Insights: April 2016

Market Overview and Performance

For the third year in a row, markets started off the new calendar year with immediate declines followed by a period of stabilization and then a recovery that resulted in net gain for the first quarter. On a pure returns basis, 2016 followed this playbook to the letter; however, the first quarter this year has been remarkable for a number of reasons. It marked the 12th positive quarter out of the last 13 for the S&P 500 Index, an impressively consistent run, but unlike the previous two years, the path was anything but consistent in terms of a trading range that eventually ended higher over a three month period. For example, the January 2015 S&P 500 return was negative three percent. This year, the Index tumbled relentlessly downward by almost 11 percent during the first six weeks of the year before racing almost 13 percent higher by the end of March. That precipitous fall was the deepest Q1 decline since World War II.

And in terms of the reversal, the strength of the snapback by quarter end has only been experienced nine other times in the last 70+ years according to S&P Capital IQ. For the month of March, the drivers behind the move higher were simply a continuation of the themes we discussed in our March Insights letter – an abatement of recession fears, an apparent stabilization in the Chinese economy and a more dovish Fed positioning. As we look toward the spring months, just how long the resulting "risk-on' posture prevails over the market remains an open question.

As always, thank you for reading our monthly Insights.

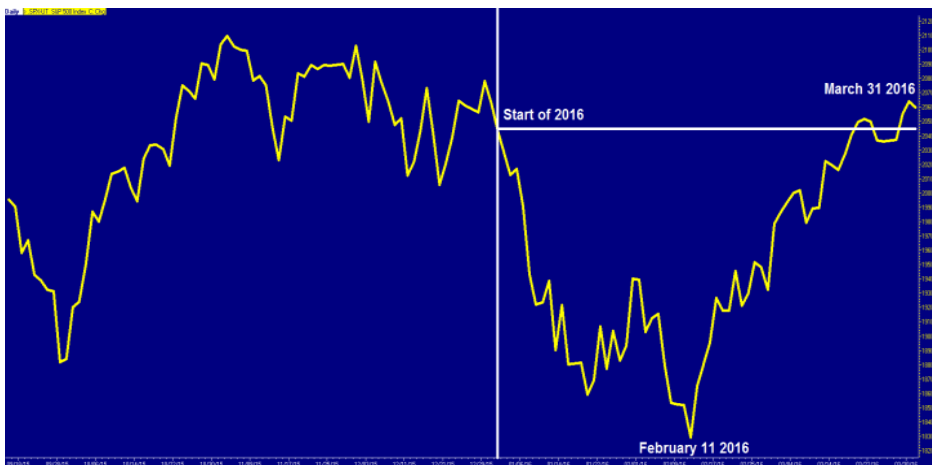
	Month to Date	***Year to Date***
Equity	***Total Return (USD$)***	***Total Return %***
S&P 500 Index	6.78	1.35
Russell 2000 Index	7.98	-1.52
MSCI EAFE Index	6.51	-3.01
MSCI Emerging Markets Index	**13.23**	**5.71**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.92	**3.03**
Barclay's U.S. Credit Index	2.52	3.92
Barclay's Corporate High Yield Index	4.44	3.35
Barclay's Municipal Bond Index	0.32	1.67
Macro Measures		
Gold	0.04	16.48
Crude Oil	**13.60**	3.51
CBOE Volatility Index	-32.12	-23.39
USD Dollar Index	-3.59	**-4.17**

April Themes – Recovery Narratives Continue; US Economic Data Strengthens; China Shows Signs of Improvement; Oil Climbs While the Dollar Declines; Earning "Recession" Sets a Very Low Bar for Earnings Season

Seven Straight Weeks of Equity Gains

As we stated in our introduction, the 13 percent snapback in the markets that spanned just seven weeks is a rare event. In fact, a positive return for the first quarter seemed almost unthinkable in early February, yet the S&P now sits less than three percent away from its all-time highs reached in the summer of 2015.

