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First Quarter 2016

Who is Driving the Bus?

Unless one owned government bonds or held cash, the first quarter was an unpleasant, wild ride as fears of slowing growth and deflation overwhelmed investors in January and February. That is, until prices snapped back violently in March to the chagrin of those who lost their nerve and reduced exposure earlier in the quarter. It was, in fact, the biggest intra quarter round trip for the S&P 500 since 1933.[1] The faint of heart could be forgiven: through February 11th, just six weeks into the New Year, high yield bonds had dropped more than 5%, the S&P 500 and the MSCI Emerging Markets Index were down 10%, and the MSCI World Index had fallen 11%. Things began to turn in mid-February when the European Central Bank presaged new measures to boost liquidity and again in March when the Chair of the U.S. Federal Reserve gave a speech suggesting a delay of her plans to increase rates. Both central bankers cited recent market turmoil as a key concern, and Chair Yellen made repeated references to global financial conditions. By then, however, commodity and currency markets were already supporting the notion that oil had found a bottom and the U.S. Dollar had run too far ahead of its trading partners. As a result, some of the profound uncertainty plaguing investors since oil peaked and the U.S. Dollar began rising sharply back in June 2014 started to diminish by quarter end. Most major equity indexes in the table below, except Japan's, were close to flat year to date through March 31st and emerging markets were up almost 6%.

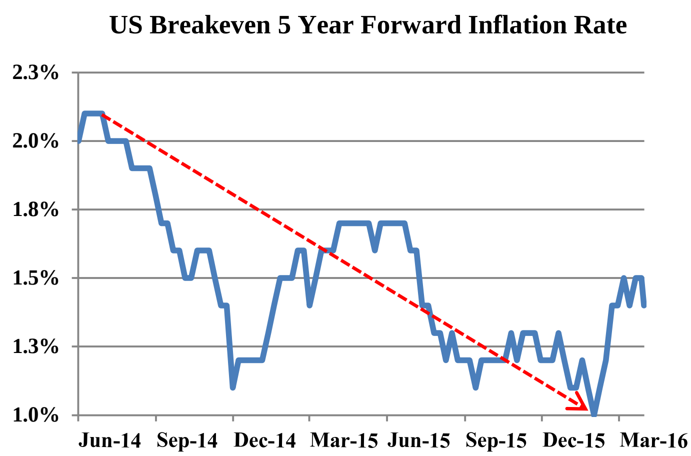
March 31, 2016

Index or ETF	First Quarter 2016	12 Months Trailing	Since June 13, 2014 *(Oil: $107 to $38)*
Barclays Capital U.S. Treasury 20+ Year	8.49%	2.46%	21.93%
U.S. Dollar (DXY)	(4.10%)	(3.83%)	17.69%
S&P 500	1.35%	1.78%	10.43%
MSCI Japan	(6.52%)	(7.06%)	0.12%
Russell 2000 Index (Small Caps)	(1.52%)	(9.76%)	(1.74%)
Markit Iboxx High Yield Bond Index	3.32%	(4.06%)	(4.30%)
MSCI All Countries (ACWI) Ex U.S.	(0.38%)	(9.19%)	(13.11%)
MSCI Europe	(2.51%)	(8.44%)	(15.19%)
MSCI Emerging Markets	5.71%	(12.03%)	(16.30%)
JP Morgan-Alerian MLP	(4.44%)	(32.12%)	(40.00%)
S&P GSCI (Commodities)	(2.50%)	(28.67%)	(58.66%)
WTI Crude Oil	3.51%	(19.45%)	(64.14%)

Total Returns in U.S. Dollars. Source: BlackRock, Bloomberg. Returns are calculated with net dividends (where applicable) in U.S. Dollars.

[1] "Could the S&P 500 Make History?" LPL Financial Research, March 22, 2016.

Whether it was the surprise Japanese move to negative interest rates, fears of another devaluation of the Chinese Yuan, rumors about insolvent European banks, stomach churning price drops in high yield bonds, another step down for U.S. inflation data, or a general loss of confidence in monetary authorities, there was an all too familiar sense of panic that the world was on the edge of a deflationary spiral in January and February. Most of the explanations we are seeing in the media fail to mention that collapsing inflation expectations can be traced back to mid 2014. It was around this time that commodities began their epic crash and the U.S. Dollar started to rally against most other currencies, putting exceptional pressure on both domestic exporters and on countries like China whose currencies are pegged to the U.S. Dollar. The graph below measures the difference between yields on Treasuries and comparable inflation-linked debt as a way to gauge the U.S. bond market's outlook for inflation. Expectations have indeed been falling sharply and reached a seven year low in February.



