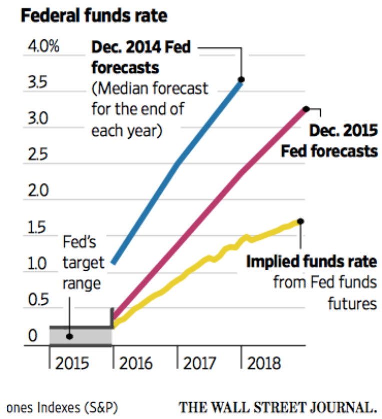

Despite rampant pessimism following the broader market's first annual decline since the financial crisis, the US economy, corporate profits and stocks are poised for growth. As unemployment falls through 5%, wage growth will boost inflation, strengthening consumer spending, home sales and eventually business investment. Furthermore a weaker dollar will give inflation and corporate profits much needed breathing room. Chinese volatility and Fed indecisiveness will continue to shock an internally weak market just as they did this fall, however consumption and inflation will drive equities higher over the long term.

US investors are worried over feeble market breadth, maturing credit markets, and elevated stocks prices as this bull market enters its 7th year. The S&P 500's valuation has become stretched as the index trades within 4% of its record high, currently priced at 18.1x trailing earnings (15.7x avg.) on profits of $109 this year and $120 in 2016 (GS). Similarly not all stocks have participated in the market's success, with 30% of the S&P 500's, 37% of the S&P 400 and 46% of the S&P 600 small cap index currently in bear market territory (Barron's).

Mirroring weakness in stocks, credit spreads have widened for a second year as the credit cycle matures, with corporate bonds returning -1% and junk bonds -5% in 2015 (Barclays, total returns). Nevertheless recent junk bond carnage has remained contained to the energy and mining sectors, comprising 15% or the market, while selling has been unfairly exaggerated by end of year tax loss harvesting. Highlighting concerns, the 2-10 treasury yield curve at one point last week touched its lowest level since 2007 (117bps), even though the movement was influenced more by dormant inflation than weak demand.

Despite 3 years of higher inflation expectations, prices appear ready to turn a corner in 2016. Currently the Atlanta Fed estimates the typical workers wage is growing at a 3.1% rate, up from 2.2% in early 2014. With all 12 Fed regions noting strong labor conditions and home prices 5-6% higher nationwide, price pressures are undeniably building. A weaker dollar will also help.

HSBC is the only bank (out of the top 11) to forecast the dollar falling against the euro in each of the next 4 years, and history serves them right. The Euro's (previously Deutschmark) and dollar's respective central banks have had opposing rate strategies 11 times since 1971, with the average divergence lasting 17 month (Fundstrat). Contrary to expectations, the dollar actually fell 6.6% (median) during this time. Given the overwhelming expectations for Euro weakness one cannot help but be a contrarian. It takes one glance at the euro's reaction to the ECB's December 3 meeting to see just how crowded the long dollar / short euro trade has become.

Any halt to the dollar's rally will take pressure off of emerging markets, which will turn into bargains as their growth accelerates for the first time since 2010, from 4% in 2015 to 4.5% in 2016 (IMF). Similarly dollar weakness will take some pressure off commodities, consequently helping these commodity dependent emerging markets.

Beyond endogenous shocks, the Fed's 4 expected rate hikes in 2016 have been cited as the greatest reason for market weakness in 2016. Prognosticators forget that the Fed will only raise rates when the economy permits. Furthermore stocks have ended up flat to higher during the initial stages of the 3 most recent tightening cycles (1994, 1999 & 2004).

More important than the Fed will be the US consumer. Consumers have money to spend with savings at a 2-year high (5.5%) and household wealth at record levels ($85.2 trillion) due to rising stock and home prices. With consumer confidence and credit at post-recovery highs, any increase in wages in 2016 will undoubtedly translate into higher consumption and economic growth.

Investors are better fear mongers than optimists. "Over the course of the VIX's history, investors have anticipated that volatility in the S&P 500 would be about 26% higher than it has turned out to be… in only one year -2008- has volatility ended up higher than predicted (Barron's)." Traders are already bracing for the worst, with VIX futures for July, August, and September pricing in a 19% jump from current levels. Given mainstream expectations for market declines / volatility, while remembering that market's peak when least expected, a contrarian approach seems warranted.