Insights: April 2015

Market Overview and Performance

2015 began with U.S. stocks experiencing a three percent decline in January largely predicated on global macro concerns that produced a "risk-off" posture in the market. However, those defensive trends were subsequently alleviated in very rapid fashion during February as the market climbed roughly six percent higher on the back of stabilization in both Europe and in the price of oil. By comparison, March proved to be relatively boring based solely on the final return figure of less than one percent, but not as measured by the path of stocks throughout the period. On the whole, equities finished the quarter with positive returns for the ninth straight quarter, bonds remained captive to the moving target of future increases in the Fed funds rate, U.S. economic data generally softened while in contrast positive economic momentum was produced abroad, and finally, the Dollar managed to reign supreme. If you are thinking that this sounds a lot like the first quarter of 2014, you would be correct, but there are also a number of interesting changes to the consensus view coming into the year that have been altered somewhat as we will discuss. The most noteworthy being that non-U.S. markets are soundly outperforming U.S. stocks so far this year, and bonds, which finally, were primed to decline this year as rates begin to rise have actually provided investors with positive returns yet again.

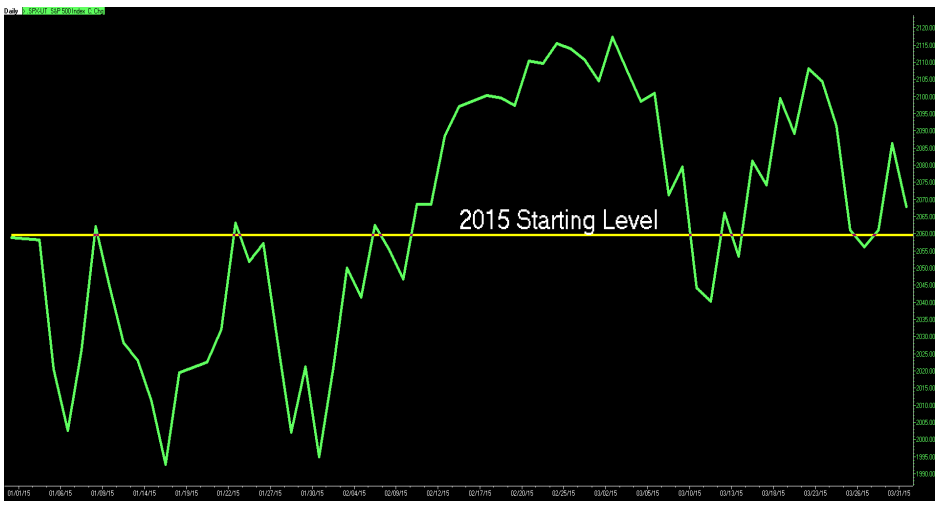
Thank you for taking the time to consider our thoughts on the markets and we look forward to hearing from you soon.

	Month to Date	***Year to Date***
Equity	***Percentage Change***	***Percentage Change***
S&P 500 Index	-1.58	0.95
Russell 2000 Index	1.74	***4.32***
MSCI EAFE Index	-1.52	***4.88***
MSCI Emerging Markets Index	-1.42	***2.24***
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.46	***1.61***
Barclay's U.S. Credit Index	0.35	***2.16***
Barclay's Corporate High Yield Index	-0.55	***2.52***
Barclay's Municipal Bond Index	0.29	***1.01***
Macro Measures		
Gold	-2.50	-0.07
Crude Oil	-4.34	***-10.64***
CBOE Volatility Index	14.60	-20.36
USD Dollar Index	3.29	***8.97***

March Themes – Consensus Coming into 2015 Proving Incorrect Thus Far – Non-U.S. Outperforming But U.S. Strength Remains

Legendary trader at UBS, Art Cashin , summed up the quarter well in his note penned on March 31st when he wrote, "Stock trading in the first quarter of 2015 was a lot like commuting by rollercoaster. You experience wild twists and turns, heart-stopping plunges and near vertical declines only to end up close to where you started and it cost you money". As you can see from the chart of the S&P 500 Index quarterly performance below, Mr. Cashin was not far from the truth. Thankfully however, being positioned with a broadly diversified asset allocation proved more fruitful during the quarter than trying to trade the short-term momentum swings seen during the same period.

