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Market Commentary

Spring 2016

Q1 Key Takeaways

- It was a tale of two halves in the first quarter of the year for global financial markets. Stock markets plunged early on, falling 10% to 16%, depending on the index one looked at.

- Then, beginning on February 12, everything changed. Oil prices spiked higher, stock markets rallied, and the dollar declined.

- The rally continued in March, on the back of better economic news in the United States and the Federal Reserve's decision to not raise the federal funds rate while lowering its projection for the number of rate hikes for the remainder of the year.

- Looking ahead, however, with consumer price inflation and market inflation expectations rising, stock and credit markets and oil prices rebounding, and the dollar no longer appreciating, the Fed may soon again turn more hawkish.

- Generally, we'd note that global monetary policy is moving deeper into uncharted, historically unprecedented territory, bringing with it unknown and unintended consequences. How and when will the current extreme monetary policy will be "normalized" and how will they impact the global economy and financial markets, no one knows.

Q1 Investment Commentary

It was a tale of two halves in the first quarter of the year for global financial markets. Stock markets plunged early on, falling 10% to 16% or more, but then sharply reversed, staging a furious rally into quarter-end. Emerging-markets stocks led the charge, gaining 5.9% for the quarter. Larger-cap U.S. stocks also finished in the black, up 1.3%, though domestic small-cap stocks trailed, down 1.5%. Developed international stocks also failed to keep pace in the rally, ending with a 1.9% loss for the quarter. While the 10-year Treasury yield rose around 15 basis points from its mid-quarter low, it was still 49 bps below where it started the year. As such, core bonds have gained 3.1% year to date.

Broadly speaking, the stock market decline in the first half of the quarter was due to:

- Ongoing fears of a hard landing in the Chinese economy, possibly accompanied by a sharp and sudden devaluation of the renminbi;
- A continuing plunge in oil prices to under $30 per barrel (bbl), using the WTI benchmark, from $40 at the start of the year;
- Some weaker-than-expected U.S. economic data and growing fears of a global recession, if not also a U.S. recession; and
- A contagious loss of market confidence (whatever little remained) in the ability of global central banks to stimulate real economic growth and increased concern that current monetary policies (e.g., negative interest rates in Japan and Europe) are now causing more harm than good.

On the last point, the Bank of Japan(BOJ) surprised markets by joining the negative interest rate policy (NIRP) club at the end of January. NIRP: a negative interest rate policy is an unconventional monetary policy tool whereby nominal target interest rates are set with a negative value, below the theoretical lower bound of zero percent. The BOJ pushed its policy rate down

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to negative 0.1%, joining the European Central Bank, which later lowered its rate to minus 0.4% in March. (Swiss, Swedish, and Danish central banks have policy rates ranging from negative 0.5% to negative 0.75%). Rather than having the intended effect of weakening the yen, Japan's move had the opposite effect, and helped trigger another leg down in global stocks and other risk assets.

Then, beginning on February 12, everything changed. Oil prices spiked higher. Stock markets started moving higher. The renminbi stabilized, then started appreciating a bit. High-yield bond prices started moving higher and credit spreads fell. Core bond prices fell and the 10-year Treasury yield moved higher. These broad market trends continued through March, as shown in the table below.

A Tale of Two Halves

Asset Class	1/1/16-2/11/16	2/12/16-3/31/16	YTD 2016
U.S. Stocks	-10.3%	12.9%	1.3%
Developed Int'l Stocks	-12.2%	11.8%	-1.9%
European Stocks	-12.1%	11.3%	-2.2%
Emerging-Markets Stocks	-10.9%	18.8%	5.9%
Core Bonds	2.4%	-0.7%	3.1%
High-Yield Bonds	-5.1%	8.8%	3.2%
Floating-Rate Loans	-1.4%	3.0%	1.5%
Managed Futures	9.0%	-5.4%	3.1%

Source: Morningstar. Data as of 3/31/2016.

As is often the case, there was no single obvious catalyst for the turnaround that began on February 12 other than speculation in the news that major oil producers might be ready to cooperate to cut oil output. At the same time, the head of the Federal Reserve Bank of New York dismissed the likelihood the Fed would need to adopt NIRP given the U.S. economy's strength and momentum. Then, over the following weekend, the Chinese central bank stated it saw no basis for further yuan depreciation.

The rally continued in March on the back of better economic news in the United States. Markets also reacted positively to dovish ECB and Fed actions during the month, as well as additional monetary and fiscal stimulus in China. On March 10, the ECB went deeper into negative rates, cutting its policy rate to negative 0.4%—its third rate cut since adopting NIRP in June 2014. The ECB also expanded quantitative easing bond purchases by €20 billion per month (to €80 billion) and will also now include investment-grade non-bank corporates in the program, boosting prices for such bonds. Finally, it initiated a new program of targeted long-term refinancing operations, where it will lend money at zero or negative interest rates to banks that increase their lending to the private sector. This should mitigate some of NIRP's negative effects on bank profits, the fear of which had been driving European bank stock prices sharply lower this year.

