Insights: May 2016

Market Overview and Performance

Global markets continued to rebound during the month of April, but the strong momentum that carried stocks roughly 15 percent higher since the middle of February faded considerably resulting in very mild returns. More interesting perhaps was the parallel between April of this year and April of 2015. In our May 2015 Insights letter, we wrote, "For the most part, the month of April was a plodding month with stocks gradually moving upward...most notably, the U.S. Dollar weakened and commodity prices moved higher". This year, the U.S. Dollar declined in April as well and has now declined by over five percent year to date. A weaker dollar has direct implications for the performance of a wide range of asset classes. This was clearly the case in April with risk assets moving higher as a result of the moves lower in the dollar. Gold and precious metals moved dramatically higher and commodities as a group rose by over eight percent. However, these trends can quickly reverse themselves and we see little evidence that this weaker dollar "risk asset friendly" environment will persist. In fact, the first trading week of May has already shown signs of just such a reversal. Additionally, there are a number of ominous clouds on the horizon including the upcoming "Brexit" vote, a June Fed policy meeting and the July presidential party conventions. These "known unknowns" are inherently volatile in and of themselves and when combined with unforeseen events, create a scenario that we feel is building toward a volatile summer period for investors.

As always, thank you for reading our monthly Insights.

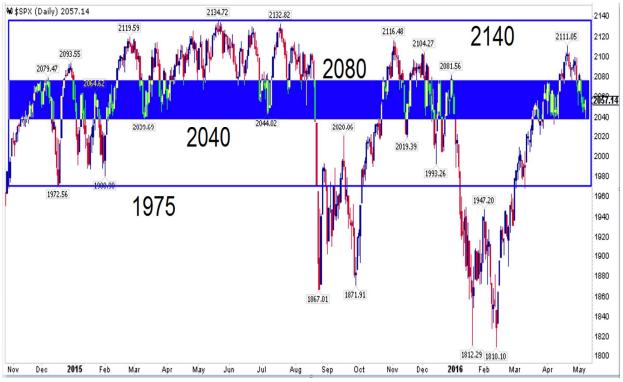
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	0.39	1.74
Russell 2000 Index	1.57	0.03
MSCI EAFE Index	**2.90**	-0.20
MSCI Emerging Markets Index	0.54	**6.29**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.38	**3.43**
Barclay's U.S. Credit Index	1.22	**5.19**
Barclay's Corporate High Yield Index	**3.92**	**7.40**
Barclay's Municipal Bond Index	0.36	**2.42**
Macro Measures		
Gold	4.44	**21.65**
Crude Oil	**19.77**	**23.97**
CBOE Volatility Index	12.54	-13.78
USD Dollar Index	-1.64	**-5.74**

April Themes – Spring Recovery Rally Loses Steam; U.S. Dollar Weakens and Risk Assets Rally; Little Belief that Stock Will Move Higher; Market Does Not Believe the Fed; Some Glimmer of Hope in Weak Earnings; Summer Period Looks Like it May be Volatile

Broad Equity Market Makes Little Progress

The fact that U.S. equities were largely unchanged in April should not have come as a complete surprise given that the market has actually been locked in a fairly narrow trading range since late 2014 as seen in the chart below. The S&P 500 Index for example entered April at the 2060 level, traded up to 2100 and then finished out the month at 2065. This is familiar territory for the Index. Since late 2014 the market has generally moved sideways in a band between 2140 and 1975 with strong tendency to reside in the 2040 to 2080 range.

Market Entrenched in Trading Range Since Oct 2014



Source: Northmantrader.com

Clearly the market has traded outside of this range most notably in February, but as we discussed last month, calls by some for an all out Bear market were unwarranted and the S&P 500 quickly moved back into its "comfort zone". The point here is that market has essentially been directionless since October of 2014. Why you might ask? Well, October of 2014 happened to mark the end of the third quantitative easing initiative by the Fed. As the following chart illustrates, the market traded lower after the end of the first QE efforts, however unlike 2010 and 2011, the Fed has begun to normalize rates and the market has seemingly come to accept this outcome. However acceptance is not the same as conviction or consensus and thus we have witnessed 18 months of back and forth trading.