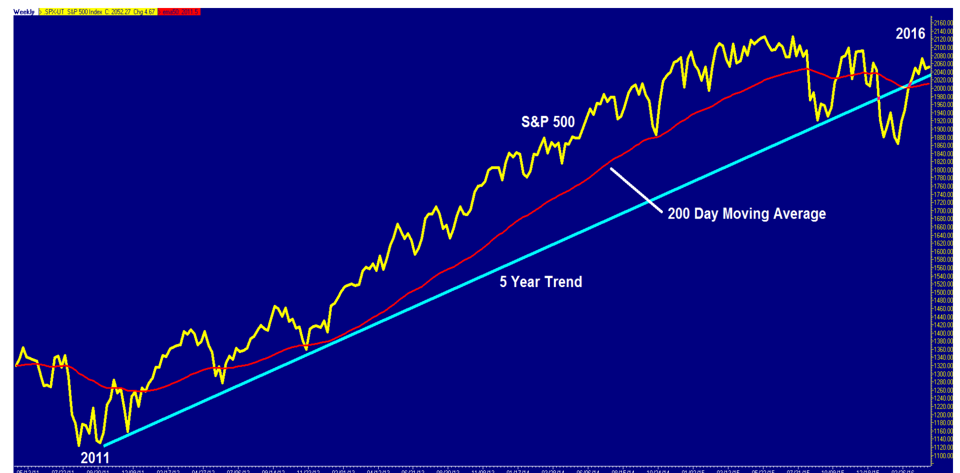
Market Climbs Into Positive Territory for the Year



Source: Thomson Reuters; S&P Dow Jones

This is a very sharp move in a condensed amount of time (in both directions in fact), but with each day to day swing being analyzed in detail by various pundits, few people take the time to discuss the fact the market is still trading within its long-term upward trend that began in 2011. The S&P 500 as a broad measure of the equity market also remains above its 200 day moving average. The 200 day moving average reflects the trading of the index over the prior 40 weeks. When the Index is trading above the moving average and the slope of the average line is moving higher, that is a good indication that the longer term momentum trend of the S&P 500 is positive. This long-lens view tends

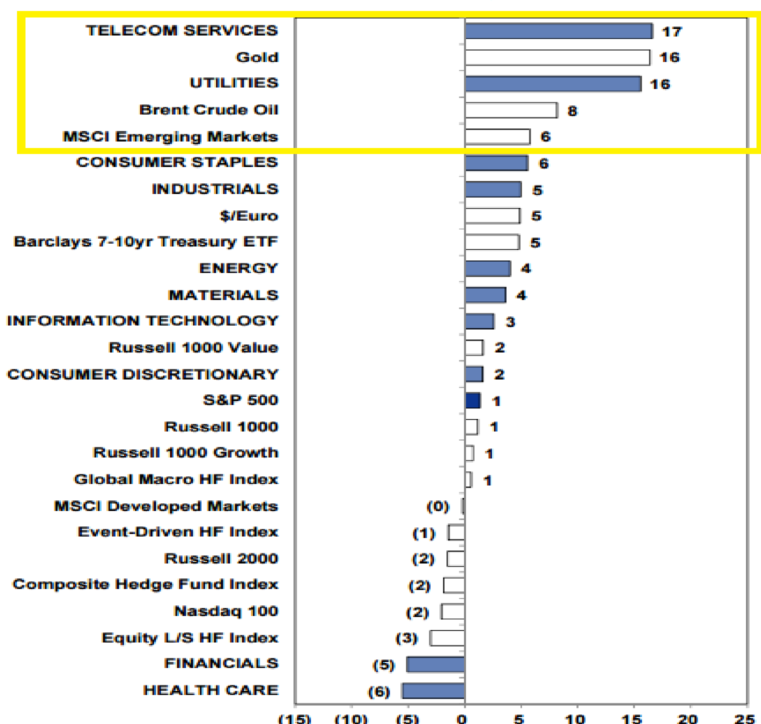
S&P 500 Five Year Uptrend Remains Intact



