Insights: June 2015

Market Overview and Performance

In our April Insights, we described the year to date stock environment as a "treadmill market" – there is some activity happening, but not a lot of progress is being made. If anything, the month of May only re-enforced that view. "Boring" is how Goldman Sachs describes it, and JP Morgan laments, "More of the same. Volumes are still light, liquidity remains thin, incremental news is essentially non-existent, and conviction levels are low." Yet, in the face of these conditions, and with the looming uncertainties around the timing of the Fed interest rate hike and a Greek resolution, the market continues to grind higher in "reluctant rally" mode. In fact, the S&P 500 managed to notch four new all-time highs during the month.

Additionally, several of the moves away from the well established trend that we saw pop up in April -including soft U.S. economic data, a weaker U.S. dollar, rising oil prices and rising bond yields - largely reverted back to their earlier path. So while quiet but positive markets might not provide investors with a lot to get excited about, they certainly are more appealing than volatile negative markets. And for the time being, the way forward appears to be more of the same.

As always, thank you for reading our monthly Insights and we look forward to hearing from you soon.

	Month to Date	***Year to Date***
Equity	***Percentage Change***	***Percentage Change***
S&P 500 Index	1.29	3.23
Russell 2000 Index	2.28	3.94
MSCI EAFE Index	-0.51	**8.60**
MSCI Emerging Markets Index	**-4.00**	**5.69**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.24	1.00
Barclay's U.S. Credit Index	-0.58	0.98
Barclay's Corporate High Yield Index	0.30	**4.07**
Barclay's Municipal Bond Index	-0.54	0.21
Macro Measures		
Gold	0.63	0.48
Crude Oil	1.12	13.20
CBOE Volatility Index	-4.88	**-27.92**
USD Dollar Index	2.30	7.32

May Themes – Equity Reluctant Rally Marches On, Bond Volatility Makes Itself Visible, Timing of Fed Rate Increases Remains Elusive

Stocks, Sentiment and Market Dynamics

As we said at the onset, May was a tame period in the equity markets, yet generally speaking, positive returns were delivered across much of the broad U.S. stock market. This is a good thing. There were plenty of reasons to be found why stocks should not have moved higher, yet they continue to do so in the face of uncertainty. This is what's referred to as "Climbing the Wall of Worry", and it's a very healthy way for market rallies to extend since prices can move higher while concerns and nervousness work to keep exuberance in check. The "climbing" dynamic has been in place all year. In fact, the graph below of the S&P 500 in May looks a lot like the picture of the market we posted for April. The pattern has been volatility in the beginning of the month, a move to new all time highs by late in the month, and then somewhat of a sell-off in the very last week, but with the upward trend in tact. May followed that script exactly with a new high of 2130 reached around May 20th.

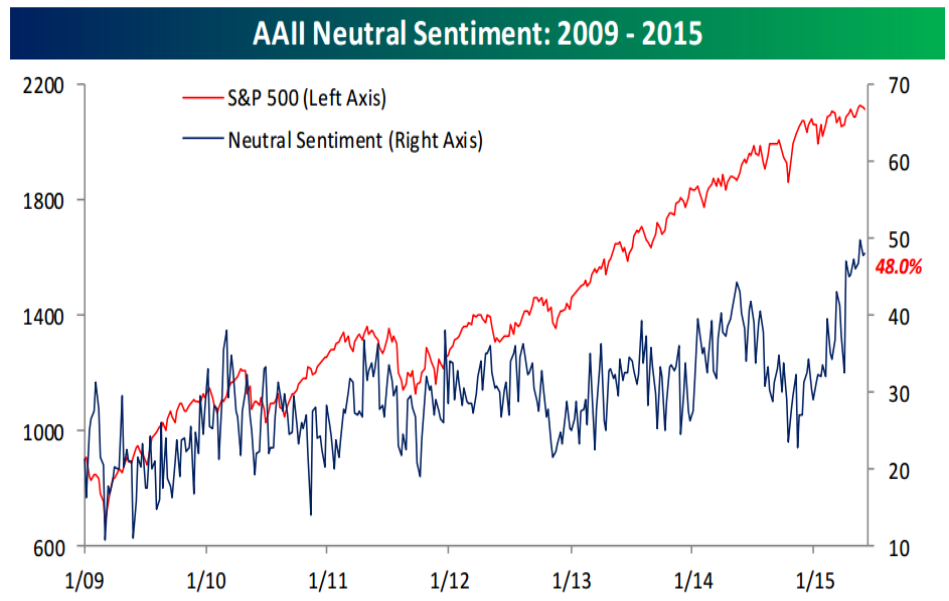
S&P 500 Index in May – New Highs Once Again