October 2014 Happens to Mark the End of QE3

Source: Pension Partners; Stockcharts.com

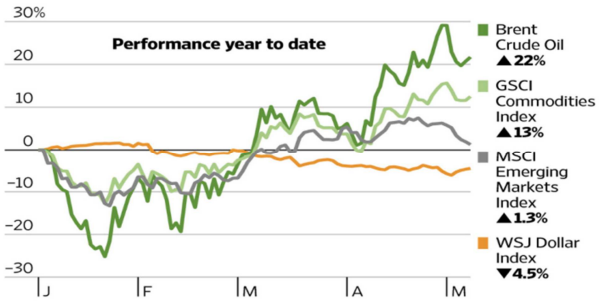
One of the most impactful factors in determining what will prove to be the actual path forward is the U.S. dollar. Thus far in 2016, the dollar has weakened defying what was probably the most strongly held consensus view among investor heading into 2016. As the chart below highlights, the dollar has fallen to support levels seen twice in 2015. (As of writing, the DXY Index had bounced back up to the 94.29 level). The dollar is closely tied to interest rates. As the Fed displayed a more cautious view on raising rates this spring and Europe and Japan held rates steady, the dollar suffered from the notion that gap between the US rates and those of other regions would not continue to widening causing the dollar to fall.

US Dollar Index Has Weakened to Levels Seen in 2015

Source: Societe Generale

A falling dollar has wide ranging implications. Most notably, the correlation between a weak dollar and investor appetite for risk assets is at a 20 year high of 86 percent according to Morgan Stanley.

Weak Dollar Has Propped Up Risk Assets



Source: Wall Street Journal

As the chart above clearly indicates when the dollar is falling, oil, commodities and emerging markets benefit. Commodities as a whole have responded well in particular. Bloomberg's comprehensive index of 22 components shot almost 9 percent higher during the month of April. Their precious metals index has risen 23 this year and in just the last month palladium was up 10 percent, platinum was up 12.5 percent and silver was up 19 percent.

Commodities Move Sharply Higher in April

Source: Bloomberg

But it should be kept in mind that these trends are precarious at best. If the Fed is perceived as taking a more hawkish tone in the next couple of months, even without an actual increase in rates, or U.S. economic data shows positive improvement investors could become convinced that that the Fed will raise rates sooner rather than later. This would force a reversal of all of the above – the dollar would quickly strengthen and risk assets like commodities and emerging markets equities would soon be sold.

The market is clearly aware of the potential for a sharp reversal in these trends and in the market in general. In other words, few believe that the current "risk-on" rally will continue. For example, Baron's magazine published its latest money manager poll in late April which displayed an overwhelming cautious view.

Despite Rally, Sentiment Remains Poor

Describe your investment outlook through December 2016.

Very bullish	3%
Bullish	35
Neutral	46
Bearish	16
Very bearish	0

Are your clients bullish, bearish, or neutral about U.S. equities?

Bullish	11%
Bearish	19
Neutral	70

Source: Baron's Magazine

Professional investment managers held either a bearish or neutral view on equities for the remainder of 2016 while an incredible ***89 percent*** of their clients claimed to be either neutral or bearish regarding U.S. equities. This is a big move up in the "neutral" reading from last fall when managers were only 29 percent neutral. Again, uncertainty and lack of conviction. Historically, one asset that tends to thrive in this type of wavering market sentiment is gold. Thus far, 2016 has been no exception. According to the Commodities Futures Trading Commission, net long positions in gold are at their highest levels since 2011 when gold prices surged to a record $1900. This is a safe haven trade. As firms like RBC Capital have pointed out, there is little increase physical demand for gold at present.

Gold Bets at Their Highest Level Since 2011

Source: Bloomberg; CFTC

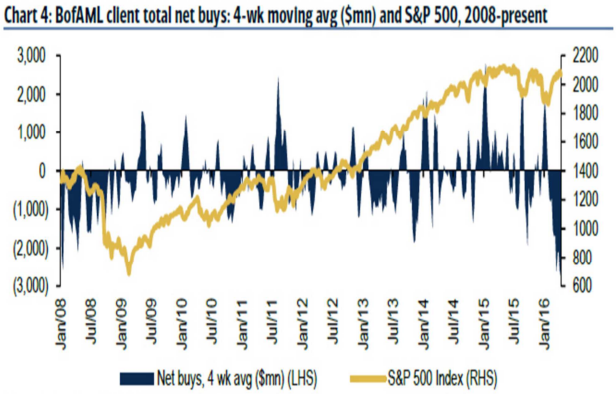
Other safe haven assets have shown remarkable behavior as well. Despite bonds delivering *negative* yields across many regions, investors have continued to funnel money in bonds across the globe in 2016 driving yields ever lower. In fact, Bloomberg's measure of aggregate global bond yields hit an all-time low on May 9th this year. This would hardly suggest that investors have faith in the notion that weak dollar/pro-risk asset environment is likely to persist.

