VOLATILE QUARTER SAW SOME COUNTER-TREND RALLIES

The year began with concerns about excess oil inventories, falling Chinese growth, and a fall in China’s foreign exchange reserves. Oil prices fell 30 percent in the first six weeks of the year, to $26 a barrel. High-yield bonds followed oil prices lower as investors worried about defaults on debt issued to low-rated energy companies. Stocks also fell and were down by more than 10 percent by mid-February. However, as U.S. oil production began to show signs of decline and there was increased chatter about a potential production freeze by OPEC countries, prices began to recover. Prices were further supported by a weakening dollar caused by the Federal Reserve’s announcement that it would raise rates only twice this year. Earlier the Fed had suggested four rate hikes in 2016. Risk assets such as global equities and high-yield bonds recovered along with oil prices and ended up posting gains for the first quarter. For the first time since 1933, the S&P 500 ended in positive territory for the quarter despite experiencing an intra-quarter decline of over 10 percent.

In addition to volatility, the first quarter saw many counter-trend rallies, beginning with the U.S. dollar. The Dollar Index, which rose 9.3 percent in 2015 against a basket of major currencies, fell 6.4 percent in the first quarter of 2016. This was the worst calendar quarter performance for the dollar since September 30, 2010. Central bank actions to alleviate some of the financial stress were primarily responsible for this. As the dollar weakened, some of the asset classes which had suffered as a result of a strong dollar reversed course. Gold, whose prices had languished for several years, rose 16.7 percent. Similarly, emerging market stocks, bonds, and currencies also did well.

STOCKS: EMERGING MARKETS SNAP BACK

Emerging markets outperformed developed markets in the first quarter of 2016. A weaker U.S. dollar, along with a rebound in commodity prices, provided a lift to emerging market currencies and commodity-centric emerging market economies like Brazil and Russia. The MSCI Emerging Markets stock index returned 5.7 percent for the first quarter, compared to the Standard & Poor’s 500-stock index which delivered a total return of 1.35 percent, and the MSCI All-Country World Index-ex U.S. which fell 0.2 percent. Large company stocks continued to outperform stocks of smaller companies, suggesting that the bull market is maturing. The Russell 2000-stock index of small companies fell 1.5 percent. Strength in currencies such as the euro and yen hurt export-driven, developed international markets. Japan was down 6.5 percent for the quarter.

As bond yields fell, sectors with high dividend yields such as telecom and utilities outperformed. Stocks in these sectors offer better yields than bonds with the potential for growth. Cyclical sectors also experienced positive performance after significant declines in 2015. Industrials, energy, and materials were all positive performers during the quarter as a result of rebounding commodity prices and a weaker dollar. Health care and financials were laggards. Health care’s underperformance was a reversal in trend as money flowed into sectors that had underperformed in 2015. Weaker investment banking revenues and lower rate expectations created pricing pressure for financial stocks.
BONDS: A DOVISH FED DROVE STRONG RETURNS
At its FOMC policy meeting in March, the Federal Reserve kept its target for the Fed Funds rate unchanged and lowered its outlook for subsequent rate hikes in 2016. Janet Yellen commented on slow growth in Europe and China along with depressed conditions in the oil industry as headwinds for U.S. growth. She was also not convinced that the recent uptick in inflation was sustainable.

Bonds rallied on the news, yields fell across the yield curve, and all major bond indices posted positive returns for the quarter. Long-term U.S. Treasury yields posted their steepest decline in more than three years. The 10-year Treasury bond settled at 1.78 percent at the end of the quarter, down sharply from 2.27 percent at the end of 2015. Not surprisingly, long duration bonds were the best performers for the quarter. The Long Government/Credit index returned 7.3 percent compared to the Barclays U.S. Aggregate bond index returns of 3.0 percent. Corporate bonds also did well. Investment grade corporates returned almost 4 percent while high yield returned 3.35 percent. The high yield sector exhibited unusually high volatility, with spreads over comparable Treasury securities widening to a high of 839 basis points before tightening and finishing the quarter at +656. Much of the rise and fall in high yield has been in the CCC and lower component of the sector. This contains most of the low rated energy companies.

COMMODITIES AND CURRENCIES: GOLD SHINES
Gold prices rose 16.7 percent during the first quarter. This was the best quarterly gain for the metal since 1986 and a reversal of the trend in prices which have been in decline for much of the past five years. Most of gold’s gains came during the early part of the year when risk assets such as stocks sold off. Gold often acts as a safe haven during turbulent times. But the precious metal held on to its gains as the central bankers embraced further monetary easing. The Bloomberg UBS commodity index, which tracks 22 commodities, was up only a modest 0.4 percent for the first quarter of 2016. A dovish Fed helped weaken the dollar providing much-needed relief to emerging market currencies. Firming of commodity and particularly oil prices also helped the Brazilian real and Russian ruble gain 10.3 percent and 7.5 percent against the dollar.

OUTLOOK 2016
The U.S. economy appears to be growing at an annual rate of about two percent. The job market is strong, the unemployment rate has ticked down to 5 percent, and wages and inflation appear to be headed higher. However, the Federal Reserve has said that it will be slow to raise rates in 2016 because “global financial and economic developments continue to pose risks.” Rates in Europe and Japan appear headed further into negative territory and Chinese growth is slowing. The bond market too expects one or maybe two rate hikes this year.

The policy to raise rates slowly is aimed at preventing a sharp appreciation in the dollar and is supportive of stabilizing commodity prices and emerging market currencies. The Fed appears to be willing to accept that as a result, inflation in the U.S. might trend higher than its stated target of two percent. Despite that, we believe negative rates in Europe and Japan and continued slowdown in China, should spur demand for U.S. bonds and keep a lid on yields. Investment grade corporate bonds are attractively valued and should do well. However, credit conditions for low-rates companies are expected to deteriorate further and we would be underweight high-yield bonds.
The equity bull market is entering its seventh year and we expect muted results for U.S. stocks. High valuations, peak margins, and flat-to-low single digit earnings growth for the S&P 500 all pose challenges. We believe international equities, particularly Europe, should do better in their local currencies. Valuations are cheaper than the U.S., and the European Central Bank remains accommodative. Within the U.S., stocks of large companies should continue to do better than small companies. The technology, healthcare, and consumer sectors should benefit from stronger growth in jobs and wages, lower oil prices, and secular trends from the Affordable Care Act.

Emerging market stocks, currencies, and local bonds have been hurt by a stronger dollar, weak commodity markets, and slowing growth. Deteriorating credit quality of many government and corporate borrowers in emerging markets also signals possible trouble ahead and we are not expecting a turnaround except in select countries. Over the long term, emerging market stocks offer some of the best risk-adjusted returns.

A slowdown in the Chinese economy and excess supply are not great for commodities. China’s economy is slowly transforming from investment spending to consumer spending, which will continue to be a headwind for commodity prices. Low oil prices may be with us for a while. While U.S. output is down, it is being replaced by increased pumping from OPEC and new supply from countries like Iran. Oil inventories remain high and prices should remain contained until excess capacity is removed.

**KEY RISKS:**

- **China** — a hard landing in China poses one of the biggest risks to stocks and other risk assets.
- **Federal Reserve** — if forced to tighten at a rate that is faster than what the market expects.
- **U.S. Presidential Elections** – the uncertainty of the outcome is often a cause of volatility and puts a lid on market gains.
- **Geopolitical Risk** - emanating primarily from the Middle East, but also Russia and North Korea.