Quarterly Commentary

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First Quarter 2016

For three consecutive years the first quarter has stirred angst and anxiety among investors casting doubts over the strength of economic growth both abroad and at home. Although the calendar year is different, common themes exist – abnormal weather, falling interest rates, declining commodity prices, currency swings, and deflation concerns. Distinguishing this year from the previous two are the severity of the volatility and the pace of recovery. Volatility was led by corporate bonds, which swung from a -3.64% YTD excess return (returns stripping out interest rate moves) on February 11th, to 0.16% YTD at the end of the quarter as measured by the Barclays U.S. Aggregate Bond Index. When the dust settled, risk premiums appeared eerily similar to where they began the year, but all-in yields were significantly lower due to falling interest rates.

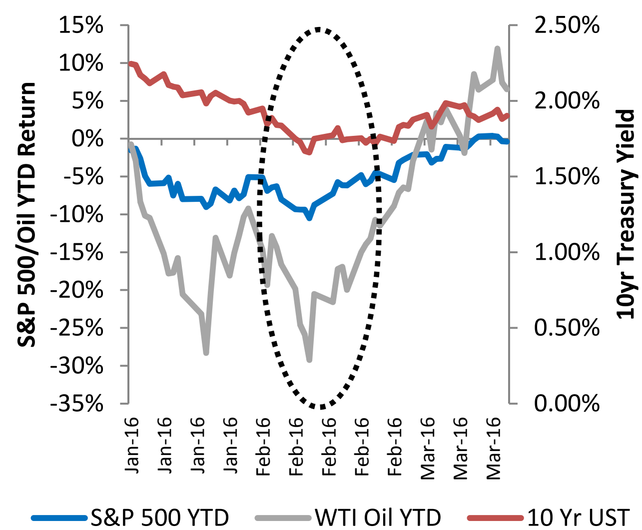
The first quarter: part 1

Just weeks after the first rate hike by the Federal Reserve in years, the markets were sharply focused on the equity volatility in China. In order to stem a downfall in equities, regulators in China implemented controls they believed would stabilize their stock markets. The result, however, was precisely the opposite as controls were tripped only minutes into trading sessions causing markets to completely shut for days. Regulators quickly reversed course and suspended the system within a week. Further shaking confidence, the People's Bank of China (PBOC) was struggling to control its currency with daily drops against the dollar exceeding established bands. Data also showed the largest annual drop on record for Chinese foreign currency reserves amid reports that capital controls were being implemented to stymie outflows. Rising fears of a hard landing in China called into question the viability of global growth and the ability of the U.S. to weather the storm.

Meanwhile, commodity prices continued to fall as oil prices hit 12-year lows with domestic stockpiles surging amid a global glut of product. Natural gas prices plunged with abnormally warm weather blanketing most of the U.S. coupled with increasing production also resulting in a surge in stockpiles. Rating agencies took notice, specifically Moody's which revised their price deck and placed almost the entire energy sector on review for downgrade.

If that weren't enough, the effects of the strengthening dollar were threatening to place U.S. manufacturing into a recession. The ISM Manufacturing Index reported its seventh consecutive month of contraction in February. Thoughts of additional Fed rate hikes added to concerns that this trend would continue, and could derail the recovery.

Exhibit 1: Equities, oil, and Treasury yields bottomed in mid-February



Source: Bloomberg

The first quarter: part 2

The case for a recovery in valuations and an easing of fears began in late January when the Bank of Japan announced negative interest rates to complement their asset buying program. This was followed by announcements by 1) the European Central Bank (ECB) to further decrease negative rates, expand asset purchases to corporate bonds, and initiate a targeted bank lending program, 2) the PBoC relaxing bank reserve requirements and regulators proclaiming they would clean-up failed state-owned companies, and 3) the Fed backing off their stance of four rate hikes in 2016 and shifting their concerns to global conditions as guideposts for future hikes. This seemingly coordinated action by the central banks to provide even more accommodative monetary policy provided a boost to investor confidence.

On the commodity front, speculation that major oil producers would agree to a production freeze delivered hope that prices could rebound. Furthermore, U.S. production numbers continued to decline as companies cut capital expenditures and focused on profitable wells. Moody's completed their review of the energy sector, which did result in downgrades to high yield, but with the more accommodative stance by central banks and the slight recovery in oil prices, fixed income investors shrugged this off and bond prices rallied into quarter end.

Through all of the first quarter, job growth remained a bright spot with gains maintaining a robust pace and the unemployment rate holding steady around 5% even as the labor force participation rate gradually increased. The dollar has reversed course and manufacturing data jumped to expansion territory for the month of March with service data maintaining its steady pace of expansion.

Closing comments

The roller coaster ride of the first quarter leaves investors with plenty to digest. Risk premiums in fixed income have returned to year end levels, and in some cases, even tighter. Monetary policy continues to be a tail wind resulting in ever lower and lower yields. Meanwhile, global growth projections are declining. Both the World Bank and IMF lowered their expectations for 2016, even the Fed dropped to 2.2% from 2.4% for the U.S. Commodity prices are still low and a production freeze remains only speculation. In the end, not much has changed.

For a number of quarters now we have written about taking a more cautious stance in our portfolios, which we reiterate again. We ask ourselves, "what are the central banks trying to tell us?" Our response is inflation and growth are not living up to expectations. As unconventional monetary policy begets more unconventional monetary policy, and volatility harvests more volatility, taking the thoughtful approach is most wise.