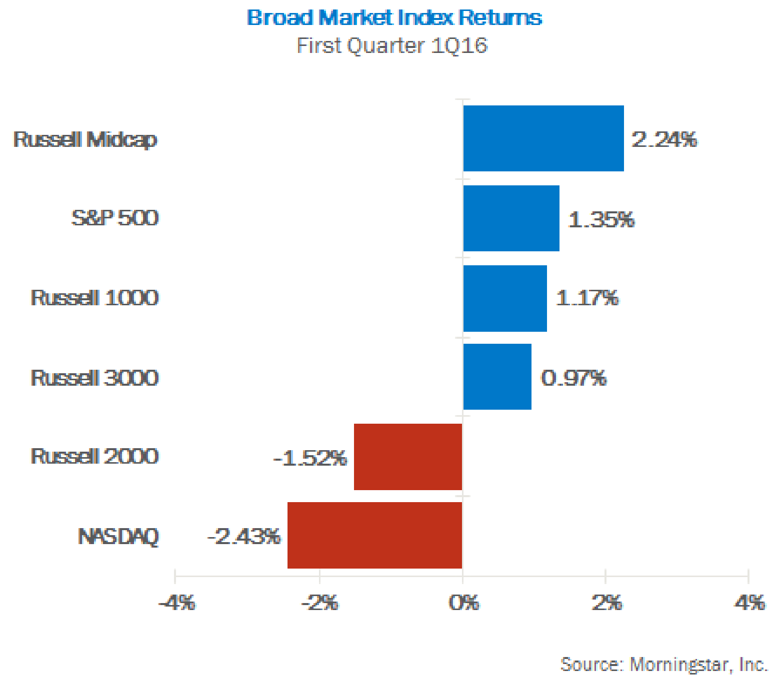
Ironwood Investment Counsel, LLC
A Registered Investment Advisor

Economic and Market Overview

First Quarter 2016

The Economy

Domestically, the economic environment was sluggish in the first quarter of 2016, with lackluster results in several areas of the economy. However, the employment situation remains an important bright spot, as are vehicle sales and retail sales. The domestic economy continued to face the fallout from ongoing issues in international developed and emerging markets economies, which resulted in economic uncertainty and financial markets volatility. The Bureau of Economic Analysis reported its third estimate of fourth quarter 2015 gross domestic product (GDP) of +1.4%, higher than the prior estimate, but lower than the +2.0% reading of the third quarter. The employment situation remained resilient, with an average of about 228,000 jobs added each month. The unemployment rate declined to 4.9%.



Globally, economic growth continued to lag as a result of several factors. In Europe, the health of banks remains a major concern, and the region is suffering from low demand despite the European Central Bank's (ECB) aggressive asset purchase program. European authorities' handling of the flow of refugees from the Middle East has also been a cause for concern. China's policymakers are attempting to engineer a soft economic landing while also navigating tricky stock, bond, and currency markets.

At its most recent meeting in March, the Federal Open Market Committee (FOMC) stood pat, deciding not to increase the target fed funds rate from the current range of 0.25% to 0.50%. The FOMC reduced the number of expected additional rate increases this year from four to two.