Flight to Safety – Global Bond Yields at All Time Lows

Source: Bloomberg; @queenofchartz

More telling in our view though is the equity fund flow data. In a note published on May 2nd when the S&P 500 was trading at close to its high for year, Bank of America Merrill Lynch noted that its clients, "were net sellers of US equities for the 14th consecutive week…this has been the longest uninterrupted selling streak in our data history since 2008". They go on further to clarify that net sales have been led by institutional clients followed by hedge funds and finally private clients – across the board selling in other words.

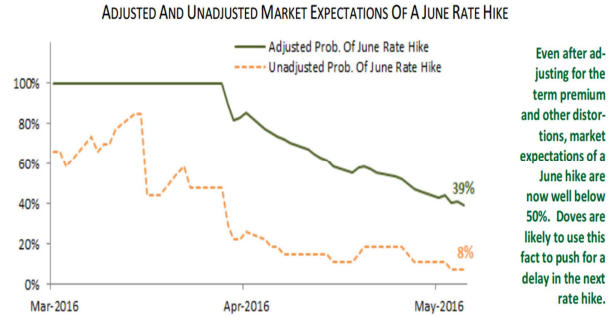
Net Outlflows from Equities Matches Record



Source: BoA Merrill Lynch Research; ZeroHedge

Economic data in April perhaps also helped foster a more cautious outlook. Although no indicators were particularly bad, as a group, the data did soften from the wide ranging positive surprises in March that we discussed in our April Insights. An "ok" April jobs report of just 160,000 (rolling six month average is closer to 250,000) was the last nail in the coffin so to speak for any expectation that the Fed would raise rates in June. As seen in the chart below, the market is not anticipating any policy changes by the Fed at their upcoming June meeting.

Odds of June Interest Rate Hike Fell Sharply in April



Source: Cornerstone Macro Advisors

The chart from Cornerstone Advisors shows that fed fund futures are only pricing in an eight percent probability of a rate hike in June. They try to adjust this figure by incorporating things like flows into safe haven assets however, the odds still appear low. As recently as late March there was an 80 -100 percent chance of a rate hike in June. Now the market is not giving above 50 percent odds of a move until December of this year. Despite this, there are some notable voices like Bill Gross and Mohamed El-Erian who caution that this positioning is potentially dangerous.

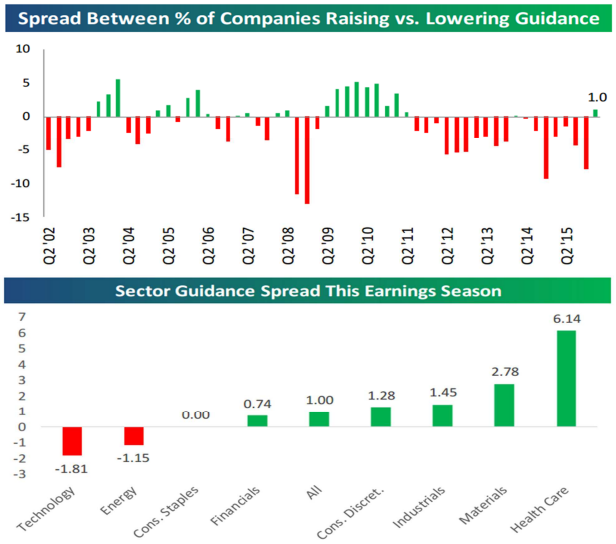
The Fed Does Have Evidence That Could Force Rate Hike

Source: US Labor Department; Bloomberg

They point to the data in the previous chart showing a clear trend higher in average hour earnings growth which is now approaching 2.5 percent on a yearly basis. They also suggest that the bond market, and particularly the two year bond, is trading at yield levels which would suggest no rate increases this year. This is not in accord with either the economic data itself or with what the Fed has been communicating to the markets.

While corporate earnings are not part of the economic picture assessed by the Fed, we wanted to comment briefly on this quarter's results since the media has broadly categorized the overall environment as very weak.