S&P 500 Index Q1 2015 Performance



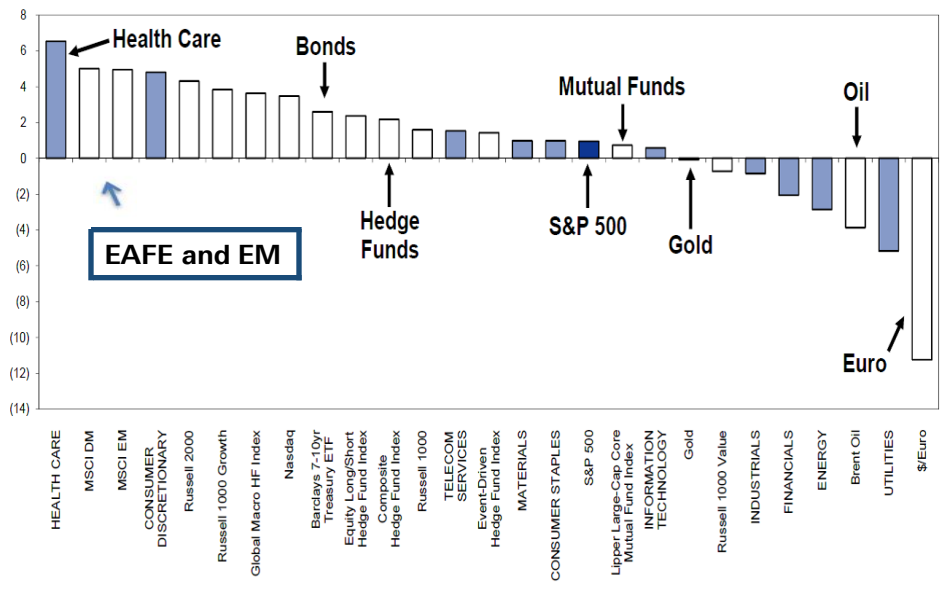
Source: Thomson One; S&P Dow Jones

The month of March in particular provided a number of events that while not meaningful enough to change the narrative, nonetheless created sharp swings in volatility. For example, the Dow Industrials, the S&P 500 and the Russell 2000 each achieved all-time highs during the period (and NASDAQ just missed). Yet by month's end, nine out of ten sectors had posted losses in contrast to February when nine out of ten advanced.

Additionally, the S&P 500 went 28 days without posting back-to-back positive returns before snapping the streak in the last days of the month; a phenomenon that has occurred only twice since World War II. So while sector performance erosion and a lack of positive trading momentum might suggest weakness in the market, other indicators of strength persist. For example, in another market oddity that can be traced back to World War II, the S&P 500 notched its ninth straight quarterly gain, a feat only achieved three times previously since the mid 1940's. According to S&P Dow Jones, on each of those prior occasions the subsequent following quarter produced an average return of 8.1 percent. Additionally in March, despite Greece doing their best to confound the rest of Europe, a co-ordinated Middle East military response to Yemini rebels and softening U.S. economic data, the S&P 500 closed just over two percent below its all-time high. That is certainly more resilience than some market pundits would have you believe.

What we haven't mentioned yet, is the trend we started talking about in last month's letter which continued through March. As the chart below illustrates, the non-U.S. markets are soundly beating the returns of equities within the U.S.

2015 Sector and Asset Class Returns



Source: Goldman Sachs, Compustat, IDC, MSCI, Lipper, HFR

U.S. Resilient and Global Markets Improving

Despite the fact that the U.S. looks like a relative laggard, especially compared to regions like Japan and Germany that enjoyed returns of over 10 percent and 8 percent respectively during the quarter, there are underlying forces that enhance the resilient narrative in the U.S. According to the table below from Bank of America Merrill Lynch, U.S. stock indices managed to post positive returns in the face of the biggest first quarter withdrawal of funds since 2009, a dent totaling roughly $44 billion this year.