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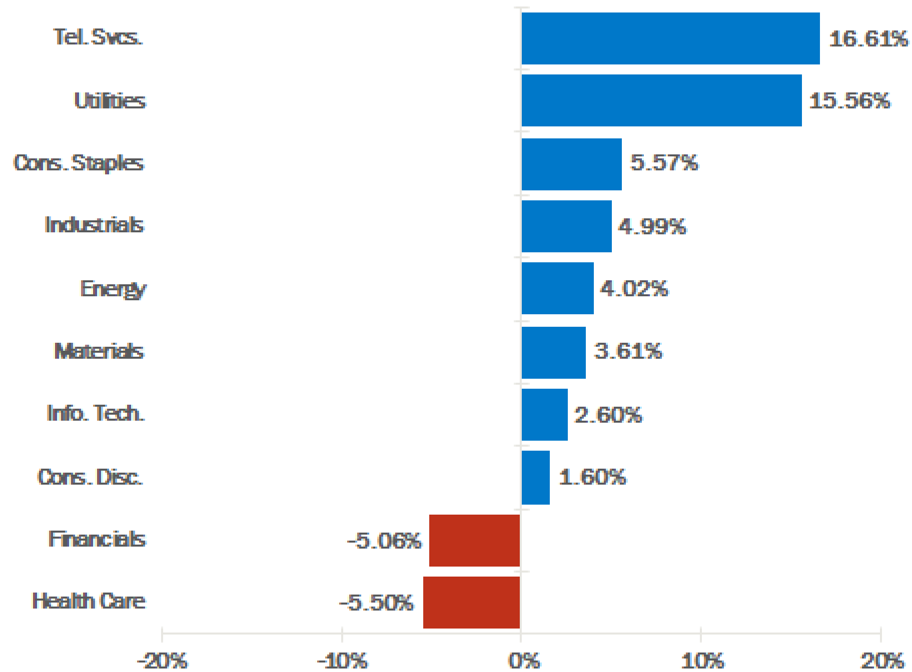
Highlights and Perspectives

GROSS DOMESTIC PRODUCT (GDP)

The Bureau of Economic Analysis released the third estimate of the fourth quarter 2015 real GDP, a seasonally adjusted annualized rate of +1.39%, down from the +2.0% annualized growth of the prior quarter, but a notch higher than the prior estimate of +1.0% growth. The results were somewhat disappointing to analysts, and demonstrated the weakness of the economy at the end of the year. The two primary impediments to growth were reduced inventory accumulation and trade. In addition, some economists have lowered their growth outlook for this year due to the negative effects of unsettled financial markets. The strong U.S. dollar continues to have an adverse impact on trade, and sluggish emerging markets economies make for a difficult environment for U.S. exports. Losses sustained in the first quarter's stock market turmoil also create a negative wealth effect, sapping consumer confidence, which may come into play in ensuing quarters. However, not all the news is negative. Lower oil prices have hurt energy companies, but are generally a positive for the economy as a whole. In addition, with the decline in interest rates resulting from the flight to Treasuries during the first quarter, mortgage rates have remained low. Corporate profits dropped by -7.8% (not annualized) after declining -1.6% in the prior quarter. As has happened in recent quarters, low energy prices kept inflation in check, with the personal consumption expenditures (PCE) index of prices rising +0.3%, following a +1.3% climb in the prior quarter.

U.S. Equity Market Returns by Major Sector
(GICS Sectors in S&P 500, First Quarter 1Q16)



Source: Morningstar, Inc.

HOUSING

The housing segment continued to struggle. Existing-home sales for February (the latest monthly data available) advanced at an annualized rate of 5.08 million units, down about -7% from the 5.47 million unit rate reached in January, but still up +2.2% from February 2015. The inventory of existing homes remained relatively loose, with about 4.4 months of supply. Existing-home prices in February were down slightly from November, but higher by about +4.3% from year-ago levels. In the new-home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at a level of 58, slightly below the reading of the prior quarter. Analysts are encouraged by the stability of the index at these levels, which suggest homebuilders have a positive outlook for the year ahead. Continued job growth and increased mortgage availability will also be positives for the housing market for the remainder of the year.