Source: Thomson One; S&P Dow Jones

As we suggested last month, this was not a year to "Sell in May and Go Away" based on the prevailing economic conditions. For the third year in a row, the adage has not been a good one to follow as the S&P rose roughly 1.3 percent. More importantly, S&P Capital IQ took a look at historical data and found that in years when May's return is positive, the average six month return from May through October is 3.5 percent and the frequency of a positive return for that same window is 87 percent.

While this type of historical pattern is encouraging it does little to shake the "boring" feeling on the part of investors. To put some numbers on just how quiet things are, consider the fact that the S&P 500 has now traded for six straight weeks with a move of less than 1 percent for the five day trading period. That is the longest stretch in 21 years. Additionally, Goldman Sachs claims that dispersion of stock returns (or the size of the range of returns), is so small that it now ranks in the ***bottom 1 percent*** of the past 35 years. As a result, market sentiment is exceedingly neutral at the moment.

Neutral Sentiment is High – Investor Conviction Low



Source: Bespoke Investments

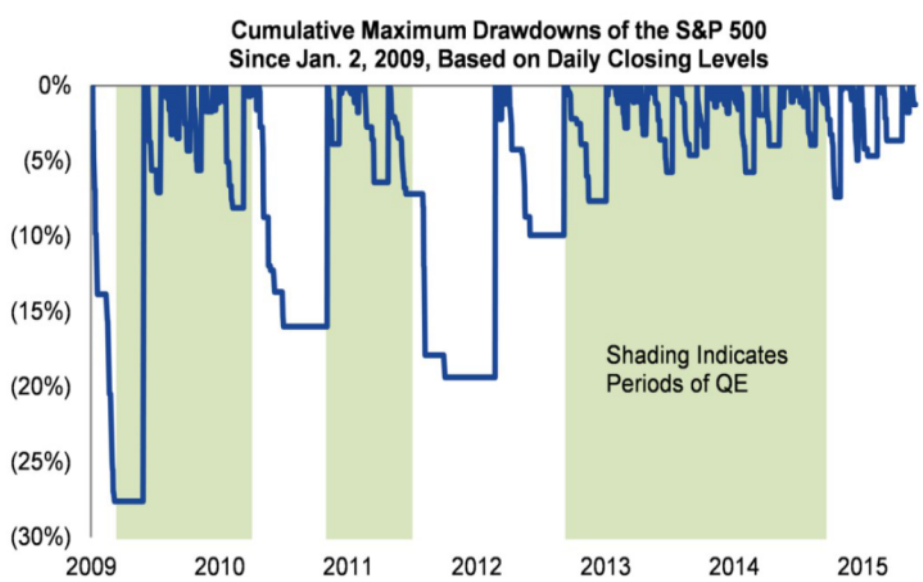
Sentiment, as measured by the American Association of Individual Investors, is close to 50 percent. The reading has now resided above 45 percent for a record nine straight weeks, the longest run in the 28 year history of the survey. Conversely, the bullish sentiment reading is currently just 27

percent and has remained below 30 for five straight weeks, the longest streak since 2003.

An entrenched neutral view of the markets implies that people simply aren't confident about the future path of equities, even though some potentially impactful events are on the horizon that could easily cause a spike in volatility. We will discuss macro events in more detail later but broadly speaking, Greece remains the wildcard. However, it has become obvious, that investors have grown tiresome of the back and forth drama, and frankly, it's hard to imagine an outcome that would meaningfully change the constructive narrative of the U.S. equity market.