2015 Global Fund Flows – US Saw $44 billion Outflow

Table 2: Net fund flows to global equities, $mn

	Wk % AUM	YTD
Total Equities	-0.1%	17,203
long-only funds	-0.1%	-23,629
ETF's	-0.1%	40,885
Total EM	-0.3%	-13,933
Global EM Funds	0.1%	-5,916
Asia	-0.7%	-5,298
EMEA	-0.4%	-424
LatAm	0.0%	-2,294
Brazil	-0.4%	-290
Russia	0.1%	377
India	0.1%	4,387
China	-1.8%	-9,975
Total DM	-0.1%	31,135
US	-0.3%	-43,969
Europe	0.5%	46,597
Japan	0.8%	10,546
International	0.0%	16,635

Total Equities = Total EM + Total DM

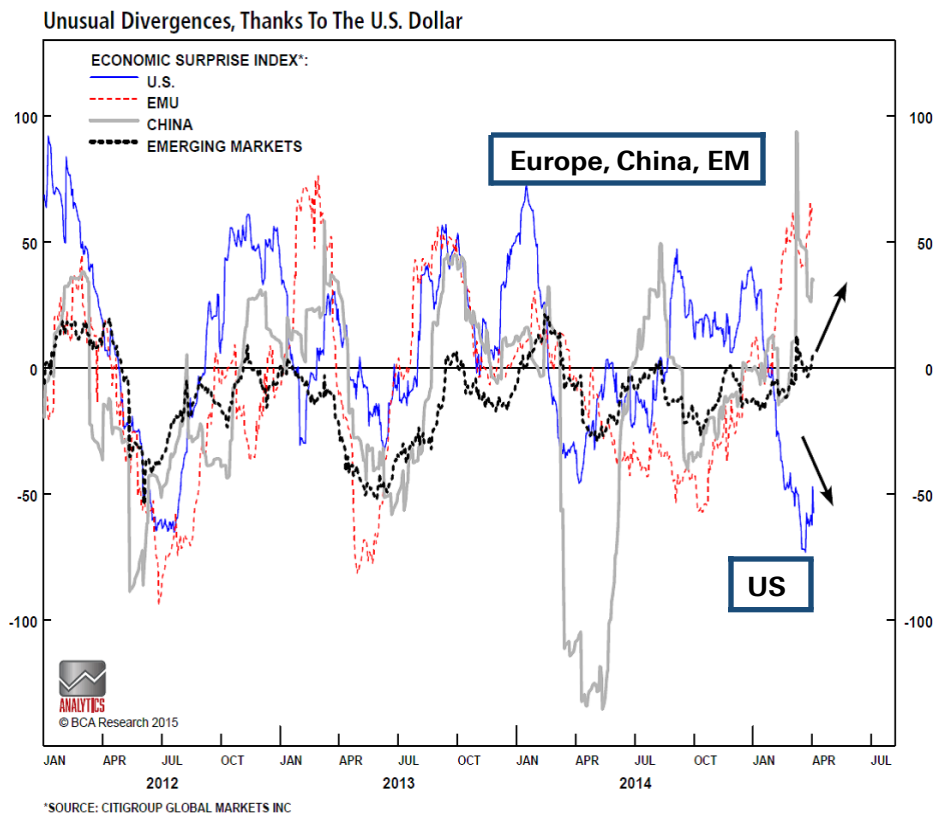
Source: BofAML Global Research, EPFR Global

While asset prices have held up, there are reasons why money would be re-allocated away from the U.S. at this time. As we discussed in previous Insight letters, money is attracted to areas like Japan and Europe because they are just initiating their quantitative easing (asset purchase) programs while the U.S. is just starting to wind down its efforts.

This process has pushed global bond yields toward zero, which has the knock-on effect of forcing assets in higher returning segments like equities.

Additionally, expectations going into this year were very high for the U.S. economy while those around the rest of the globe were much more muted. The overall result has been a decline in U.S. economic indicators versus expectations and a surge in positive surprises elsewhere as can be seen in the chart below from BCA Research. As this research group suggests, a large component of the U.S. economic disappointment can be traced to the incredibly sharp nine percent spike higher in the Dollar that has occurred this quarter.