EMPLOYMENT

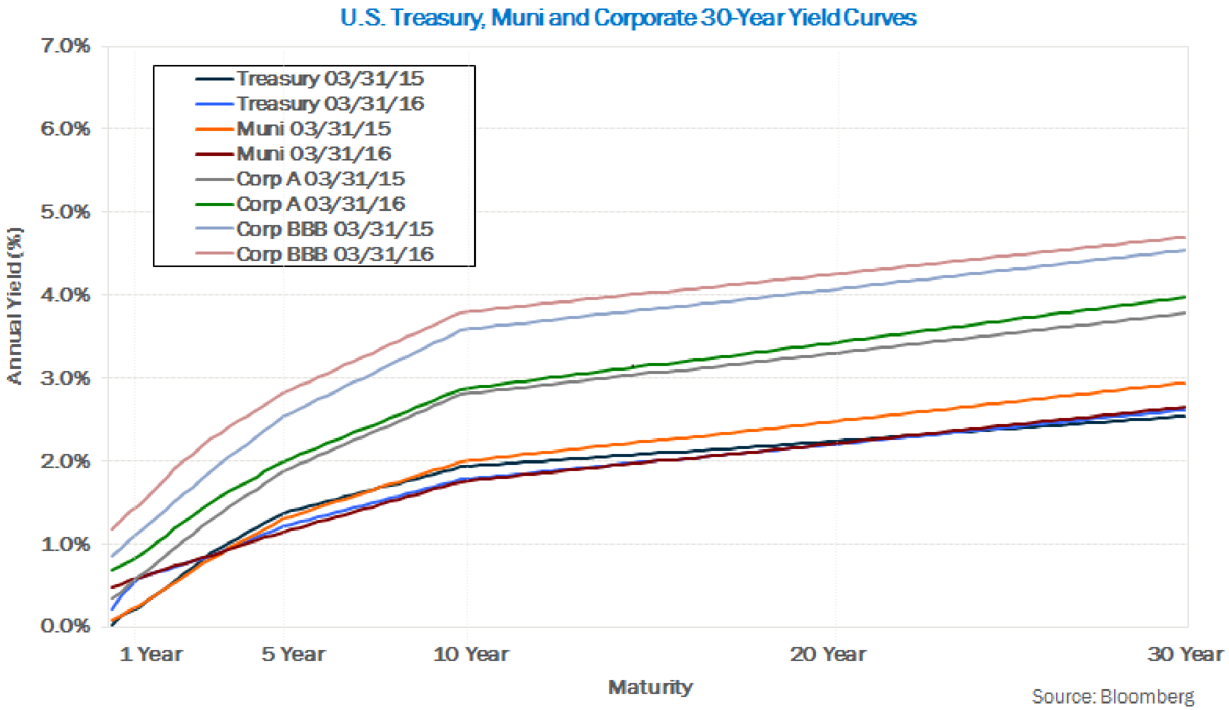
The employment situation remained encouraging, despite the headwinds of slowing global economic growth and financial markets turmoil. Employers added 242,000 jobs during February, far exceeding consensus expectations. In addition, the gains for each of the prior two months were revised higher. The three-month moving average was 228,000, modestly lower than the average for the period ending in November, and also below the levels of each of the prior two months. As in the prior quarter, payroll gains were broad across industries, with segments such as education and healthcare setting the pace, adding a combined 86,000 jobs for the month. The unemployment rate in February was 4.9%, below the 5.0% level in November, and the same level as the prior month. Average hourly earnings increased 2.2% in the past 12 months, a somewhat weaker rate than previous months, yet still a sign of an improving labor market. Analysts expect the employment gains to remain above 200,000 through 2016, and that the unemployment rate should remain below 5%.

FED POLICY

The FOMC ended its recent March meeting standing pat, maintaining a target range of 0.25% to 0.50% for the fed funds rate. The FOMC's decision was expected by economists, as the committee took into consideration the financial markets convulsions of the first quarter. Importantly, the committee's statement reduced the number of expected rate increases in 2016 from four to two, meaning that the likely amount of rate increase for the year may not exceed 0.50%. The FOMC's median estimate for where the fed funds rate will end 2017 remained at 3%, although there is some skepticism by the markets that it will achieve that level. A growing consensus among analysts is that the next increase will occur at the June meeting.

INTEREST RATES

In the first quarter, global market volatility was the primary driver of the prices of fixed-income securities. Many analysts had expected rates to begin to trend higher following the FOMC's decision in December to begin interest rate policy "lift-off" by initiating the first increase in the fed funds rate in almost 10 years. However, yields were quickly driven sharply lower at the beginning of the year as a result of a flight to quality precipitated by the historic decline in global stock markets. As a consequence of the stock market instability, the FOMC has reduced the number of rate increases it expects to make the remainder of the year.



As happened in the prior quarter, 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 declined to 1.77%, from 2.27% on December 31st. Yields declined sharply for the first six weeks of the quarter before trending somewhat higher through the end of the quarter.

