

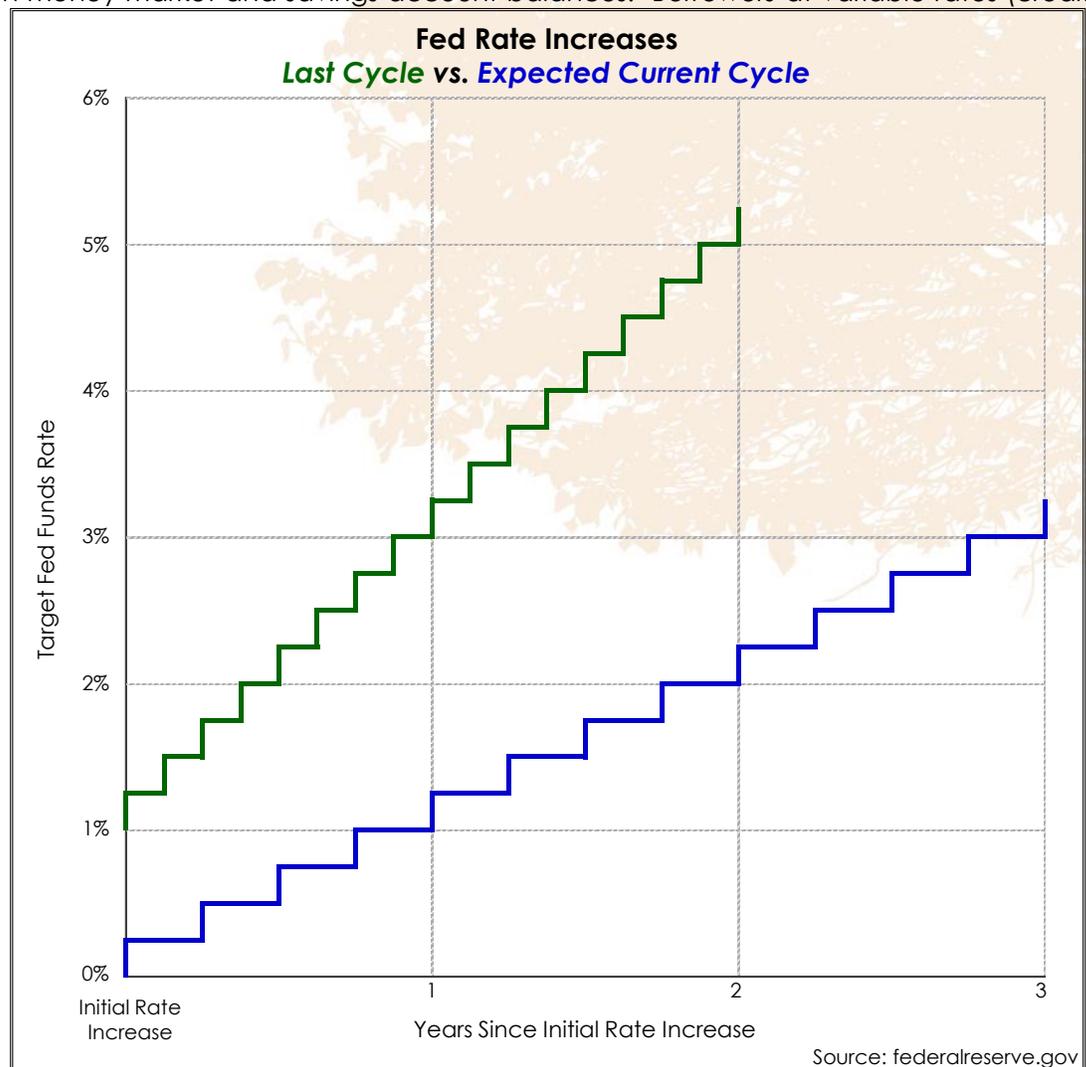
January 2016

**CAPITAL MARKETS UPDATE** | Equity markets bounced back from the third quarter sell off, though returns for the full year were weak. Global equities posted a modest loss (-2.4%) for the year with U.S. Large Cap narrowly positive (+1.4%). International was nearly break-even (-0.8%) while U.S. Small Cap (-4.4%) and Emerging Markets (-14.9%) struggled. Global bonds were also negative (-3.2%) due to the strong U.S. Dollar. The U.S. bond market offered little support (+0.6%). Real Estate did well (+3.2%) while Commodities did the worst in 2015 (-24.7%) led by the abrupt decline in the price of oil. The big news for the year: the Fed charted a new path for its monetary policy.

