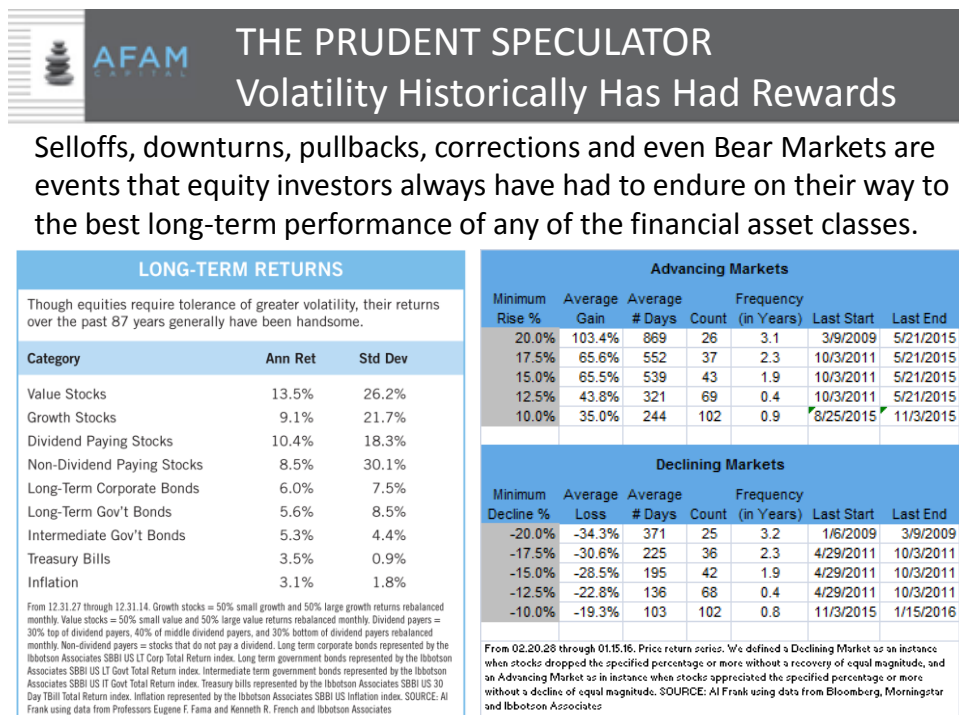


2016 Market Outlook

The following is an excerpt from our 2016 Market Outlook. To request a copy of the full report, please [click here](#).

PERSPECTIVE ON THE BIG JANUARY DOWNTURN

2016 got off to an awful start with the worst first two weeks in history, as evidenced by the 8.25% (more than 1,400 points) plunge in the Dow Jones Industrial Average. And the third week continued the turbulence with the Dow dropping an additional 500 points at one point on January 20. We provide additional perspective on the sell-off further below in our Market Outlook section, but we offer the reminder that downside volatility is not an unusual equity market characteristic with stocks enduring sizable setbacks at some point in time every year, including some where the gains for the full year were superb, with setbacks similar or greater in magnitude to the current downturn having occurred with regular frequency throughout market history and certainly during the nearly-four decades that we have been publishing The Prudent Speculator...