In the United States, the Federal Open Market Committee held its mid-March meeting and did not raise the federal funds rate, stating that "global economic and financial developments continue to pose risks." It also highlighted solid U.S. economic fundamentals. The FOMC also lowered its projection of the number of rate hikes for the rest of the year (from four to two) and longer term, communicating both a slower pace and a lower trajectory of rate hikes than what it had projected in December. This was broadly consistent with the market's views (e.g., as reflected in Treasury futures markets), which had already discounted a high likelihood of just one or two hikes this year.

Financial markets responded positively to the Fed announcement, with stocks and oil/commodities continuing to rally and the dollar falling. After peaking in late January, the dollar (whose prior rise was likely driven in part by anticipated higher U.S. rates) ended the quarter down more than 4% for the year.

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Looking ahead, however, with consumer price inflation and market inflation expectations rising, stock credit markets and oil prices rebounding, and the dollar no longer appreciating, the Fed may soon turn more hawkish again. (In fact, just a few days after the March announcement, several Fed governors suggested the Fed could raise rates at the April meeting.) This could trigger market reactions that reverse these recent reflationary trends.

Generally, we'd note that global monetary policy is moving deeper into uncharted, historically unprecedented territory (i.e. negative interest rates), bringing with it unknown and unintended consequences. This continues to be a key uncertainty and risk as we construct and manage investment portfolios for a range of potential outcomes. How and when will the current extreme monetary policy will be "normalized" and how will they impact the global economy and financial markets, no one knows.

Market Outlook

In our prior commentary, we stated that the market was too focused on the drop in oil prices and that a recovery in oil would provide an opportunity in stocks. Such was the case as the market's sharp rebound was in concert with the recovery in oil. Our investment outlook—both in terms of potential return drivers and risks—has not materially changed over the past quarter. We still feel the market will follow earnings growth of 6% by year end resulting in a total return (dividends) in the upper single digit range.

From a valuation perspective, the S&P trades at 16.6x forward earnings, just a 5.1% premium to the 25-year average.

The debt market are fascinating and we believe have surprised more investors than the stock market. Who would have ever thought there would be bonds issued at negative interest rates? This is definitely uncharted waters and something not covered in business school text books. As a result, we are not confident anyone can predict the ultimate impact a negative interest rate policy will have. One thing seems certain, that interest rates are going to remain low for a while. The current ten year US Treasury yield of 1.74% is *attractive* compared to the less than 1% yield on 60% of all outstanding government loans (half of which have negative interest rates). In fact, in Switzerland, you can buy the 15-year treasury bond and "earn" an annualized return of -0.13%!

You may wonder who buys bonds that have a negative yield? We see two kinds of investors. First, if you are a wealthy citizen of Russia, paying -0.13% per year is a small insurance premium to keep your wealth tied up in a more stable currency. Secondly, if you are a bank in Europe and the European Central Bank (ECB) is going to fine you 0.50% for excess reserves, wouldn't it be cheaper not to put the money with the ECB, but to loan it to a client at -0.25%? As we stated, the debt markets are fascinating!

Even at low rates, bonds are still important for a range of clients. In the US investment grade corporate debt market, five-year paper will give you a total return of over 2.5%. High yield spreads can be 2-3x the investment grade yield and can be appropriate if one has the risk tolerance for them and can diversify. Additionally, if rates continue to decline, the total return on bonds will go higher, as they have in 2016, possibly shrinking the opportunity cost of not being fully invested in equity with much less risk.

Concluding Comments

The below historical calmness of the markets the past five years has given way to slowing economies and unprecedented central bank policies across the globe. The market volatility experienced in the past 8 months

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has garnered the attention of most investors following the market significantly aided by the relentless media coverage. Despite that volatility, the Dow Jones and S&P 500 are just 3.4% and 3.3%, respectively, off the all-time highs seen in 2015. The U.S. markets have been resilient and we believe performance comes down to earnings which are projected higher in 2016.

We understand that headlines such as negative interest rates and volatile markets can rattle one's investment resolve, as can presidential elections and terrorist actions. That is why it is so important to have a portfolio that reflects one's risk tolerance. If the two are out of line, emotions take over and can badly influence one's decision making. It is better to have the two "properly in sync" so that it is easier to ride out the volatility that is inherent with investing. This allows an investor to maintain the discipline that is essential to the process of building wealth.