**HIGHER RATES AT LAST!** | After seven years of anchoring short-term interest rates at 0%, the Federal Reserve announced the beginning of a new rate hike cycle on December 16<sup>th</sup> and raised its target rate by 25 basis points (1/4 of 1%). The last time the Fed increased rates...nearly a decade ago (June, 2006)! Generally speaking, it is good news when the Fed decides to raise rates, especially from emergency levels. In fact, the Fed's December 2015 statement was upbeat, citing continuing improvements in the labor market and healthy economic activity. Hence, it was time (some would argue overdue) to remove emergency support for the economy and financial markets. At the outset, the anticipated effects are small. At the margin, savers should benefit from higher rates on money market and savings account balances. Borrowers at variable rates (credit cards, home equity lines of credit, some corporate loans) may pay modestly higher interest costs.

**WHERE DO WE GO FROM HERE?** | Looking out the windshield, we are most interested in the journey ahead for interest rates—what is the likely trajectory (how quickly will rates rise) and end point (how high will rates go)? Citing stubbornly low inflation, Janet Yellen and her colleagues at the Fed have gone out of their way to telegraph a slow and gradual pace for rate increases that will likely end at a lower level than in the past.

The chart at right offers some perspective by comparing the last rate hike cycle (green line) with the Fed's stated expectations for this time (blue line).



In the last cycle, the Fed robotically raised the Fed Funds rate by 25 basis points at each Fed meeting from June 2004 through June 2006. For the current cycle, the Fed expects to raise rates approximately 1% per year in 2016, 2017 and 2018. As a simplifying assumption, we have charted a 25 basis point increase at every other meeting. By following this cadence, the ending rates for one, two and three years out matches the Fed's median forecast.

As the graph suggests, the Fed expects the current rate hike cycle to be much more accommodative than the last cycle. The Fed expects to increase the Fed Funds rate by less (a cumulative increase of 3.25% vs. 4.25%), at a slower pace (over 3 years vs. 2 years) and stop at a much lower level (3.25% vs. 5.25%). All other things equal, the benign expected trajectory and end point for rates should continue to be supportive of the economy and financial markets. Bear in mind that these are only the Fed's current expectations for short-term rates—the actual path will depend on future data for the labor market, inflation and overall financial conditions; a bigger question is what happens with intermediate and long-term rates since Fed policy does not directly control those yields. As a side note, the market (Fed Funds futures) expects an even friendlier path for rates (more gradual and lower).

**FLOATING RATE SECURITIES ARE ESPECIALLY ATTRACTIVE** | Floating Rate Securities are a good diversifier in bond portfolios given their near-zero correlation to the Barclay's U.S. Aggregate Bond Index. Floating rate holdings are even more appealing in the current environment when the Fed is increasing short-term rates. As review, the investment vehicle we use is generically referred to as a *floating rate fund*. Specifically, this is a well-diversified portfolio of bank loans made to non-investment grade corporate borrowers. In the industry, these loans are referred to as *leveraged loans* since these corporations tend to borrow more (i.e., have greater financial leverage) than their investment grade counterparts.

The interest rate these borrowers pay consists of a base rate that floats with short-term market rates (e.g., LIBOR) plus a spread that provides additional compensation for the credit risk (the riskier the loan, the larger the credit spread). Currently, the mutual fund that we primarily invest in pays income of 4.3% and the loans in the portfolio are priced at an attractive discount of \$0.92 while contractually owed at \$1.00. In the table below, we calculate an annualized expected return of 5.4% through a full credit cycle assuming historical credit losses of 0.8% and no increase in short-term interest rates.