Source: Thomson Reuters; S&P Dow Jones

We advocate a long-term approach to investing and asset allocation so trends like this are important in our decision making process. While we focus on the fundamentals of an investment opportunity rather than the surrounding "noise" on the margins, changes in the narrative are important. The first quarter was a good example of this. Consider the fact that on December 1st, the CBOE Volatility Index stood at 14, historically very low. By February 11th it had reached 28, and by March 31st, it had retreated back to 14. This is a challenging environment for active managers in general, but even more so when you consider the performance table below. During the first quarter, the best performers were those viewed as the least attractive by many portfolio managers at the beginning of 2016.

Least Favored Areas Have Performed the Best

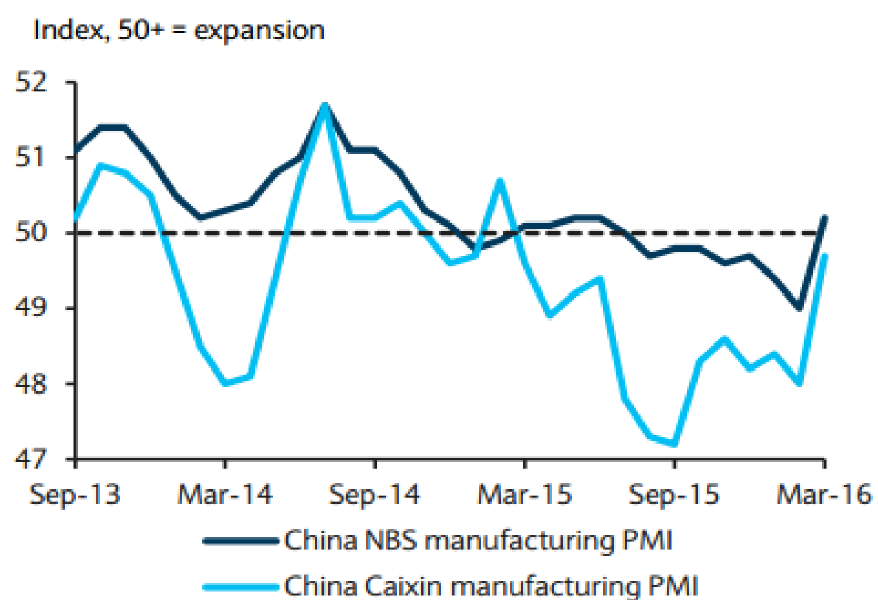


Source: Goldman Sachs Investment Research

The impact was dramatic. According to Goldman Sachs, 70 percent of large cap core mutual funds trailed the S&P with average returns some 200 basis points behind the Index for the three-month period. Things were worse for value managers, 75 percent of whom trailed, while an astounding 92 percent of growth managers were bested by their benchmark. According to Bank of America, this is the worst quarterly fund performance since 1988. This is not to suggest that active mutual funds cannot add value, but rather that they were caught wrong-footed so to speak. Defensive areas like utilities, telecommunications and gold soared by double digits while broadly favored sectors like healthcare, financials and technology actually declined. Given those returns one could easily assume that the quarter was one in which the world was seemingly coming apart; however, the rally was built on increasing evidence that the world actually got better.