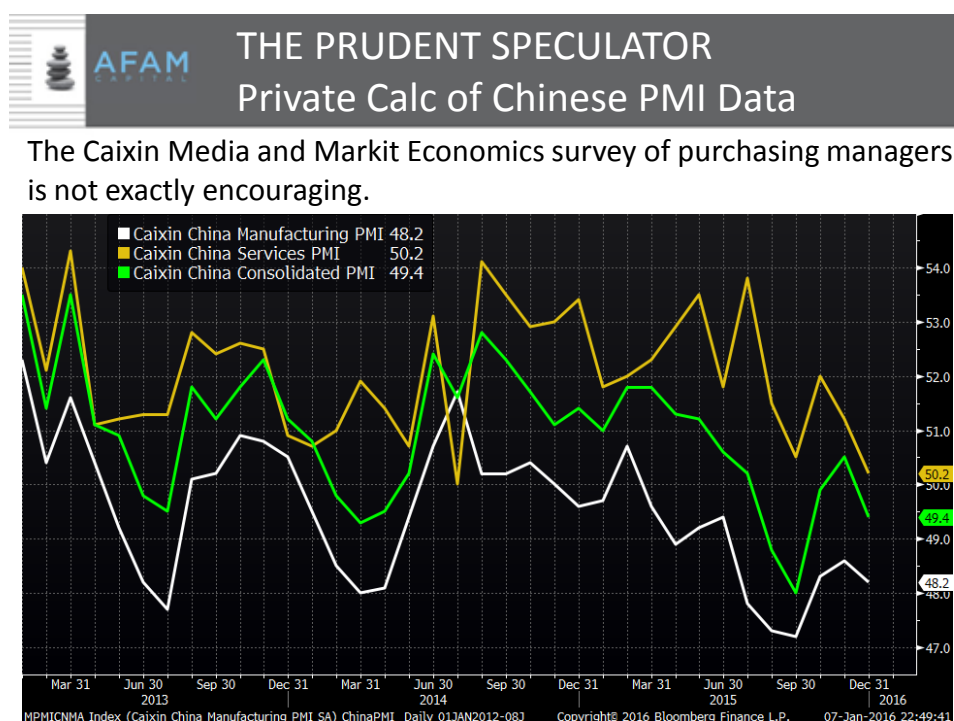
...and 10% corrections happening every 10 months on average and 20% Bear Markets taking place every 3.2 years. Happily, 10% and 20% advances have also occurred with equal regularity, with the winning periods gaining far more than the losing periods lose, providing historically handsome returns in the fullness of time to those who have been able to keep their emotions in check, stay focused on their long-term objectives and resist the temptation to bail out after a big downturn has taken place.

After all, as Lao Tzu once said, "If you do not change direction, you may end up where you are heading." And for those who prefer even more concrete evidence in support of staying the course during times of turmoil, we offer historical subsequent return numbers following periods when investor sentiment has headed south.

CHINA PERSPECTIVE

Incredibly, the China Securities Regulatory Commission was quick to suspend the pair of new 5% and 7% “circuit breakers” for the always volatile Shanghai Composite Index that had been instituted just four days earlier. The 7% trigger was hit both on January 4 and January 7, halting trading each day, with selling no doubt exacerbated by the devaluation of the yuan and changing restrictions on the sale of stocks by large shareholders. Needless to say, it is tough to invest when the rules of the game are constantly changing.

Frankly, it has always been tough to invest in China, given the lack of transparency and consistency in financial filings, not to mention the fact that few have faith in the “official” economic numbers put out by a government that constantly seeks to “manage” the economy. On that point, consider that Beijing reported a surprisingly sharp increase to 54.4 in the most recent measure of the health of the service sector known as the non-manufacturing PMI...



...while the privately compiled Caixin Media and Markit Economics survey of purchasing managers showed a modest decline to a 17-month low of 50.2 in December, down from 51.2 a month earlier. The Caixin manufacturing purchasing managers’ index also decreased slightly to 48.2 last month, down from a five-month high of 48.6 in November, and below the “official” reading of 49.7. Believe it or not, both sets of PMI figures were not far off the range of expectations...