Strong Dollar Weighing on US Economic Surprises – Providing a lift Elsewhere

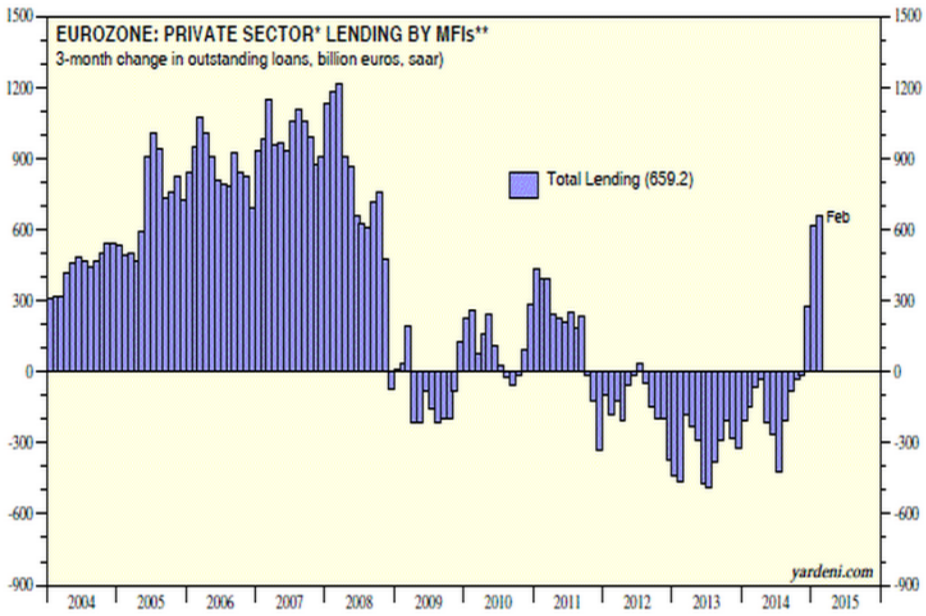


Source: BCA Research

To be fair, the strong Dollar cannot take all of the credit. The efforts of the European Central Bank (ECB) to launch their quantitative easing platform have had beneficial effects, the scale of which should not be discounted. For example, the ECB purchased about 60 percent of the gross issuance of Eurozone sovereign debt in the first quarter according to J.P. Morgan Asset Management.

This stimulus, combined with a steeply weakening Euro and negative deposit rates, have ignited things like private sector loan growth, which economist Dr. Ed Yardeni states is now at a annualized rate of almost 660 billion Euros.