Manufacturing Data in China Improved Dramatically

China: Sharp improvement in PMIs supports our view of short-term stabilization

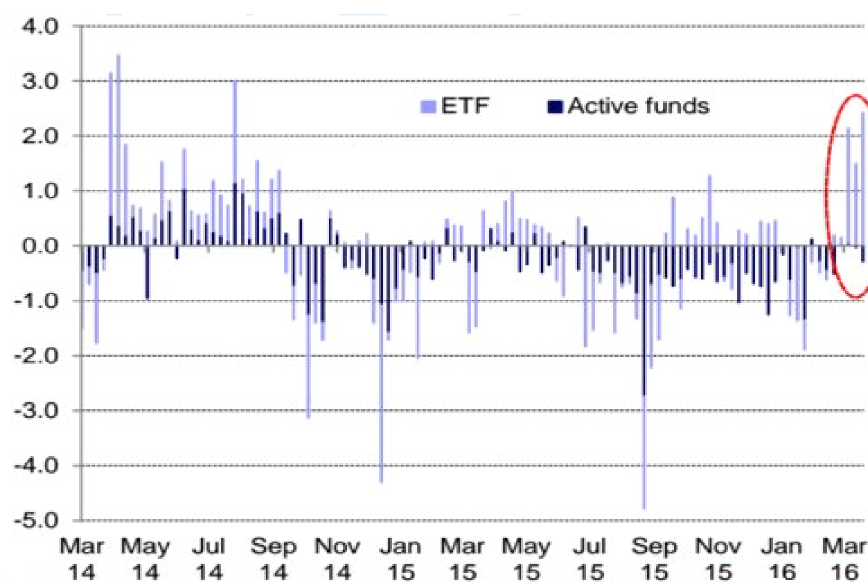


Source: Barclay's Research; Bloomberg

Perhaps the most important change in the narrative was the fact that the economic data out of China showed notable improvement. Following the apparent stabilization of the Yuan in February, signs of expansion in measures like manufacturing activity went a long way toward easing investor concern that a slowdown in China was going to drag down global growth overall.

In conjunction with abating fears of a China hard landing, the Fed also removed another big overhang in the eyes of investors by talking down their planned rate hikes from four in 2016 to just two (maybe…data depending).

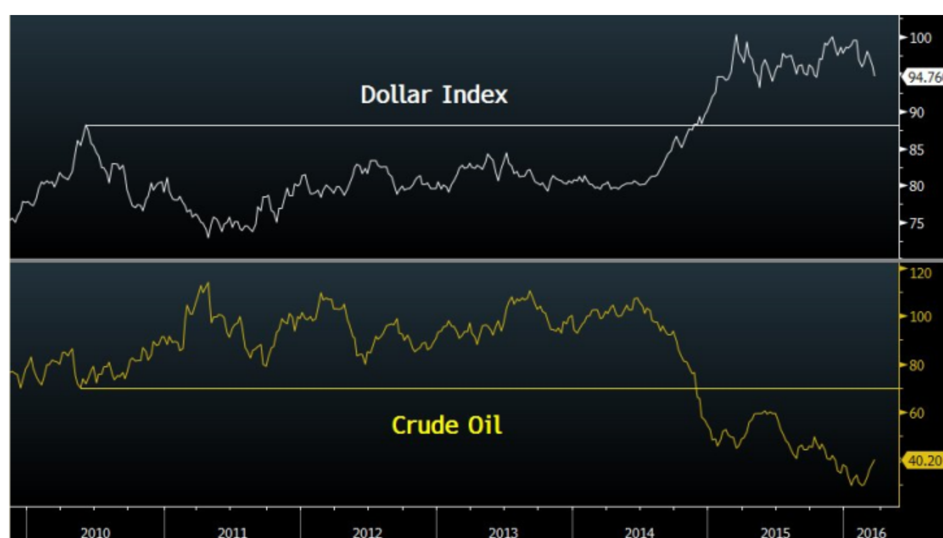
Emerging Markets See Biggest Inflow in Two Years



Source: Credit Suisse Research; EPFR Global

Emboldened by these turn of events, investors began returning to areas long since left by the wayside when the global growth slowdown seemed all but assured. The materials and industrials sectors witnessed strong rallies and even emerging markets, a 10 year laggard relative to developed markets, saw the largest inflows in two years. No one was positioned for this heading into 2016. Adding wind to the sails of this is rotation was the fact the U.S. Dollar finally started to weaken somewhat for the first time since 2014 while oil moved higher.