AFAM THE PRUDENT SPECULATOR
Services Growing Importance in China

China % Composition of Gross Domestic Product							
	Primary Industry	Secondary Industry	Tertiary Industry		Primary Industry	Secondary Industry	Tertiary Industry
	Agriculture	Manufacturing & Construction	Services		Agriculture	Manufacturing & Construction	Services
				1996	19.7	47.5	32.8
				1997	18.3	47.5	34.2
1978	28.2	47.9	23.9	1998	17.6	46.2	36.2
1979	31.3	47.1	21.6	1999	16.5	45.8	37.8
1980	30.2	48.2	21.6	2000	15.1	45.9	39.0
1981	31.9	46.1	22.0	2001	14.4	45.2	40.5
1982	33.4	44.8	21.8	2002	13.7	44.8	41.5
1983	33.2	44.4	22.4	2003	12.8	46.0	41.2
1984	32.1	43.1	24.8	2004	13.4	46.2	40.4
1985	28.4	42.9	28.7	2005	12.1	47.4	40.5
1986	27.1	43.7	29.1	2006	11.1	47.9	40.9
1987	26.8	43.6	29.6	2007	10.8	47.3	41.9
1988	25.7	43.8	30.5	2008	10.7	47.4	41.8
1989	25.1	42.8	32.1	2009	10.3	46.2	43.4
1990	27.1	41.3	31.5	2010	10.1	46.7	43.2
1991	24.5	41.8	33.7	2011	10.0	46.6	43.4
1992	21.8	43.5	34.8	2012	10.1	45.3	44.6
1993	19.7	46.6	33.7	2013	10.0	43.9	46.1
1994	19.9	46.6	33.6	2014	9.2	42.7	48.1
1995	20.0	47.2	32.9	2015	8.0	40.6	51.4

Source: National Bureau of Statistics of China. 2015 Data as of Q3.

...and it is somewhat reassuring that the services sector has become a much more important component of GDP growth in China. To be sure, we are not suggesting that Chinese growth is not slowing from a torrid to a merely robust pace. But this is hardly a surprise given the law of large numbers as the country has grown so rapidly that it is now rivaling the U.S. for the title of the world's largest economy. And though we respect that the World Bank trimmed its forecast for Chinese real (after inflation) GDP growth this year to 6.7%, the giant-Asian economy is hardly falling off a cliff, especially given that the 2016 outlook for global GDP growth is "just" 2.9%.

AFAM THE PRUDENT SPECULATOR
Global Growth Projections

	2013	2014	2015e	2016f	2017f	2018f
REAL GDP (% change)						
World	2.4	2.6	2.4	2.9	3.1	3.1
High income	1.2	1.7	1.6	2.1	2.1	2.1
United States	1.5	2.4	2.5	2.7	2.4	2.2
Euro Area	-0.2	0.9	1.5	1.7	1.7	1.6
Japan	1.6	-0.1	0.8	1.3	0.9	1.3
United Kingdom	2.2	2.9	2.4	2.4	2.2	2.1
Russia	1.3	0.6	-3.8	-0.7	1.3	1.5
Developing countries	5.3	4.9	4.3	4.8	5.3	5.3
East Asia and Pacific	7.1	6.8	6.4	6.3	6.2	6.2
China	7.7	7.3	6.9	6.7	6.5	6.5
Indonesia	5.6	5.0	4.7	5.3	5.5	5.5
Europe and Central Asia	3.9	2.3	2.1	3.0	3.5	3.5
Turkey	4.2	2.9	4.2	3.5	3.5	3.4
Romania	3.5	2.8	3.6	3.9	4.1	4.0
Latin America and the Caribbean	3.0	1.5	-0.7	0.1	2.3	2.5
Brazil	3.0	0.1	-3.7	-2.5	1.4	1.5
Mexico	1.4	2.3	2.5	2.8	3.0	3.2
ME and North Africa	0.6	2.5	2.5	5.1	5.8	5.1
South Asia	6.2	6.8	7.0	7.3	7.5	7.5
India	6.9	7.3	7.3	7.8	7.9	7.9
Pakistan	4.4	4.7	5.5	5.5	5.4	5.4
Sub-Saharan Africa	4.9	4.6	3.4	4.2	4.7	4.7
South Africa	2.2	1.5	1.3	1.4	1.6	1.6

Source: World Bank January 2016

The amount of consternation surrounding China and its economy is fascinating, given that the latest, admittedly just reduced, projections for GDP growth from the World Bank for the Middle Kingdom still stand at 6.5% or better for each of the next three years.

