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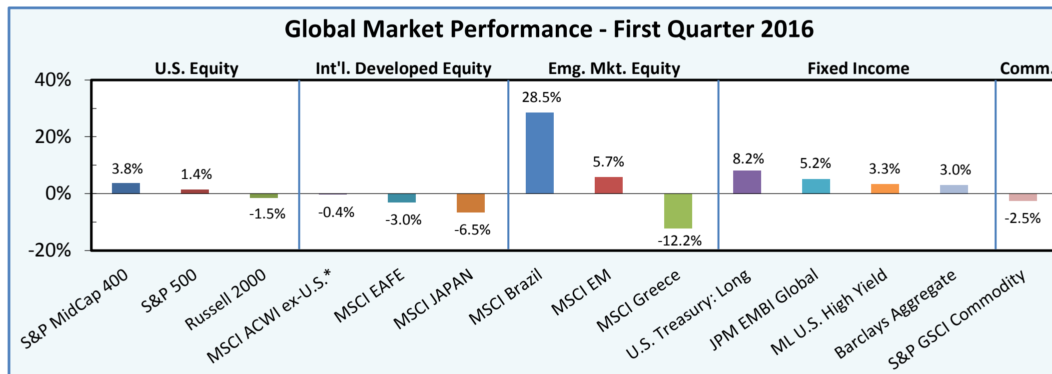
MARKET SUMMARY

First Quarter 2016

INVESTMENT ENVIRONMENT



**MSCI ACWI ex-U.S. Index includes approximately 22% allocation to emerging markets.*

The first quarter of 2016 started with global equity markets confronting a number of serious issues including decelerating growth in China, the negative side of lower oil prices, and Great Britain's potential exit from the European Union. These concerns were heightened by what was described as skirmishes in the currency markets and unease resulting from the Presidential campaign in the U.S. The quarter was characterized by unexpected volatility in the commodities and equities markets. A "flight to quality" boosted returns of investment grade bonds and dividend paying stocks. Gold also began to shine again and gained 16.7% after a three year hibernation.

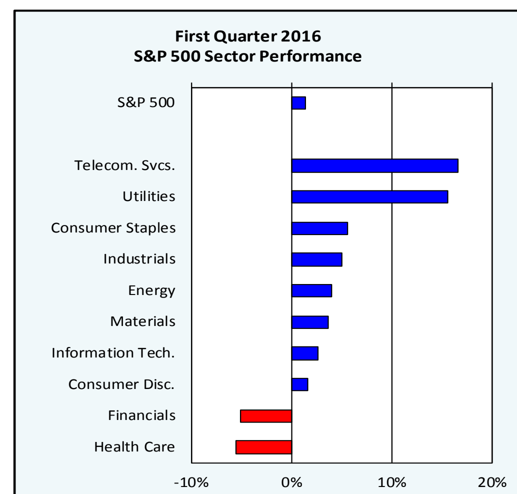
Moderately good economic numbers were registered by the U.S. including rising housing starts and reduced unemployment. Wages also experienced some improvement. The U.S. continues to recover faster from the economic downturn of 2007-08 than all other economies, yet the pace of growth is still modest. With the U.S. Government now carrying debt equal to 100% of GDP, a governor on growth may now be in place as was projected by Rogoff and Reinhardt in their seminal book, *This Time It's Different*. Budget deficits have decreased from two years ago, but according to the congressional Budget Office are estimated to rise dramatically within a few years partially because of the substantial increases in transfer payments.

There is surprisingly little alarm over the amount of overall debt, both public and private. The panacea for central bankers and governments worldwide is to promote aggregate demand through ever-lower interest rates despite the fact that absurdly low borrowing costs have failed to spur the demand for loans. Japan opened a new door in January with the introduction of negative interest rates. Currently, 70% of Japanese bonds provide no interest or are negative. Negative interest rates, the ultimate oxymoron, have never existed before in the history of the world and have the potential to become extremely disruptive.

EQUITY ENVIRONMENT

Early in the quarter, the change in FED policy and the decline in the price of oil drove volatility in equity markets higher, unsettling investors. Stocks got off to a slow start with the Standard & Poor's 500 declining 5.0% in January. The big growth stocks known as FANG (Facebook, Amazon, Netflix and Google) had masked the declines in the broader market last year and rolled over in January. The market got some reprieve as economic numbers became more encouraging and a dovish stance on the part of the FED continued, encouraging some investors. The February 11th bottom marked a shift in market leadership that was propagated across all capitalization ranges that saw value stocks outperform growth issues. The worst performers of 2015 became the best performing issues. Confidence grew and stocks registered a spectacular month in March with a gain of 6.8% for the S&P 500. Mid-capitalization stocks had that lagged their larger counterparts since the first quarter of 2015, outperformed in the first quarter with a gain of 3.8%. In the midst of the turmoil, the S&P 500 eked out a gain of 1.4%. The S&P Small Cap rose 2.7%, while the Russell 2000 lost 1.5% due its exposure to companies included in the Russell Microcap index which fell 5.4% in the period.

Dividend yield was a key component to driving defensive sectors higher. Telecommunication Services provided the best total return at +16.6% followed by Utilities at +15.6%. These higher and steady dividend payers provided an added attraction in a world of no interest rates. Consumer Staples was the third best at +5.6% where earnings predictability was appealing during a volatile period. Health Care lagged at -5.5% as pharmaceutical pricing became a focus. Financials fell -5.1% because positive interest rate spreads were unavailable to generate bank profits. Consumer Discretionary gained +1.6%, as it was believed that consumers would become less inclined to spend on larger items.