That leaves the timing of an increase in Fed interest rates as the remaining issue. For quite some time, it seems that the market has been wed to the notion that "bad news is good news" and zero interest rates are the only thing supporting the market. We highlight these conceptions because the transition to a healthy, normal, fundamentally driven market with a favorable view of growth, inflation and monetary policy needs to occur. This has been a key event anticipated by market participants because it would likely lead the way out of this low conviction market. Fortunately, there is evidence to suggest that this transition might finally be taking place.

QE No Longer Necessary to support the Market?

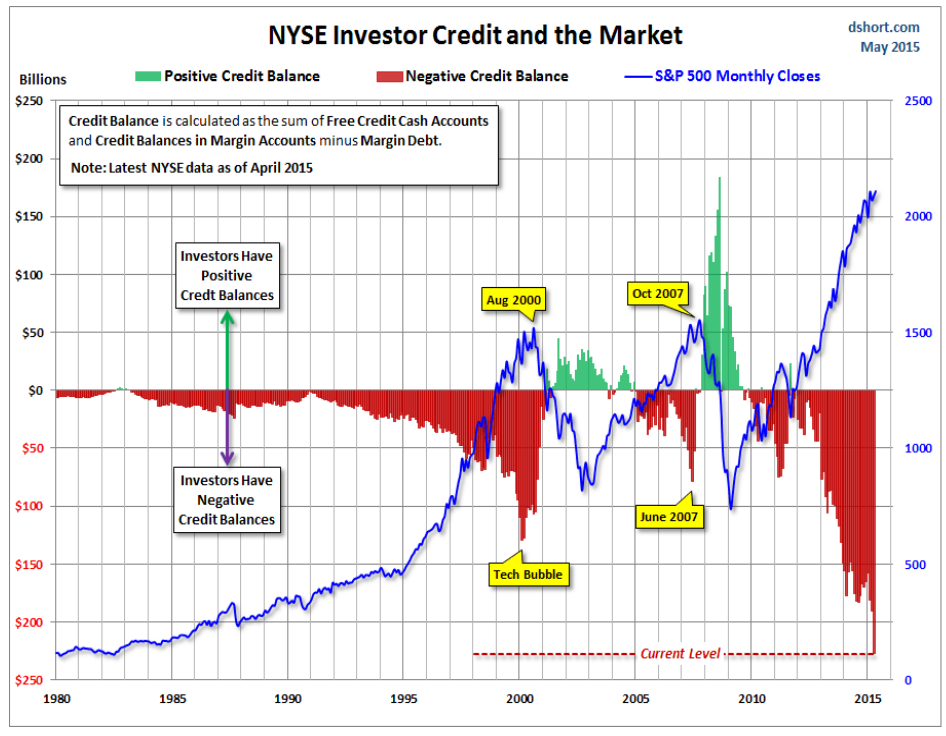


Source: Bloomberg; Morgan Stanley Research

While certainly no guarantee, the chart above from Morgan Stanley illustrates the fact that unlike 2010 and 2012 when the Federal Reserve began tapering their quantitative easing policies, in the fall of 2014 the markets response was not a sharp sell-off, but rather moderate volatility with shallow drawdowns and – importantly - a continuation of stock prices moving higher. If this trend remains in place, this would be a significant change.

An obvious counter argument to the placid attitude in the market is that investors are unprepared for future volatility and may even be taking actions that are riskier than they may otherwise be aware. One of the very common measures supporting this argument in May was the record levels of margin debt which is essentially a gauge of how much money people are borrowing to purchase stocks, which in the past has coincided with market tops.

Margin Debt and Market Tops? Not a Leading Indicator



Source: Doug Short

The problem with this argument is two fold. First, margin debt is not a leading indicator and has been at "record levels associated with tops" since 2013. Second, the magnitude of the margin debt needs to be taken into account. As the chart below clearly shows, debt as a percentage of market capitalization for the overall market has been steadily constrained to under 2.5 percent of total stock market cap value since the mid -2000 period.

This hardly suggests that investors are levering their portfolios to dangerous levels.