Change in Trend: Dollar Falls While Oil Moves Higher



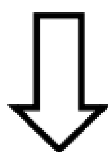
Source: Pension Partners; Bloomberg

As we noted, the moves this quarter have been sharp – both in terms of market returns and in terms of the moves in oil, commodities and the Dollar. All of these factors could just as easily reverse themselves in the coming months, so there is no "all-clear" signal just yet. In order to build sustainable gains going forward, more evidence of improving fundamentals may be required. Fortunately, the first quarter delivered much more broad based advancement than almost everyone anticipated. Focusing here in the U.S., purchasing managers index readings improved across the board during March.

Domestic PMIs Improve Across the Board in March

Domestic PMIs	Feb-16	Mar-16
Empire Manufacturing	(16.6)	0.6
Philly Fed Survey	(2.8)	12.4
Richmond Fed Activity	(4.0)	22.0
Markit Mfg PMI	51.3	51.5
Kansas City Fed	(12.0)	(6.0)
Markit Svcs PMI	49.7	51.0
Dallas Fed Index	(31.8)	(13.6)
Chicago PMI	47.6	53.6
Milwaukee Mfg. Index	55.2	57.8
ISM Manufacturing Index	49.5	51.8
Detroit PMI	52.0	59.1
ISM Services Index	53.4	54.5

Clean sweep so far for March! ...



... April 2009 was the last time we saw a 100% hit rate.

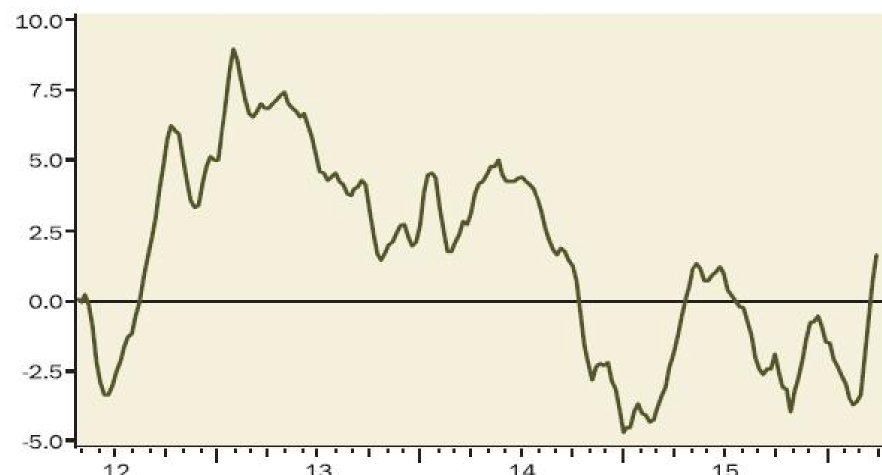
Source: CornerStone Macro Advisors

As Cornerstone Macro points out in the chart above, the last time they saw all twelve of these indicators of economic activity improve together within the same month was April of 2009 which was start of the current seven year bull market. That is pretty remarkable. We are not suggesting that the market is at the beginning of another seven year run, however, it would be hard to argue that economic activity in the U.S. is not improving much less falling into recessionary levels. Cornerstone goes further, suggesting that the current rise in equities was driven by better growth prospects and not just oversold conditions – a notable difference from the rebound seen last fall.

Leading Economic Indicators Pointing Higher

CHART 1: ECRI WEEKLY LEADING INDEX

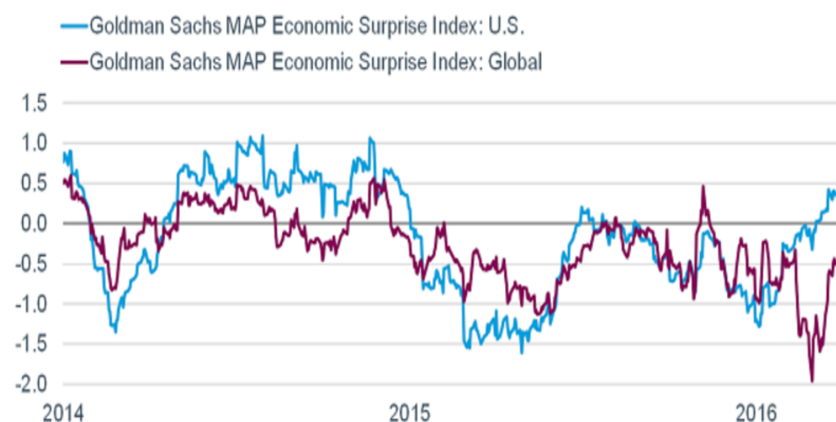
United States
(percent; smoothed growth rate of the four-week moving average)