Yield changes along the yield curve were a function of both the FOMC's decision to raise rates and the volatility in financial markets. 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 December 31st. The yield on the 3-month T-bill settled at 0.2% at the end of the quarter, up just slightly from the end of the previous quarter. The yield on the five-year Treasury plunged, ending the quarter at 1.21%, compared to 1.76% on December 31st, and as mentioned above, the yield on the 10-year Treasury fell to 1.77% from 2.27% over the same period. At the same time, the yield on the 30-year Treasury also eased, to 2.61% from 3.02% during the quarter. Inflation expectations continue to be within the FOMC's comfort zone, with the Fed's gauge of five-year forward inflation expectations closing at 1.61% on March 31st, down from 1.72% on December 31st. In terms of total returns, fixed income securities almost universally delivered positive returns. The Barclays Treasury 5-7 Yr. Index rose +3.6%, and the Barclays U.S. Corporate 5-10 Yr. Index added +4.1% during the three months. High yield securities fared well despite the equity market's volatility, advancing +3.4%. Municipals continued to generate solid gains, as the Barclays Municipal Bond Index gained +1.7%. Prices of non-U.S. fixed-income securities surged, as the Barclays Global Aggregate ex-U.S. Index posted a +8.3% return. Emerging markets bonds were one of the best-performing fixed-income asset classes, with the JPM EMBI Global Index jumping +5.2%.

EQUITIES

The first quarter of 2016 was, if nothing else, a volatile period for equities. The advances posted by many broad market indices belie the tumult of the quarter. The new year began ominously for stocks, as a mix of global economic slowdown, slumping emerging markets economies, China's stumbling efforts to re-ignite growth, and the December decision by the FOMC to raise rates conspired to produce stocks' worst two-week opening of any year on record. The S&P 500 tumbled about 9% over the first 12 trading days of the year, and remained depressed through the middle of February, as investors sought clarity on the economy and interest rates. However, buyers began to step in during the latter half of February and through March, not only recouping losses for many indices, but tacking on modest gains. The S&P 500 Index finished the quarter with an advance of +1.4%

The ten primary economic sectors generated a significant dispersion in performance, creating a difficult situation for active managers. Utilities and telecommunications services were by far the strongest performers for the quarter, delivering gains of +15.6% and +16.6%, respectively. Managers with underweight exposure to these sectors lagged their benchmarks. The financial services and healthcare sectors were the poorest relative performers during the quarter, posting losses of -5.1% and -5.5%, respectively.

The Russell 1000 Index of large capitalization stocks generated a +1.2% total return. Within the large cap segment, value stocks outperformed growth stocks. Small capitalization stocks, as represented by the Russell 2000 Index, underperformed large caps, ending with a total return of -1.5%. However, within the small cap segment, value surged relative to growth, reversing a recent trend. The Nasdaq

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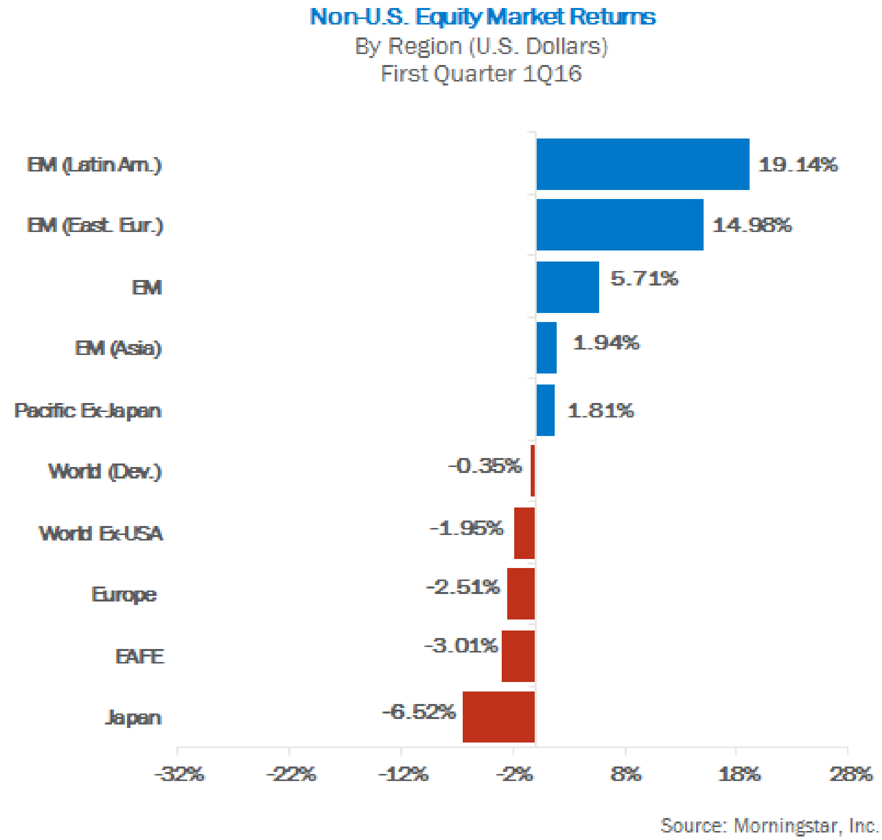
Composite, dominated by information technology stocks, was one of the indices posting a loss, ending down -2.4%. The Dow Jones Industrial Average of 30 large industrial companies gained +2.2%.