Margin Debt is Just 2% of the Total Market Cap

Source: www.seeitmarket.com

Bond Market Volatility

In theory, if investors are generally complacent with their equity exposure, they must be nervous about some other area of the market. The month of May clearly highlighted the bond market as that focus of concern. As we discussed in last month's Insights, beginning in mid April bonds yields globally began to climb higher. That trading pattern continued throughout the majority of May, most notably in Germany.

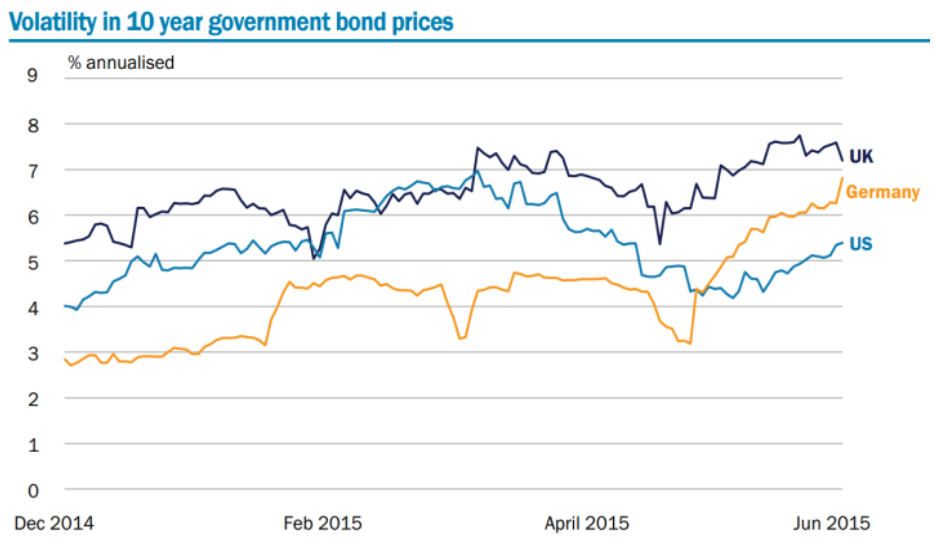
Global Bond Yields Continued Higher in May

Source: Bloomberg; Atlas Asset Management

The German 10 Year Bund yield had collapsed to a low of just 0.07 percent on April 20th before sharply reversing to peak of 0.72 % by mid-May. (We should note that this reversal continued dramatically during the first week of June with the Bund yield reaching close to 1.00 percent). The contagion effect appeared to spread to other markets as well with U.S., U.K. and Japanese bonds selling off in tandem. As we said last month, while the moves have been sharp, more concerning to investors is the fact that there was no clearly identifiable catalyst for the change in direction.

The culprit is likely not one single factor, but rather, a confluence of several forces. The optimistic explanation would be that improved growth, inflation and sentiment outlooks in Europe and the U.S. could lead to more immediate rate hikes, putting pressure on bonds. More pragmatically, as we suggested last month, it could be an accelerated unwind of extreme positioning fueled in particular by the ECB's quantitative easing program. Another school of thought suggests that the lack of progress on the financial crisis in Greece has increased the risks of contagion to the rest of Europe. And finally, large players in the bond market have been aggressively reducing their exposure to treasuries. While we don't know the precise influence of each of these factors in the sell-off, we do know that in this time of uncertainty bond market volatility is likely to remain at the recently elevated levels as seen below.