When the seeds of deflation were planted in 2014 for the developed world, much of the emerging world began the painful odyssey of raising interest rates to defend their falling currencies, only to watch them fall further as companies rushed to buy Dollars needed to retire expensive, and burgeoning, U.S. Dollar debt. Simultaneously, their all-important natural resources companies were forced to cut spending and workers. Economies contracted and serious problems arose. It took a while for this negative feedback loop to affect safe haven U.S. stocks and corporate bonds, but it is a measure of the severity of the world's imbalances that it finally did, and a reminder that currency devaluations (and possibly negative interest rates) are a zero sum game.

A recent research report from Stifel Nicolaus gives us perspective by noting that "the Fed's domestic mandate of price stability and full employment predates globalization of finance, and has been the principal risk for markets the past two years…"[2] In retrospect, the desire among some members of the FOMC to raise rates throughout the global commodity meltdown has been powerful and perhaps a bit tone deaf given the magnitude of the changes suffered by at least one third of the global economy. We wonder how many calls the Federal Reserve and the U.S. Treasury received last quarter discussing the potential need for emergency U.S. Dollar liquidity. In our opinion, the change in tone at the top was warranted.

Amidst the gloom and low expectations, it is important to consider what these painful rebalancings may be achieving. First, March was the first month in the last eighteen to show a year over year decline in the U.S. Dollar. A cheaper U.S. Dollar reduces many of the pressures

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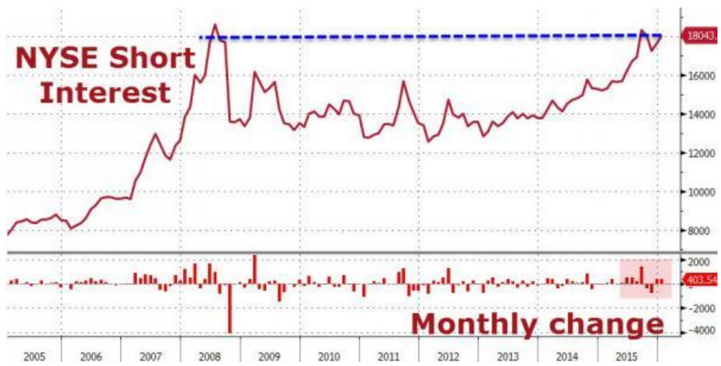
[2] "2Q16 Macro: S&P 500 Up/Sectors Rotating with Fed Pause, ECB Help and China Stability," Market Commentary/Strategy, STIFEL NICOLAUS & CO., March 16, 2016.

discussed above on stressed emerging markets (especially China, where recent data has been seen as encouraging), U.S. exporters, oil, energy lenders and of course the Fed. Second, we still believe there are huge benefits to consumers and manufacturers from cheap commodities, but unusually large shocks need time to digest and physical capacity in the sector simply cannot be reduced faster than market prices can decline. Third, and somewhat controversially, we wonder whether the efficacy of monetary policy is as diminished as the current narrative suggests. It is possible that the commodity crash and accompanying U.S. Dollar shortage was so unexpected and so severe that a much worse scenario has been avoided.

Time will tell if the recent stock market rally and the 46% gain in the price of oil since February 11th was a new beginning on firmer footing, or just a massive exercise in short-covering. The graph to the right shows that short interest on the NYSE through mid-February had risen to levels last seen in July 2008. Our sense is that many investors are now seriously underweight emerging markets and commodities after years of disappointing performance and declining inflation expectations, and will look to rebalance if the Federal Reserve keeps its newfound peripheral vision and exercises some caution in the months ahead.



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Source of data not specifically cited: Bloomberg.
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Special Note to Clients

We are very pleased to welcome two new hires to North American Management:

1) Bill Bereszniewicz joins us from JP Morgan Chase, where he worked as a hedge fund accounting analyst. Bill is a Wealth Management Administrator who will be assisting Lea Ann Knight and her Wealth Management team as they continue to provide the best possible guidance and support to our valued clients.
2) Matthew Duggan joins us from Brown Brothers Harriman, where he was a Supervisor and Senior Client Account Manager involved in the calculation of daily net asset values for mutual funds. Matt is a Senior Client Services Administrator reporting to Jessica Vacanti, head of our Client Services group, and he will be assisting clients with new and existing account transactions and processes, including cash requests.