Source: Gluskin Sheff; Haver Analytics

It is also important to note that PMIs are leading indicators of the economy meaning they illustrate where the economy is headed rather than where it was in past.

Positive Economic Surprises Occurring Globally

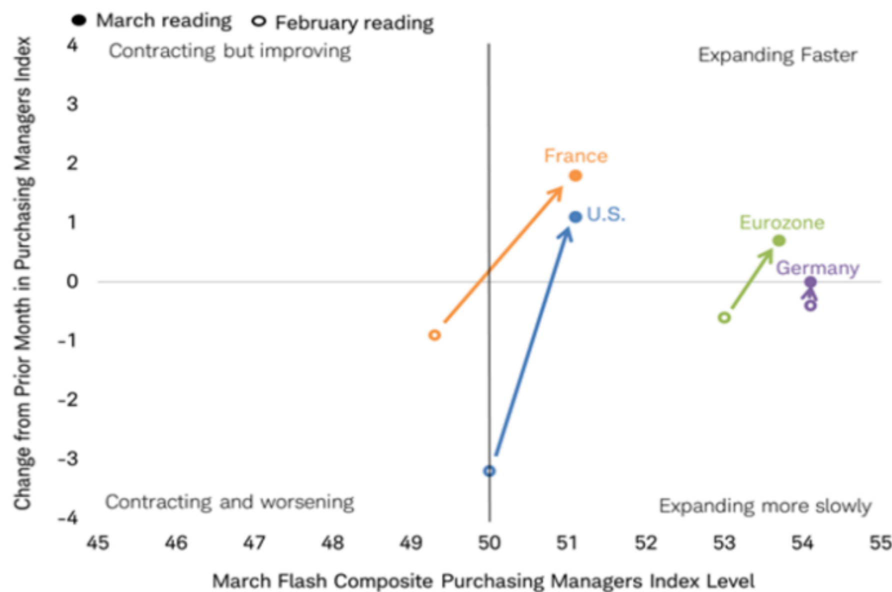


The Goldman Sachs MAP Surprise Indices summarize the importance and strength of economic indicators and track whether the economic data as a whole are outperforming or underperforming consensus expectations. Source: Bloomberg, as of April 8, 2016.

Source: Goldman Sachs; Charles Schwab

As the chart above highlights, positive economic surprises have occurred globally throughout the first quarter and particularly in March outside of the U.S. Again, this is especially important because much of the concern at the start of the year centered on the fact that the environment outside of the U.S. was materially worse than it was here. Additionally, trend is also important when looking at data. Sometimes more so than an actual "good" or "bad" individual data point. As the chart below highlights, selected PMIs for U.S. and the Eurozone not only moved toward greater expansion (to the right), but also at a faster pace (higher).

