Despite a strong start to the fourth quarter, domestic financial markets staggered into the close of 2015 amid fears of an economic slowdown in China and concerns over the energy-related segment of the high-yield bond market. The 7.04% gain for the fourth quarter, led by a four-year best 8.44% gain in the month of October, helped the S&P 500 recover its earlier losses and finish the year with a 1.38% total return. For bonds, a portion of the volatility experienced in the high-yield market spilled over into the investment grade arena, nudging yields higher, but not enough to erase gains for the year. Municipal fixed income, as measured by the Barclays Managed Money Municipal Short/Intermediate Index, finished the quarter up 0.84% to bring its year-to-date return up to 2.78%. Taxable bonds, as measured by the Merrill Lynch US Corp/Gov't 1-10 Year A or Better Index finished -0.66% for the quarter, bringing their year-to-date total return to 1.35%.

In our last letter, we called for a volatile rebound in the U.S. stock market during the fourth quarter following a retest of the lows experienced during the late August selloff in Chinese markets. That call proved correct, but as we turn the calendar to 2016, Chinese market gyrations are once again roiling global financial markets. The heart of the matter is identical to what sent markets tumbling in late summer. The Chinese yuan has depreciated relative to other currencies, causing investors to fear that Chinese officials are seeking to prop up an economy that is potentially trending below their set target. Government officials would never admit it, but currency wars have been going on for several years now with both the U.S. and the Eurozone attempting to devalue their currencies by embarking on massive amounts of quantitative easing. Despite the short term choppiness, we would welcome a cheaper yuan if it brought about stability in the Chinese economy and continued the risk-on trend that our markets have enjoyed since the Fed embarked on "QE1" back in December of 2008. If the yuan stabilizes and the fears of a hard landing in China subside, we believe that our markets will trade less on fear, and more on fundamentals.

Another issue facing investors as we head into 2016 is the continued drop in the price of oil. The price of a barrel of WTI crude oil dropped by just over 30% in 2015, extending the slide that began in the summer of 2014. Oil is currently facing a number of headwinds: an overabundance of supply, weaker global demand, and the strengthening of the U.S. dollar. While it is difficult to attribute the daily fluctuations in the price of oil to any one of these reasons, we believe the most recent downtrend is related to the move in the dollar. Our currency is a key factor because oil is dollar-denominated, leading to an inverse relationship between the two. The Fed has begun a gradual rise of interest rates at the same time that China, as noted above, and other central banks continue to lower their rates. This divergence in monetary policy has put upward pressure on the dollar, weighing on oil. At Appleton, we cannot predict when and at what price oil will bottom, but believe that the price of oil will stay low for the foreseeable future. The dramatic drop in oil prices has reverberated through many asset classes, including fixed income, and in particular the high-yield or "junk" bond market which sustained its first annual loss this year since the end of the financial crisis. Due to better credit quality and less energy representation, the investment grade bond market held up much better in 2015, down less than 1%. We have sustained our underweight to the energy sector across both stocks and bonds, and will continue to do so in the near term.

As the presidential election cycle heats up we would be remiss not to mention the potential for politics to create some uncertainty in the latter half of 2016. Currently, there appears to be no strong consensus on who will emerge victorious from the primaries on either side, and any policy discussion has not been meaningful. Investors loathe uncertainty so, as we get closer to the election, we anticipate some politically-based volatility in both equities in fixed income. All else equal, we would expect markets to regain their footing once we gain clarity on who will occupy the White House.

Despite the poor performance to start this year, we believe that stocks can achieve modest gains in 2016. We've just completed a record year for merger and acquisition activity and we expect the trend to continue as companies look to put their cash hordes to work in an effort to bolster top line growth. Similarly, corporate boards will likely continue the record trend of authorizing the return of capital to shareholders via share repurchase programs. The domestic economy, particularly service-oriented industries, continues to grow at a modest pace and the yield curve, though flattening, has not inverted. Historically, the likelihood of entering a bear market in stocks while not in a recession and with a normal yield curve is low. Given the continued pressure on commodities and subsequent low inflationary outlook, we would expect the Federal Reserve to take a more dovish tone than their most recent forecast, which implied several rate hikes in 2016. Finally, we look for the pattern of companies beating lowered earnings expectations to continue. There should be fewer sequential headwinds from oil and the dollar and we would look for the market to reward companies that beat consensus revenue and earnings. As volatility persists, stock selection will be paramount.

Turning to fixed income, despite significant flattening in the 4th quarter, the yield curve remains poised to flatten further in 2016. The front-end will remain pressured by potential interest rate increases, while the long-end remains stable with minimal threats of inflation and the potential for further stagnant global economic pressures and upward pressure on the U.S. dollar. We will continue to take our cue from the U.S. Treasury market in this low rate environment, while supply/demand imbalances in the bond market remain a positive factor. Despite market expectations for at least two increases in the Fed Funds rate in 2016, benign inflation and lackluster global economic output drive our expectations for continued flattening of the yield curve. Therefore, we are maintaining our intermediate duration target and remain focused on individual credit selection.

As always, we welcome your comments and questions. Please contact us if there are any changes to your financial situation or investment objectives. Appleton is also now active on Twitter: follow us on Twitter at @AppletonPtnrs.