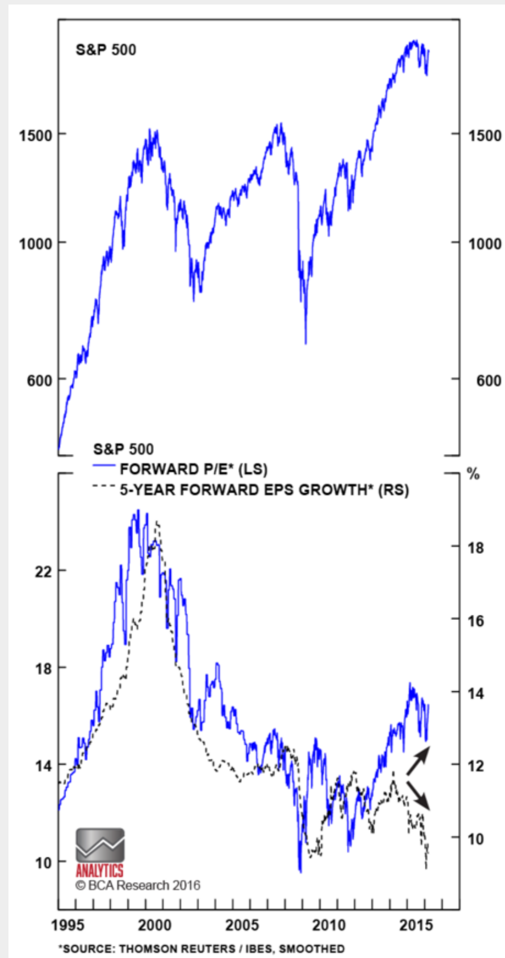
first quarter 2016

INVESTMENT *perspective*

The first quarter of 2016 continued the volatile trading pattern equity markets have experienced since August of 2015. During the quarter, the S&P 500 fell in excess of 10% before bottoming in early February and rallying to generate a modest gain for the quarter of less than 1%. Equity volatility in the small cap universe was more pronounced with the Russell 2000 index declining 16%, before bottoming and ending the quarter with a loss of approximately 2%. So, what is driving the equity market volatility for the last six to eight months and what should we expect as we move through 2016?

Tightening monetary conditions that began in mid-2014 and led to the strong rally in the U.S. dollar created a bifurcated equity market that reached its peak divergence in July of 2015. For the first half of 2015, companies with limited exposure to foreign markets, to commodities, and to tightening credit conditions (referred to as growth/defensive companies) significantly outperformed the companies with such exposure (referred to as cyclical companies). Relative valuation and sentiment became excessive early in the third quarter of 2015. Optimism for U.S. dollar strength continued to build through the end of 2015 and also became excessive. The correction in risk assets, including currency markets, over the last six to eight months has restored the relative valuation balance between growth/defensive companies and cyclical companies. The correction has also restored balance between developed and emerging markets and reduced some of the excessive optimism for continued U.S. dollar strength.

CHART 1



Post the volatility of the last six to eight months, the relative valuations across equity markets are balanced but are not necessarily more attractive. With markets virtually unchanged since year end, but 2016 earnings expectations actually declining, equity valuations have increased **(Chart 1)**. The primary driver of the equity market recovery from the initial decline in the first quarter of 2016 was a loosening of monetary conditions caused by declining credit spreads and a falling U.S. dollar. In order for equity markets to maintain current levels and ultimately move higher we will need to see economic fundamentals and earnings expectations begin to rise in line with the improving monetary conditions. With balance in valuation and sentiment restored across equity markets, earnings fundamentals will become the primary driver of equity prices instead of market positioning and sentiment as has been the case for the last six to eight months.

There are reasons to be optimistic regarding an improvement in economic fundamentals and earnings expectations in the latter half of 2016. Employment growth and real wage gains continue to be supportive of further economic improvement. The biggest headwind to economic activity is the destocking of inventories across the global economy. Should inventories become balanced with final demand and should oil prices increase further in 2016, the equity market will discount accelerating real economic growth and a modest increase in inflationary pressures which should lead to rising equity markets.

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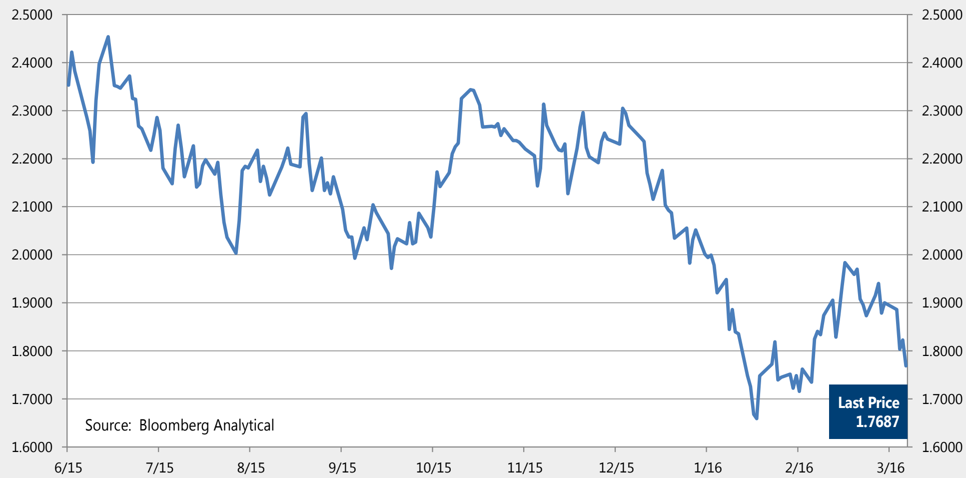
The Federal Reserve still has an important role to play in the equity market recovery even if their monetary tools are much less impactful. Equity markets will need confirmation from the Federal Reserve's actions more so than their rhetoric that the Federal Reserve's monetary policy will lag an economic and inflationary recovery. Should the Federal Reserve's "normalization" of interest rates prove too aggressive it will place upward pressure on the U.S. dollar and interest rates, which would again tighten monetary conditions and pressure equity markets.

As the nature of the market continues to change there are still individual stocks that will perform well over the medium term despite the increasing market headwinds. Our outlook has become more balanced, stock-specific, and not reflective of opportunities in specific industries, regions of the world, or broader market indices.

Within fixed income, the 10-year Treasury bond yield declined 50 basis points from 2.27% to 1.77% during the quarter **(Chart 2)**. Investment grade corporate spreads were volatile starting the year 173 basis points wider than Treasuries then widening to 210 basis points before rallying to end the quarter 172 basis points wider than Treasuries.

CHART 2
10-Year U.S. Government Bond Yield (%)
6/30/15 - 3/31/16



Source: Bloomberg Analytical

While there were many factors influencing spread volatility in the quarter, in our opinion, supply and demand technicals drove the majority of the move in both directions. Mutual fund and hedge fund liquidations pushed credit spreads wider for several months, but then record inflows to bond funds starting in late February generated the swift reversal in both the investment grade and high yield sectors of the corporate bond sectors. We continue to believe that corporate bonds offer fixed income investors the most attractive place to generate excess returns, although security selection has become even more important in 2016. Municipal bonds have also performed well as they provide taxable investors with both safety and solid tax-free income during times of increased volatility within the equity markets.

Even though the Federal Reserve has communicated a pause to their rate normalization process, we expect at least one to two increases in the Federal Funds rate by year end. Additionally, we see the 10-year Treasury ending the year around 2.50%, leading us to remain shorter in duration as compared to our benchmarks.