Eurozone Private Sector Loans Accelerating After Long Decline

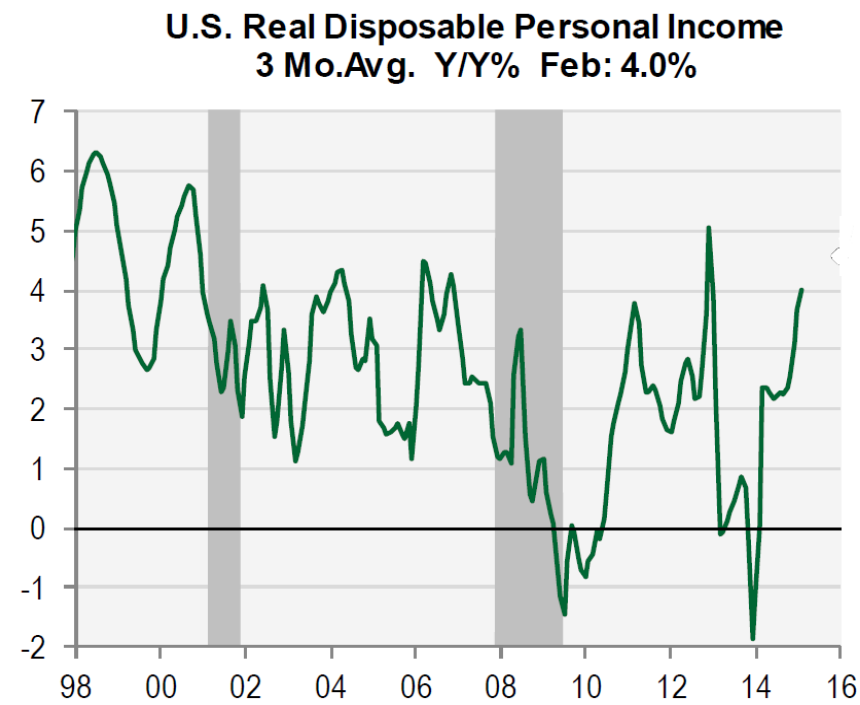


Source: www.yardeni.com

As we have indicated in the past, we are believers in prudent diversification of portfolios and have therefore benefitted from our non-U.S. exposure year to date. But one might ask, if Europe and Japan for example, are appealing on a relative basis, why not move assets there more aggressively? As we have pointed out, a sizable amount of assets have already flowed to these areas since the end of last year and many structural impediments still remain in place. Most notably, the Greek debt situation and slowing economic growth in China combined with an unreasonably strong stock market rally in that country's shares (up over 90 percent in the last 12 months). Unwelcome developments in both countries could have negative ramifications across their respective regions.

And importantly, while it appears that first quarter economic growth in the U.S. will suffer from the temporary effects of paralyzing snow and a West Coast port strike, a significant amount of underlying strength remains in place. Perhaps the graph below from Conerstone Marco gives us the best understanding of why that is true.

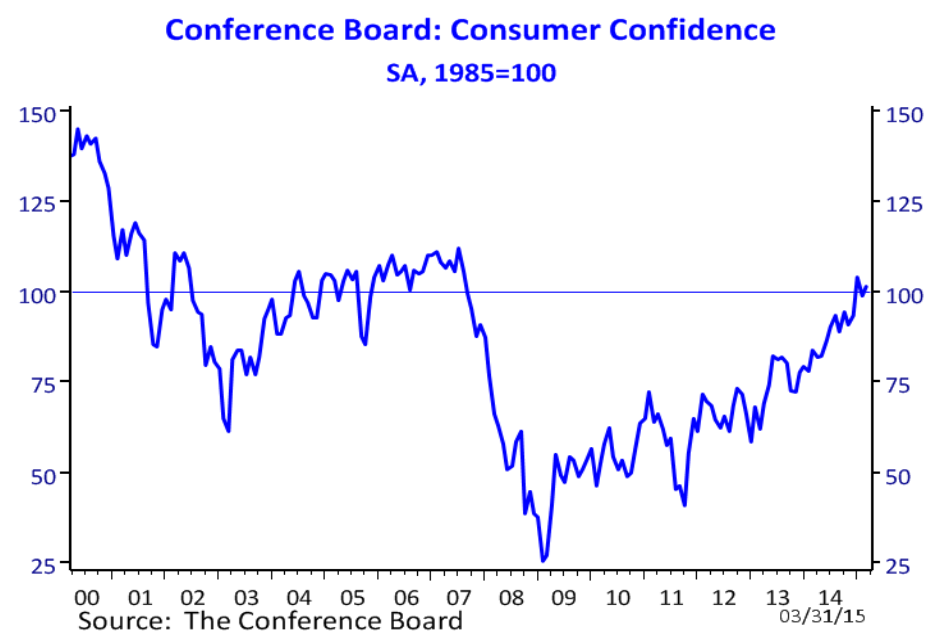
Real Disposable Income Has Risen Significantly



Source: Cornestone Macro

The fact that real income - the money consumers have in their pocket after adjusting for inflation - is moving significantly higher has translated into not only more spending power, but improved sentiment as well.