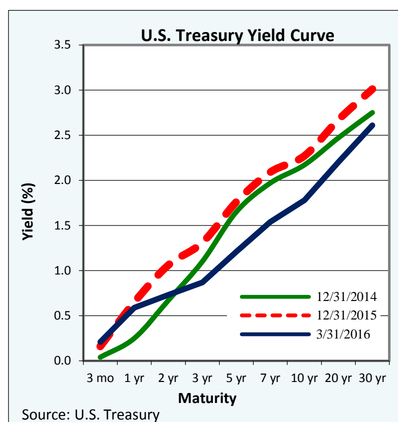


While there is always uncertainty over the performance of stocks, a wide dispersion of expected returns exists. Given current conditions, a less optimistic outcome seems likely. Corporate earnings, the real seed corn of equity markets, are the reason for caution. Analyst estimates have been reduced significantly as profit margins are high and expected to come down. Over the past few years, earnings growth has resulted from cost cutting, consolidation, and financial engineering such as stock buybacks. Outside of the auto industry, organic growth has been anemic for a great number of companies. Corporate debt has doubled since 2008 with proceeds used for stock buybacks and to pay for dividend increases, while capital expenditures for productive assets have been short changed. The arcane corporate tax system is partly to blame. Most of these problems could be solved with an intelligent, comprehensive and pragmatic approach, but none have been put forward. Meanwhile, stocks continue to perform relatively well. GDP growth of less than 1% for the past six months is worrying investors, as is four straight quarters of zero earnings growth. This may be why value oriented stocks began to outperform momentum growth issues in the middle of the first quarter.

FIXED INCOME ENVIRONMENT

In the first quarter, fixed income markets were presented with two distinct surprises. The first was in February when the People's Bank of China cut the Reserve Requirement Ratio. This action signaled a move to more aggressive policy easing through short term stimulus intended to promote higher GDP growth. Worldwide, the adoption of shorter-term moves has evidently gained the upper hand over much needed longer term structural reforms.

The second surprise came in March from the Bank of Japan which introduced negative interest rates to the world. They applied a negative 0.1% to excess bank reserves. The European Central Bank quickly followed suit, and others have followed or are supportive. The Barclays Global Aggregate Bond Index covers $44 trillion in assets, of that, 20% was trading on negative yield at the end of the quarter. The Japanese have been the master of the art: the world has long awaited Prime Minister Shino Abe's promised implementation of his "Third Arrow" which was to bring about significant structural reform to the financial system. There is no central bank that would not benefit from some monetary tweaking and modest reforms, but it is imperative that more comprehensive change be concurrently instituted.



High-quality credit rallied during the first half of the quarter in response to the rise in volatility and the retreat of risk assets such as equities and commodities when fears of a possible recession intensified. As oil later began to find a bottom and economic woes seemed to subside, capital returned to the markets. In March, strength in the high-yield market provided a positive boost as the fear of bankruptcies in the energy industry subsided. The Barclays U.S. Aggregate Bond Index rose 3.0% in the quarter with help from Long-term Treasuries and long dated corporate bonds that rose 8.2% and 6.8%, respectively, as interest rates declined at the long-end of the yield curve. The Merrill Lynch U.S. High Yield Index recovered to finish the quarter up 3.3%. Emerging market debt bounced higher, along with emerging market stocks. The JPM EMBI Global Index was up 5.2% over the three months.

INTERNATIONAL ENVIRONMENT

Global investors were confronted with slower growth in China, which has accounted for a significant percentage of global growth in recent years. Commodity producing countries have been hit particularly hard as their largest customer transitions from a mercantilist, industrial, and export dominated economy to one more focused on internal consumption. This massive change in the world's second largest economy increased uncertainty and was the catalyst that sent commodity prices lower early in the quarter. It is well known that growth in China is slowing, but the magnitude is difficult to ascertain. The 10% growth of recent decades is not achievable now. Estimates vary but a consensus seems to be that China's future growth is likely to settle in the 5.5%-6.5% range. If this rate is achieved, other things being equal, this should result in 2.5%-3% growth for global activity near term. The unlikely exit of Great Britain from the Eurozone could prove to be another turning point. Concern has been muted but will be

more closely considered as the vote by the electorate approaches. A “yes” vote to exit might reignite separation talk from the Scots and Catalans, creating more turmoil.

All markets have been affected by the currency markets. Strength of the U.S. dollar has been notable and its effects have been far reaching. Because commodities are priced in dollars, higher prices have resulted, creating a headwind for producers and a major problem for emerging markets that account for a large percentage of production. The more dovish tone of the FED had applied some braking power to the dollar’s advance and some analysts project further weakening.

The first quarter’s strongest moves were in the MSCI Emerging Markets Index that jumped 13.2% in March to finish the period up 5.7%. Late quarter reductions in commodity prices and positive political events provided the backdrop for Latin American issues to top the quarter’s performance for the first time in three years. Dominated by commodity-driven businesses that traded well with the bounce in oil and metals in the second half of the quarter, Brazil, Peru and Colombia rose 28.5%, 27.0% and 22.5%, respectively. All of these economies are going through recalibration and they will ultimately lead global growth. Dr. Rob Arnott of Research Affiliates notes that investors can buy 45% of global GDP earnings at a multiple of 10 times through emerging market stocks as compared to 17.5 times for U.S. shares.

In sharp contrast to the performance of emerging markets, the MSCI EAFE (Europe, Australasia and Far East) Index rose 6.5% in March, but finished the quarter at -3.0%. Japan, off 6.5%, engaged in concerted efforts to promote economic growth and was the third worst performing country in the EAFE Index, behind Italy’s -11.7% and Israel’s -10.2%. Japan had the largest negative impact on the index due to its 22% weight. In local currency terms, Japan was down 12.7% as investors remained concerned about the slow progress of its financial reforms.