LOOKING TOWARDS THE FUTURE

Standard & Poor's itself is presently projecting that bottom-up operating earnings per share for the S&P 500 will rise to \$124.13 in 2016, up from an estimated \$106.42 in 2015. Certainly, we are well aware that earnings projections have been coming down for quite some time, and we are highly skeptical about the \$141.11 EPS number currently being predicted for 2017, but it is hard to envision stocks staying down for long if bottom-lines are growing.

AFAM THE PRUDENT SPECULATOR Solid EPS Growth Still Expected

There is plenty of consternation about the health of corporate profits, but Standard & Poor's presently expects EPS for the S&P 500 to rise to \$124.13 this year, up from \$106.42 in 2015. Bloomberg is a bit more cautious, but the data provider's 2016 estimate still stands at \$122.97.

S&P 500 Operating Earnings (Bottom Up)									
OBSERVATION	Q3,'15	Q4,15	2015 EST	2016 EST	2017 EST	PRICE	2015 P/E	2016 P/E	2017 P/E
3/31/2014	34.74	36.95	137.19			1872.34	13.6		
6/30/2014	34.86	36.75	137.52			1960.23	14.3		
9/30/2014	34.28	36.43	136.07			1972.29	14.5		
12/31/2014	33.35	34.81	130.99			2058.90	15.7		
3/31/2015	30.49	32.01	118.36	134.75		2067.89	17.5	15.3	
6/30/2015	29.75	31.49	115.47	132.36		2063.11	17.9	15.6	
9/30/2015	28.55	30.28	110.78	129.32		1920.03	17.3	14.8	
12/31/2015	25.44	29.00	106.38	125.56		2043.94	19.2	16.3	
Current	25.44	29.04	106.42	124.13	141.11	1880.33	17.7	15.1	13.3

Source: Standard & Poor's (estimates as of 1.14.16)

We expect volatility to remain elevated and we have quite a hurdle to overcome after the first two weeks of trading this year, but our long-term faith is always supported by the financial fundamentals that serve as the foundation of our analytics.

AFAM THE PRUDENT SPECULATOR Lengthening the Hold Lowers the Risk

The odds of making money in stocks very much favor those with a long-term investment time horizon and a Value-focused investment strategy.

VALUE STOCKS				GROWTH STOCKS			
	Count >0%	Count <=0%	Percent Positive		Count >0%	Count <=0%	Percent Positive
1 Month	669	392	63.1%	1 Month	631	430	59.5%
3 Months	724	335	68.4%	3 Months	686	373	64.8%
6 Months	752	304	71.2%	6 Months	720	336	68.2%
1 Year	779	271	74.2%	1 Year	764	286	72.8%
2 Year	882	156	85.0%	2 Year	816	222	78.6%
3 Year	901	125	87.8%	3 Year	835	191	81.4%
5 Year	909	93	90.7%	5 Year	853	149	85.1%
7 Year	945	33	96.6%	7 Year	909	69	92.9%
10 Year	908	34	96.4%	10 Year	902	40	95.8%
15 Year	882	0	100.0%	15 Year	882	0	100.0%
20 Year	822	0	100.0%	20 Year	822	0	100.0%

From 07.31.27 through 11.30.15. Value stocks are represented by 50% small value and 50% large value returns rebalanced monthly. Growth stocks are represented by 50% small growth and 50% large growth returns rebalanced monthly. SOURCE: AI Frank using data from Professors Eugene F. Fama and Kenneth R. French

Lots still to worry about...as is always the case...but for those that share our lengthy time horizon, we will simply ride through the inevitable ups and downs, just as we have done for each of our 38 years.

To download the full 2016 Market Outlook, please [click here](#).

Important Information:

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