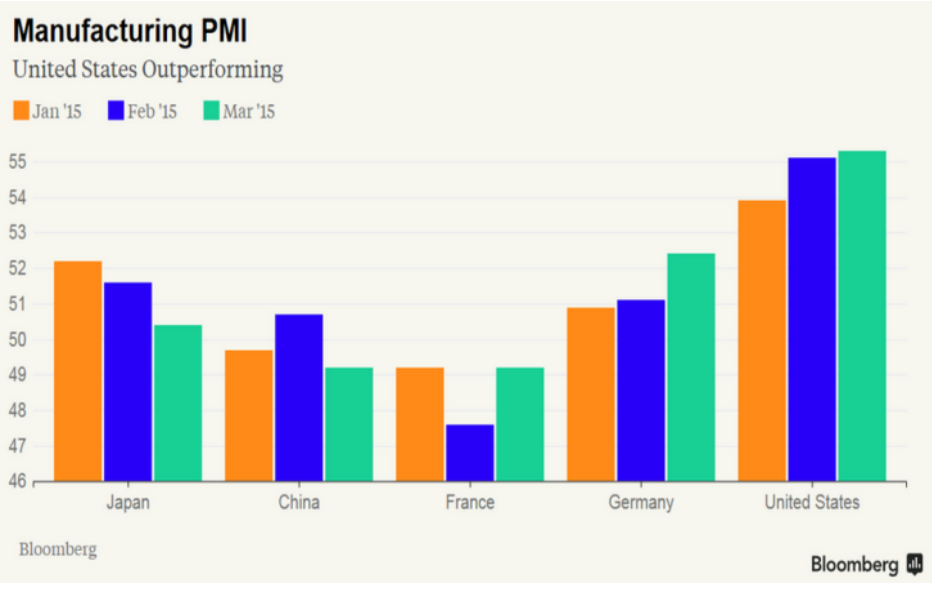
Consumer Confidence Back to Pre-Crisis Levels



With renewed consumer confidence came a number of additional readings that all pointed to sustained momentum such as strong car and new home sales, increased wage and job opportunity expectations, and continued improvement in anticipated new hires from small businesses.

And finally, it's worth bearing in mind that the U.S. remains the growth engine of the global economy as seen in the chart below from Bloomberg.

US Leading Global Manufacturing

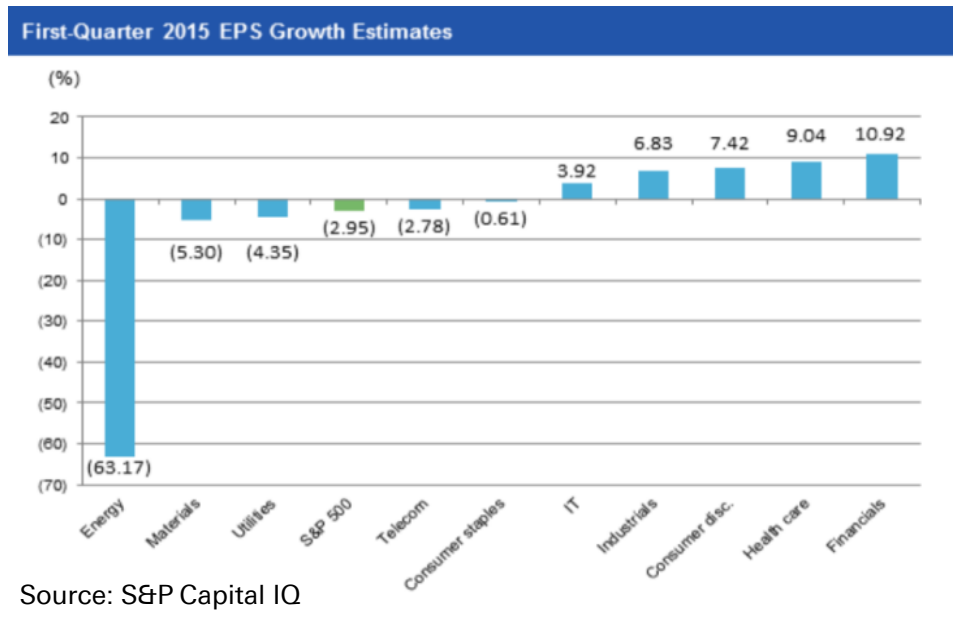


This is not to suggest that there have not been signs of softening in the U.S. economy this quarter. We are very aware of the importance of monitoring trends and are therefore, like others, looking to first quarter earnings and the Fed for our next signposts.

Earnings and Fed Funds

It has been well publicized that first quarter growth estimates have been sharply reduced. As we discussed in last month's Insight letter, the main drivers of those revisions have been the strong dollar and the precipitous fall in the price of oil with the severe winter and port strike thrown in for good measure. But as you can see from the chart below from S&P Capital IQ, the bulk of the earnings decline comes from the energy sector (down 63 percent!) while growth remains in other areas.