March Global PMIs Also Saw Marked Improvement

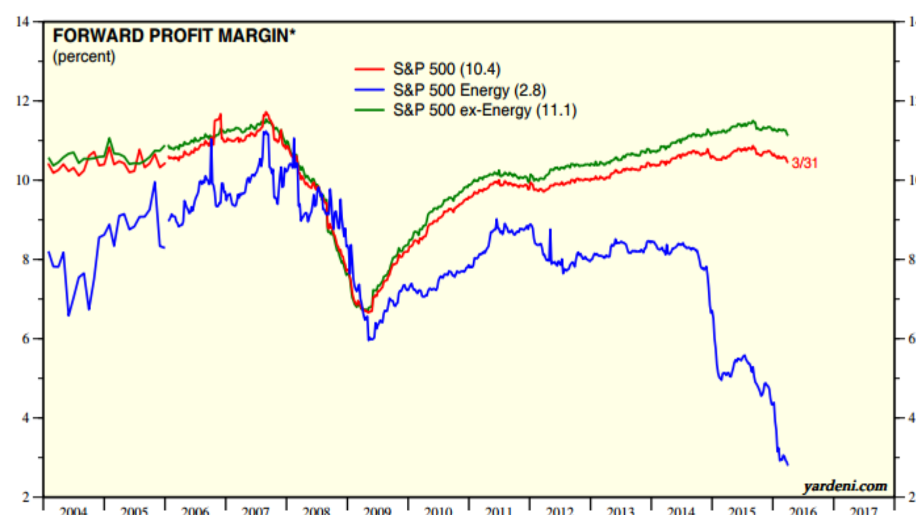


Source: Charles Schwab; Bloomberg

Let us reiterate that while these data are encouraging, they are likely to fluctuate. The big take-away is not that "all is well" but rather that extreme views which garner a good deal of attention need to be considered very carefully. Actual reported data for the quarter proved completely contrary to what many were saying just a few weeks ago.

As we start April, the tone of concerns have shifted toward what many have suggested is a "profit recession" and the fact that the market is no longer "cheap". We certainly agree that earnings this season will not look very good with expectations currently for a decline of roughly nine percent, but some things should be considered.

Profits Margins Outside Energy Remain Healthy

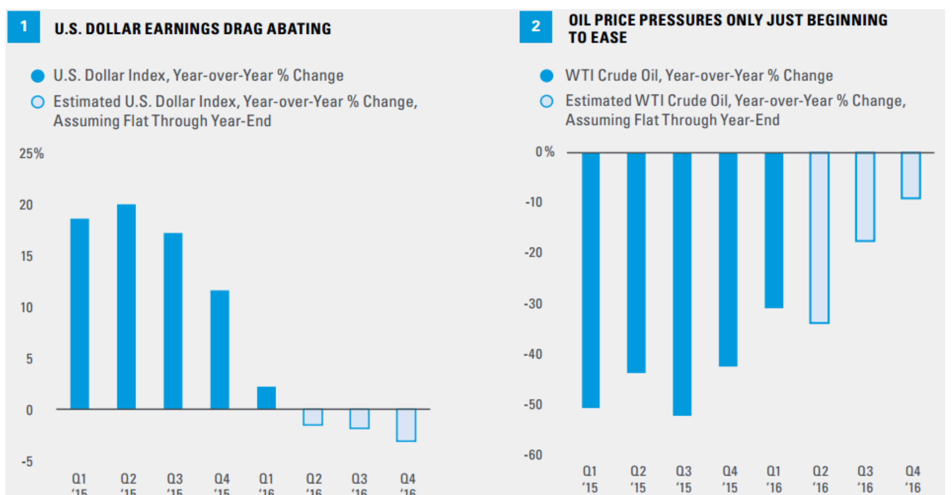


Source: Ed Yardeni

First, the notion that companies are in a profit recession is misleading. As we have written about in prior Insights, many of the summary figures cited are heavily influenced by the energy sector. As you can see in the chart above, profit margins remain at near peak levels outside of the energy sector which has been decimated by the decline in oil since 2014.

Second, earnings for the quarter are by their very nature backward looking – they reflect what happened in the past. As we just noted in the prior pages, the economic environment both in the U.S. and abroad improved dramatically in March and generally points to an increase in activity moving forward. Additionally, the two main headwinds that have been impacting earnings, the strong Dollar and the collapse in oil, have begun to reverse and therefore will actually start serving as tailwinds for earnings as the year progresses.