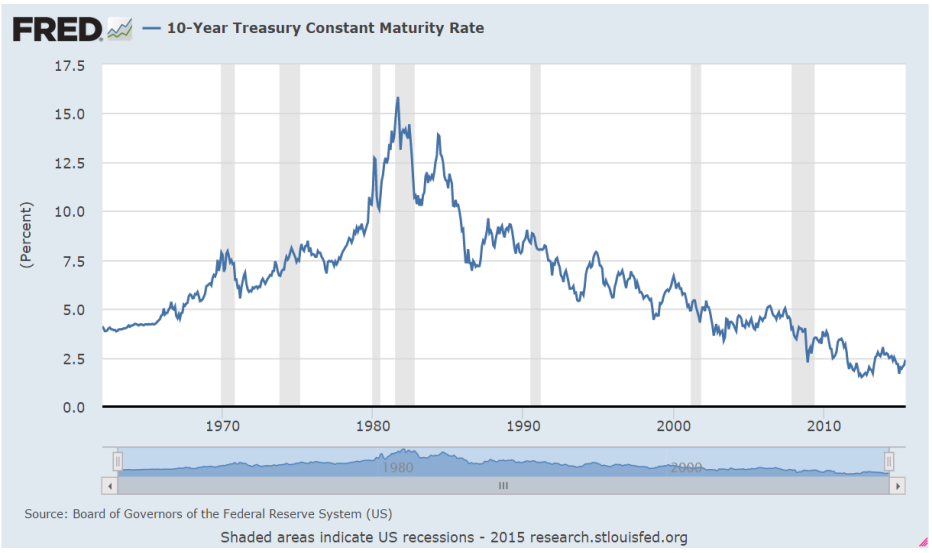
Bond Market Volatility Could Remain Elevated



Source: Bloomberg; Sarasin & Partners

With regard to the U.S. specifically, it is helpful to note that despite the headlines of a "bond market rout", yields are still firmly entrenched in the downward trend that has been in place since 1981. There have been no material changes as of yet to suggest that this trend will not continue.

Some Perspective on the Recent Moves in U.S. Bonds



Source: research. stlouisfed.org

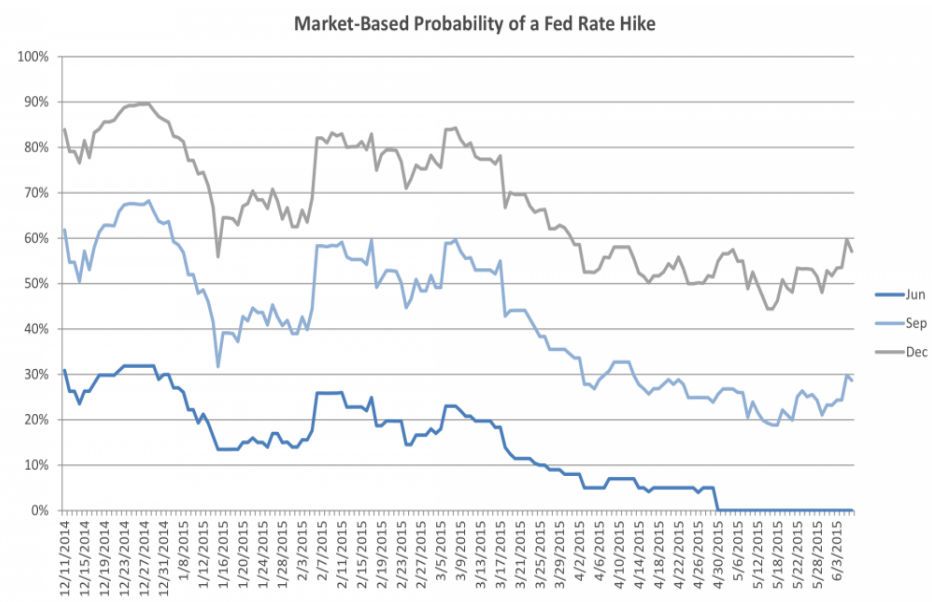
Timing of Rate Increases

The optimistic scenario we alluded to earlier seemed rather unlikely back in April as U.S. economic data disappointed throughout most of the month. As we discussed in our April Insights, most of the softness was likely due to transitory events that were not likely to last. As the progression of various economic indicators were reported in May, that temporary weakness reasoning seemed to have validity.

In particular, the labor situation showed strong improvement with a payroll number of 280,000 jobs added in May, well ahead of the 225,000 expected. Additionally, the ISM manufacturing index came in well ahead of expectations as well, suggesting that businesses are building up inventories and increasing productivity. Further, the Fed's Biege Book survey which measures overall economic activity showed expansion in almost all regions during the month. These items, combined with other confirming inputs such as record high vehicle sales and strong small business hiring and confidence, changed the conversation around when the Fed may begin raising interest rates.