Earnings Revisions Now Positive After Extended Declines



Source: Bespoke Investments

It is true that earnings this quarter have been less than inspiring in aggregate with earnings declining by -5.5 percent and revenues falling by -1.9 percent. However, as we discussed in the past, these index level results are heavily influenced by the difficulties in the energy sector. More telling than just a headline number are inflection points and we perhaps saw one this quarter. Several strategists have suggested that we are approaching the trough in earnings and prior headwinds like a very strong dollar and free-falling oil prices should now be diminished. Potential evidence of this turn might be the shift we saw in earnings revisions. For the first time since June of 2014, but more realistically for the first time since June of 2011, positive earnings guidance is outpacing negative revisions. In other words, more companies are saying that they believe results will be better in the future than what is currently anticipated by the market. And as you can see from the bottom panel of the chart from Bespoke Investments, positive guidance is wide spread among sectors. This is not to suggest that a small reversal in a trend necessarily indicates an "all-clear" signal, but when corporate managements turn more optimistic it is worth taking note.

In addition to the over- analysis of first quarter earnings results, this time of year also brings out the annual "Is it time to sell in May?" market coverage. We are not believers in market timing strategies, but there are some interesting nuances this year. For the first time in six years, the S&P 500 recorded a negative return in the historically strong November to April timeframe. As LPL Research found, when the market has been down for the preceding 6 months, the average following six month return for equities in May through October has averaged -4.2 percent. Additionally, they found that the volatility of the market during the summer months as measured by standard deviation is roughly 35 percent higher than the historical average.

As we said in our opening paragraphs this month, we believe that markets are indeed facing a volatile summer given the market dynamics and the important macro level events that are set to occur over the next few months. We shall see.

A Negative Nov-May Often Leads to Weak Summer

S&P 500 PERFORMANCE DURING MAY THROUGH OCTOBER WHEN S&P 500 IS DOWN NOVEMBER THROUGH APRIL

	If Down November through May	All Periods
Average	-4.2%	1.3%
Median	-4.0%	2.1%
% Positive	43%	62%
Max Gain	18.7%	19.9%
Max Drawdown	-30.1%	-30.1%
Standard Deviation	12.7%	9.3%

Source: LPL Research

Going Forward

As we have discussed in last two month's Insights, the February reversal initiated the surprise to the upside that we viewed as an increasing likelihood given the extreme pessimism prevalent at the beginning of the year. We also stated last month that given the fact that markets have moved so far so quickly, we have used the strength in equities to take profits and remove some risk from our portfolios. We continued to do so during the month of April. As we approach the summer months, we feel that the likelihood of a pull-back is now substantially higher. There are a number of upcoming events that could potentially create uncertainty and angst among investors. These include an upcoming meeting of major oil producers, a June Fed Policy Meeting , a June "Brexit" vote; unresolved debt issues in both Greece and Puerto Rico; and a contentious U.S. presidential party conventions in July. We are therefore positioned defensively in our portfolios in anticipation of a decline that we feel will present a good re-entry opportunity for gains toward the end of the year.

Within equities we continue to favor the large cap segment of the U.S. market. With a recently weakening dollar and stabilizing of oil, late-stage cyclicals are poised to potentially perform well over the near term. This would lead us to focus on sectors like technology and energy, however we do continue to have exposure in selected areas of the consumer discretionary and healthcare sectors as well. Traditionally defensive sectors such as utilities and consumer staples are overvalued in our estimation so we prefer to limit exposure to those areas despite our near term caution on the market.

While we are believers in the strong U.S. growth story, we think that areas of outside of the U.S. appear attractive as well. As we have stated for quite some time, the potential for positive surprises in Europe is probably the highest of any global region. That was indeed the case this month and the MSCI EAFE Index rose almost three percent as a result. Japan continues to be impacted by their status as a "safe-haven" currency. As a result, the Yen has strengthened, slowing their efforts to spur inflation. However, we will monitor the changes in currency markets to a give us a better signal for the direction forward.

After an extended period of underperformance, emerging markets are becoming more of an interest. As a group they have already experienced a very strong run in the first few months of this year. If the dollar continues to weaken and oil slowly climbs higher, emerging markets will be a direct beneficiary going forward. Their unexpected 6.3 percent year to date return provides strong evidence for holding a diversified portfolio.

While we do not view traditional fixed income as being undervalued, we have shifted some assets toward fixed income as a result of profit taking within equity exposures. In a rising interest rate environment, we place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We continue to favor our explicit exposure to the muni markets which has performed well relative to other asset classes.

Despite the rally in March and April, commodities remain structurally challenged in our view. That being said, we believe that high quality names within the energy sector represent good long term value. While we do not believe the volatility in oil is behind us, we do feel that the year to date rally has helped establish a more sustainable trading range. Thus far in 2016, gold has been the one asset class to both serve its purpose as a diversifier and provide attractive returns. Given the macro outlook, we are not buyers of gold for fundamental reasons however we have maintained a small position in certain portfolios as a hedge which has performed well year to date.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.