Energy Sector Swamping Overall Earnings Growth

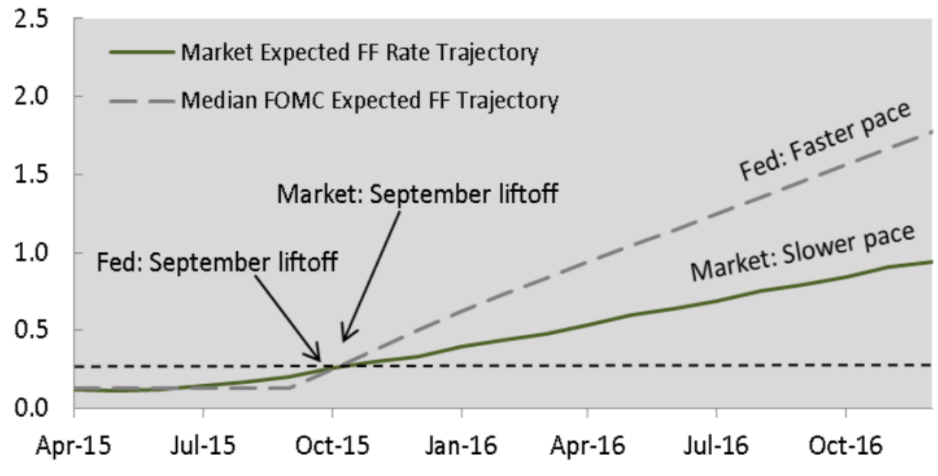


Source: S&P Capital IQ

In fact, Wells Fargo estimates that 74 percent of the S&P 500 by market capitalization will report earnings growth and if you simply factored out the energy sector, overall market-wide earnings growth would be 2.4 percent for the quarter.

So there is reason to think that the bar may be set too low for Q1 results, but forward guidance from corporations and the insight they give on the impact of the strong dollar on profits will also prove informative as to the direction of the economy in the coming months. This is particularly important as the Fed has explicitly stated that they are on a "data-dependent" path. At the beginning of the quarter, market consensus was that a June rate hike was virtually assured. Now, three months later, the Market is pricing in a September rate hike.

Market On a Different Path than the Fed



Source: Cornerstone Macro

While we agree that a September "lift-off" date is the most likely scenario, it is interesting that the futures market suggests no additional rate hike in December and much slower pace of rate hikes in general than the Fed itself has suggested may take place. We are not in the business of forecasting the actions of central planners, but we will be closely watching the economic developments as the second quarter begins since the future of rates has a tremendous impact on the asset allocation decisions we make throughout the remainder of the year.

Going Forward

As we stated last month and would re-iterate here in March, 2015 has been a wonderful reminder that diversification plays a large role in prudent portfolio management. It is precisely the unexpected moves, like those we have seen outside the U.S. this year, which prove why we advocate a well diversified portfolio for our clients. You simply cannot time the markets.

Within equities, we continue to favor the large cap segment of the U.S. market. We would prefer to gain our exposure through cyclical areas of the market such as the technology, health care and consumer discretionary sectors which stand to benefit the most from a strong U.S. economy and a strong dollar. One adjustment we did make in March was to take some profits in the biotech sector and reduce our exposure in light of the very strong returns seen in the space already this year.

Given the movements in markets outside of the U.S., we have gained increased confidence in current allocation to non-U.S. developed markets and will be monitoring the structural developments among those opportunities closely in the coming months.

In particular, we find a compelling risk/reward case present in Japan, Europe and selected emerging markets such as India.

We remain underweight traditional fixed income. With an anticipated increase in the Fed fund rate most likely coming in September, we continue to advocate an emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus.

As we have stated previously, traditionally diversifying assets in the commodities area such as gold remain challenged as the combined headwinds of a stronger dollar and rising rates do not look to be abating anytime soon. With the apparent stabilization in the price of oil in the $45-$50 range, we will be assessing opportunities for reasonable entry points to long-term investments in the energy sector. From a fundamental perspective, the market appears to be over supplied; however, events surrounding aggressions in the Middle East could rapidly move the price of oil higher.

Thank you for taking the time to read some of our thoughts this month. We hope you found our ideas valuable and insightful. We would be happy to discuss any items in greater detail with you in the future.