As seen in the chart below, the weak data seen in April took a June rate hike off the table and pushed the implied likelihood of a September rate increase to below 20 percent.

September Rate Hike Probability <30%; December Probability Now Close to 60%



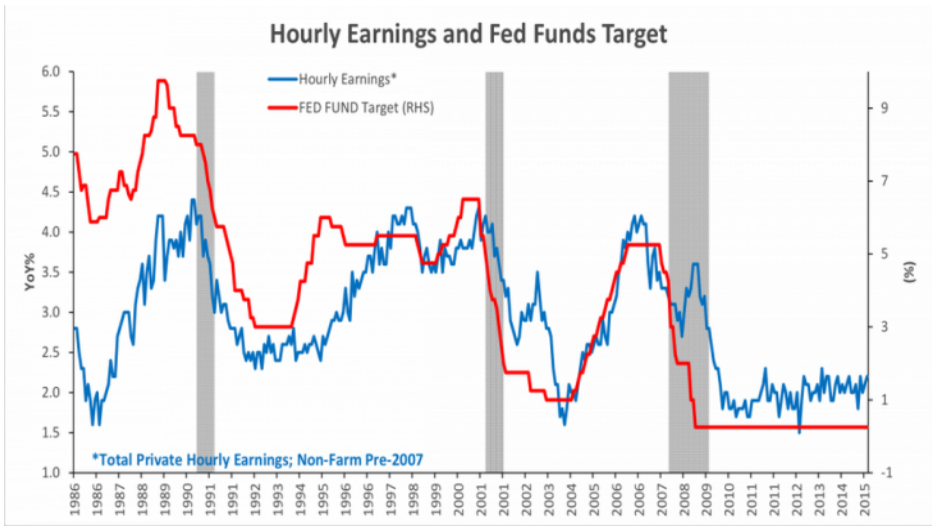
Source: Bloomberg; Doubleline; Business Insider

However, with the improvements in May, the market began to price in a 30 percent chance of a move in September and roughly 60 percent hike in December. This is not to suggest that these are certainties by any measure. In fact on June 3, in an unprecedented speech, Christine Lagarde, who heads the International Monetary Fund, urged the U.S. not to raise rates until 2016.

So what can we look to for further guidance going forward? Bond manager Jeffrey Gundlach at Doubleline has staunchly argued that the Fed will not raise rates until 2016.

However, he recently suggested that if we see a rise in average hourly earnings, increases in rates could come sooner. This is exactly what we saw in the May payroll report so stayed tuned.

Wage Increases Could Be the Impetus for Rate Hikes



Source: Minack; Doubleline; Business Insider

Going Forward

As we have tried to highlight over the past few months, 2015 has been a wonderful reminder that diversification plays a large role in prudent portfolio management. Year to date, developed Non-U.S. equities are up 8.6% and emerging markets stocks are up 5.7% while U.S. stocks are up 3.2% and U.S. bonds are up just 1.0%.

Within equities we continue to favor the large cap segment of the U.S. market. We would prefer to achieve 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. These sectors have performed well so far this year. However, we continue to look for areas of future opportunities in areas such as the financial sector.

We think this group is well positioned to benefit from a weaker dollar, higher bond yields and improving global growth and we will be looking to add to our exposure.

Our non-U.S. developed markets exposure has served us well this year. While we are still believers in the strong U.S. growth story, we think that international diversification through allocations to Europe and Japan in particular will allow us to participate in improving economic conditions globally. Both of these global regions continue to provide confirming data points on the progress of their respective recoveries and each remain in a very accommodative policy environment.

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. Whether the first hike comes in September or December, the narrative is the same.

Commodities remain structurally challenged in our view. With the apparent stabilization in the price of oil in the short-term, we are carefully looking at entry points for long-term investments. With regard to oil in particular, at around $65 a barrel, stagnant production in the U.S. will come back online creating downward pressure. However, as we have stated before, negative events in the Strait of Hormuz could quickly cause the price of oil to spike higher. We continue to cautiously monitor this sector before increasing exposure.

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.