Real Estate Investment Trusts (REITs) were a strong performer, owing in part to the favorable interest rate environment. The DJ US Select REIT Index produced an advance of +5.1%. Commodities stabilized somewhat, with the Bloomberg Commodity Index inching up by +0.4%.



With only a couple of regional exceptions, international stocks performed poorly relative to U.S. equities, as both developed and emerging economies continue to struggle. Disappointing economic data continues to overhang both the Eurozone and Asia (including Japan), and sluggish demand is contributing to a persistent low-inflation environment. In addition, the Eurozone is grappling with the swell of refugees from Syria and other regions where Islamic State (ISIS) has infiltrated. In China, policymakers are attempting to employ all monetary and fiscal policy levers at their disposal to reverse the negative changes in the country's growth rate over the past several quarters. Against this backdrop, international stock indices were mostly lower. The MSCI ACWI ex-USA Index, which measures performance of world markets outside the U.S., declined -0.4%. The MSCI EAFE Index of developed markets stocks fell by -3.0%. Regional performance exhibited significant dispersion. Latin America and Eastern Europe were far and away the strongest performers, with the MSCI Latin America and MSCI EM Eastern Europe indices posting advances of +19.1% and +15.0%, respectively. China and Japan were the poorest relative performers, suffering losses of -4.8% and -6.5%, respectively. Emerging markets performance was finally a bright spot, as the MSCI Emerging Markets Index gained +5.7%.

Outlook

In a sign of its resilience, the domestic economy has held up well in the face of many negative factors, including a weak international economic growth outlook; a shift in domestic interest rate policy; an unsettled presidential election campaign; and volatile equity markets. U.S. employment growth is one indication of the economy's underlying strength, with many economists expecting employers to continue to add an average of 200,000 jobs per month for the remainder of the year. In addition, domestic vehicle sales and retail sales also remain solid. Analysts continue to anticipate the U.S. economy will be at full employment by sometime this summer. More job-seekers are re-entering the workforce, and earnings are expected to increase as the labor market continues to tighten. The FOMC's decision to stand pat at its recent meeting, coupled with committee chairwoman Janet Yellen's dovish comments during congressional testimony, have assuaged financial markets in the near term. However, the FOMC will be looking for continued signs of improvement—and whiffs of inflation—to ratchet up rates at upcoming meetings. The international economy outside of the U.S. continues to experience low demand. In the Eurozone, concern over the health of financial institutions remains, despite the European Central Bank's (ECB) pledge to enhance its asset purchase program if necessary. Eurozone policymakers must also consider the potential effects of a possible exit by the U.K. from the European Union. Potential risks to the global economy include how the Eurozone institutionally handles the refugee crisis, which many analysts believe has been poorly managed so far. In addition, China's navigation out of a slowing-growth environment will be closely watched. Geopolitical risks such as the Middle East situation and the heightened tension between Russia and the West could result in economic and financial market uncertainty.

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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 EM (Emerging Markets) Latin America Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets in Latin America. 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 **Russell Midcap Index** is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. 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.