2016 First Quarter ReView of the Markets

Index	1st Qtr Return
S&P 500	1.35%
MSCI ACWI Ex USA	-0.38%
Barclay's Bond Index	3.03%
Consumer Price Index	-0.05%

Investment Commentary

Equity markets had record declines for the first six weeks of the year with a peak to trough loss of 10% for the S&P 500. This was fostered primarily by economic concerns and continued weakness in the price of oil. Mid way through the quarter, economic data improved and the highly negative sentiment reversed. These factors contributed to the sharp rebound in the second half of the quarter in both oil prices and equity markets. The S&P finished the quarter up 1.4%. Small cap stocks had a slightly more volatile quarter than their larger counterparts, while foreign stocks ended the quarter down 0.4%.

We have consistently written that we are now living in a low economic growth world, something that markets have struggled to come to terms with which has led to considerable market volatility. In terms of market fundamentals, earnings in the fourth quarter of 2015 (as reported during the first quarter of 2016) fell for the second straight quarter, pulled lower by poor earnings from the energy sector and a strong dollar.

Investment grade bonds provided protection, as intended, during the equity market gyrations. As the concerns mentioned above impacted equities, investors bid up the prices on safe U.S. government bonds, decreasing their yields. The Barclays U.S. Aggregate bond index was up 3% for the quarter. Low quality bonds saw their prices move lower along with equities.

Economic Outlook

After years of relying on unprecedented experimental economic measures in an effort to boost growth and maintain stability in a post financial crisis global economy, economic growth still remains well below historical averages. Furthermore, any whispers of normalizing what are, by anyone's standards, extraordinarily accommodative policies tend to be greeted with significant bouts of market volatility. Central bankers seem beholden to financial markets at this point, and the latest and greatest in experimental monetary policy is the use of Negative Interest Rate Policy ("NIRP"). NIRP can be thought of simply as a tax on bank reserves to incentivize them to lend out more money. The Bank of Japan, the European Central Bank ("ECB"), and others have undertaken NIRPs in addition to continuing to flood markets with cash through large scale asset purchases in a process initially used by the Fed known as Quantitative Easing.

In terms of global developed markets, the Fed continues to stand alone in attempting to tighten monetary policy. The Fed seems to be in a holding pattern after just a single interest rate hike late last year. To this point, market based expectations of future rate hikes have continually come down. While the Fed has certainly left the door open to continue along the tightening path, the rhetoric has shifted as market volatility has increased. It is difficult to fault the Fed for reacting to economic data; however, the thought of the U.S. central bank being compelled by financial markets is troublesome. The Fed is struggling to raise rates as it will eventually need to return to normal interest rate levels, whatever they may be, in order to prevent long-term market distortions as well as to have ammunition to fight future recessions.

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The low unemployment rate in the U.S. is in large part attributable to the decrease in the labor participation rate since the financial crisis (*i.e.*, fewer working age adults wanting to work). At the end of the quarter, we saw unemployment increase very slightly to 5%, however the labor force participation rate increased to its highest level in two years. Encouraged by job growth, workers are returning to the labor force, which could be a stabilizing force in the economy.

You are likely exhausted of hearing about the various presidential candidates and what they could ultimately mean for global economies and markets. Suffice it to say, no one really knows. This election cycle, however, seems to have favored various extremes that would minimize the status quo. This says to us that, even though we do not know how policy might ultimately change under the various candidates, a dramatic change in policy could likely occur. The biotechnology sector is one example of markets reacting to political commentary. Hillary Clinton, in particular, has been very vocal about curtailing pricing power for drug manufacturers. Some version of regulated ceilings on the prices of various medications would negatively impact the profitability of a number of pharmaceutical and biotechnology firms. In response to this possibility, the Nasdaq Biotechnology index was down over 20% in the first quarter.

Investment Strategy

Ultimately, markets are still struggling to understand the long-term effects of the series of unprecedented stimulative policies. While this may not be clear at this point, we do have to try to answer the question "what does this mean" both in our conversations with clients as well as in our construction of client portfolios. As a function of both the above economic backdrop and, at best, moderate valuations for stocks and bonds, we have reigned in our clients' exposure to risky assets and returned to "neutral weights" in our allocations. Beyond valuations and tepid global economic growth, above trend profit margins are also a cause for concern. As has been the case in our previous reviews, we continue to maintain minimal exposure to small cap U.S. stocks, which we believe will provide more downside during market weakness and are still on the overvalued side. Short term, we are not anticipating a recession, although we continue to believe that the risks to the global economy are skewed to the downside. We are always cognizant that timing market tops or bottoms is a fool's errand and that majority of our clients need to have some exposure to risk assets in order to accomplish their long-term goals. The risk free rate, after all, is still close to zero.

Our clients' exposure to fixed income has generally crept higher over the previous twelve to eighteen months, and much of the incremental exposure has been to bonds of intermediate maturities and higher quality. That being said, we have somewhat increased exposure to lower quality high yield bonds opportunistically throughout the first quarter as their prices became attractive. Low absolute yields on longer maturity investment grade bonds are tough to swallow. However, as seen during the first 90 days of the year, we do see value in U.S. Treasury bonds as a portfolio ballast during volatile equity markets. Yields on these bonds can be understood as the "cost of insurance," and we will continue to add insurance where appropriate when prices are reasonable.

We remain positive on developed market, non-U.S. equities relative to their domestic counterparts. While in hindsight we were early to this allocation, our original thesis around accommodative monetary policies, a strong U.S. Dollar, and lower energy prices remains intact. Unemployment in the Eurozone is falling, a sign of an improving economy. Further, earnings are generally stable and, unlike U.S. equities, their earnings remain below their pre-financial crisis levels, which we believe gives them room to meaningfully increase.

As difficult as this may be, we advise our clients to have patience in this market. Low yields on bonds, average valuations on stocks, and slow global economic growth all point to expectations of very modest returns for the near term. Periods of low returns can be frustrating, but ultimately we know they will not last forever, and we are comfortable with portfolio positioning given our modest near term expectation. While we do our best to identify and take advantage of opportunities, we must operate within the confines of what the markets give us. If you have concerns with either your portfolio or financial markets in general, we encourage you to reach out to us.