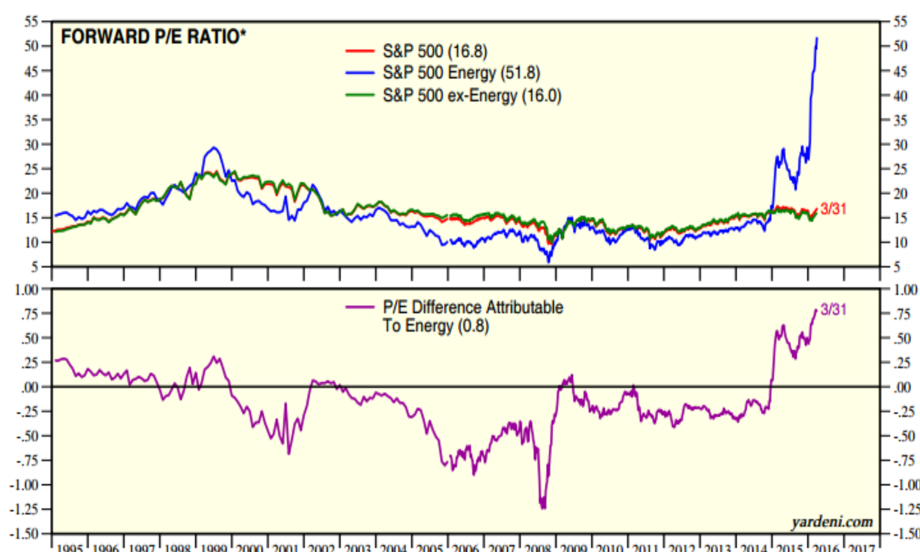
US Dollar & Oil: Headwinds Shifting to Tailwinds



Source: LPL Financial; Factset

Third, the bar for earnings has been set very low. One could rightly argue that this is a common phenomenon, but in the February period, consensus expectations were slashed by over nine percent – more than double the typical pre-earnings season move according to Bank of America Merrill Lynch. This suggests that sell-off was the primary reason for the reductions rather than weaker evidence. While only a small sample, of the 24 S&P 500 companies to have reported so far, 83 percent have exceeded estimates and EPS growth has been 6.1 percent according to The Earnings Scout.

Energy Impacted Earnings and Valuation



Source: Ed Yardeni

Finally, as of writing, the S&P 500 P/E ratio stood at 17.2 times the 2016 earnings estimate of roughly $120. Not cheap, but not stretched. As the chart above shows, the collapse of "E" for the energy sector has an impact of 0.8 on the Index, bringing the market measure for the overall market outside of energy closer to 16.4 – not far from its historical average.

Going Forward

As we mentioned in last month's Insights, the February reversal initiated the surprise to the upside that we viewed as an increasing likelihood given the extreme pessimism prevalent across the market at the beginning of the year. Additionally, we stated that we would be monitoring the environment for confirmation of the path upward given that March and April are historically some of the very best periods for equity returns. As we have written this month, the US and global economic developments have improved since February so we remain constructive regarding the prospects of higher returns by the end of the year. However, given the fact the market has moved so far so quickly, we would not be surprised to see a mild pullback followed by a generally sideways trading period as we head into the summer months. Therefore, we have used the recent strength in equities to take profits and remove some risk from our portfolios.

Within equities we continue to favor the large cap segment of the U.S. market. With the 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. The outlook for the financial sector has dimmed somewhat. Our initial thesis was that financials, which had underperformed the broader market, would benefit from a rising interest rate environment in 2016. With the Fed backpedaling from their fairly aggressive original plan to raise rates four times this year, the upside for financial names is likely more muted.

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 earnings surprises in Europe is probably the highest of any global region and the economic data across the Eurozone improved notably this quarter. Our outlook on Japan has grown more tempered. Despite the central bank's policy actions, 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. 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 quarter, but if the dollar continues to weaken and oil slowly climbs higher, emerging markets will be a direct beneficiary going forward.

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 February and March, 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 Q1 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.

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