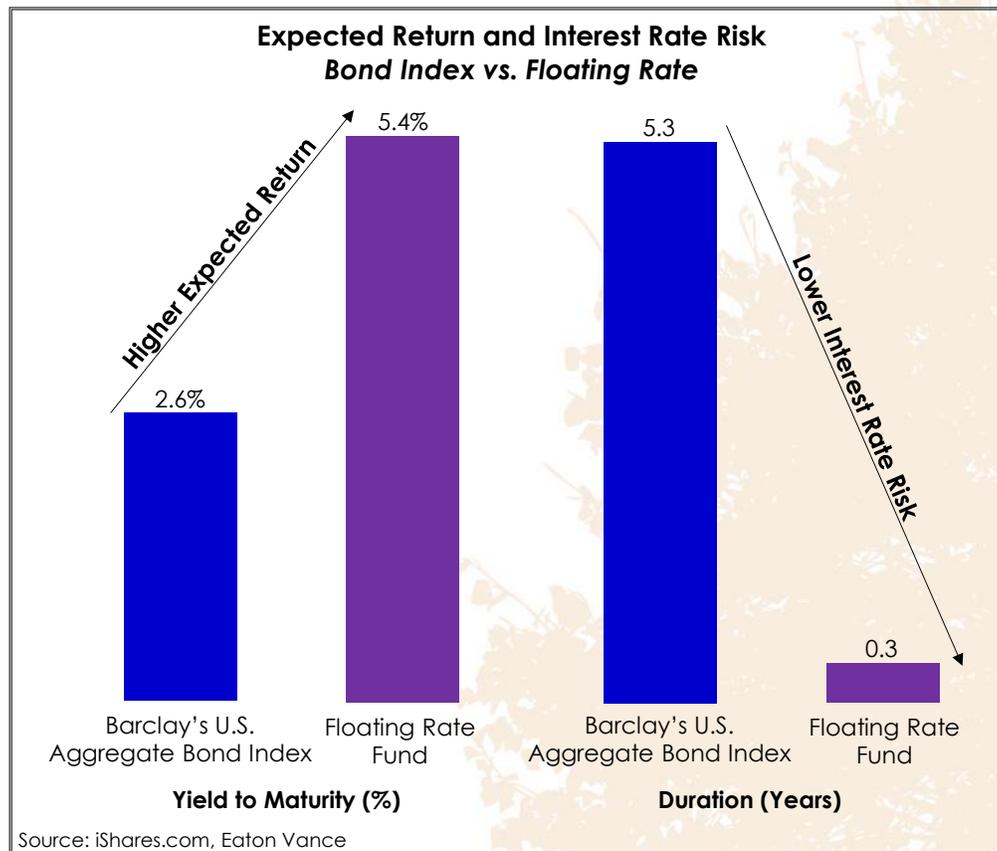
Expected Return	Notes
Income 4.3%	Current yield net of expenses
Capital Appreciation 1.9%	Annualized price gain from \$0.92 to \$1.00 over 4 ½ year average maturity
Potential Credit Losses (0.8%)	Historical annualized credit loss over full cycle
5.4%	

Source: Eaton Vance

After a few more Fed rate hikes, the base rate (LIBOR) should clear the 1% floor that is most often in place in these types of loans and the income paid should then rise in lockstep with future Fed rate increases, further boosting the return. Naturally, returns may be less if credit losses are higher than average.

Per the chart on the following page, Floating Rate Securities are indeed a compelling diversifier: they offer significantly higher expected returns and much lower interest rate risk than the U.S. bond market.

**TAX ITEMS** | Tax time is here again. Fidelity expects to have complete tax data by mid-February and will both post online and mail its annual Tax Reporting Statement at that time. This information is not distributed sooner in order to avoid a series of corrected tax reports (mutual funds often submit several amendments). This statement will provide information that you will need for your 2015 tax return including Form 1099 Dividends and Distributions, Interest Income, Realized Gains and Losses and Arbor's Investment Management Fees that are debited from taxable accounts. Some clients will also receive Form(s) 1099-R summarizing certain IRA activity. Separately, we will send you a summary of any charitable gifts of appreciated stock. Please let us know if you have any questions about your tax reporting. Thank you.



**QUALIFIED CHARITABLE DISTRIBUTIONS** | In 2016 and beyond, individuals at least age 70½ may take Qualified Charitable Distributions (QCDs) from Traditional or Rollover IRAs for payment directly to a qualifying charitable organization. To process the QCD, a check is issued directly from your IRA to the charity. Fidelity offers the following guidance on restrictions that apply to QCDs:

- A qualifying charitable organization is a public charity as described in IRC 170(b)(1)(A), but does not include donor-advised funds, supporting organizations, or private foundations.
- Only outright gifts are eligible; contributions to charitable gift annuities, charitable remainder trusts, pooled income funds, or other split-interest entities do not qualify.
- The amount of the distribution can be excluded from income up to a maximum amount of \$100,000 per year.
- The entire amount must otherwise be includable in income.
- The entire amount must otherwise be tax deductible as a charitable contribution.
- The amount of the distribution cannot also be taken as a charitable deduction.
- The amount distributed to the charity counts toward meeting the required minimum distribution for the year distributed.

Please consult your tax advisor to see if QCDs are an attractive option for you. In order to ensure that the charity issues a timely and correct donation receipt, we recommend processing these QCDs by early fall. Similar to stock gift reporting, Arbor will provide you a year-end summary of your QCDs to ease in tax preparation. Your advisor will be in touch prior to processing your required minimum distribution to discuss whether we may help you with QCDs in 2016.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Arbor Investment Advisors, LLC), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Arbor Investment Advisors, LLC. Please remember to contact Arbor Investment Advisors, LLC, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/reviving our previous recommendations and/or services. Arbor Investment Advisors, LLC is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of Arbor Investment Advisors, LLC's current written disclosure statement discussing our advisory services and fees continues to remain available upon request.