Economic & Market Commentary

The first quarter of 2016 culminated what was a frustrating period for investors. Starting in August of last year, the U.S. equity markets have exhibited a W shaped pattern that, from point to point, have gone nowhere. During this time, U.S. equities had the worst start of a calendar year in history, with a sharp decline of more than 10% through February 11th. The market then reversed that "correction" with a gain of 13% through the quarter's end, producing a gain of less than 1% for the 3 months (+1.3% including dividends). It was a real roller coaster ride! The rest of the world fared no better, as global equities returned well under 1%, with the major markets all negative by 2% or more. Bonds and gold were the only asset classes that showed any strength. Large capitalization stocks continued to outpace small cap and value reversed the dominance of growth for the first time in some quarters. The utility and telecom sectors produced double-digit positive returns, while the other eight S&P sectors languished. Those two sectors have gone from worse to best, reversing their positions from the prior year. This reversal of sector performance, which we have referred to before, created dispersion among sectors that was unusually high. The lackluster performance of the U.S. and global economies, underscored by weak data reports and heightened fears of U.S. recession, led to a high degree of sector reversal over the past six months. Interestingly the so-called "FANG" (Facebook, Amazon, Netflix, and Google) stocks – the darlings of last year - suffered a sharp reversal this year. Goldman Sachs research points out that the momentum stocks, which gained 28% last year, were down 7% for the quarter.

These circumstances continued the difficulties that actively managed portfolios had last year. We wrote about this extensively in our previous Economic and Market Commentary, and the trend continued into the first quarter. According to Merrill Lynch, less than 20% of U.S. equity funds beat their benchmark in the period, with only 6% of large cap funds doing so. This continued the flow of money away from active strategies and into passive. Morningstar reports that passive management now accounts for about 33% of U.S. assets managed in mutual and exchange traded funds. We pointed out in our last outlook that we had been through periods like this before, (Nifty Fifty – Oil embargo – Tech bubble) and they usually last 2-3 years, and that, we believe, we are in year 3 of the current distortion. We concluded that while underperformance is not pleasant it does happen to most investors at some point, but does come to an end. We recently found a study published in the Columbia Business School quarterly 40 years ago, that examined the long term investment records of a handful of investors considered outstanding – Warren Buffett, Walter Schloss, Tweedy Browne, Sequoia Fund and others. Their finding showed that even legendary investors suffered periods of underperformance. In fact, the handful in the study underperformed for 30% of the years on average, yet produced returns that beat the market by between eight and sixteen percentage points, per year.

The volatility the markets experienced early in the quarter was primarily caused by exogenous factors, not U.S. economic performance. As we wrote in January, soft data from China (and other emerging market economies) caused the Chinese stock market to collapse and the yuan to weaken, coupled with severe declines in commodity prices (oil hitting $26/barrel) ignited fears that a deflationary wave would sweep globally and result in a U.S. recession. This was reversed mid-quarter when the European Central Bank (ECB) introduced another monetary package that went further than expected, and provided the promise of another dose of liquidity that the addicted financial markets have come to demand. In spite of all this noise, the U.S. economy continues to move along at a slow, but steady pace. First quarter economic activity started slowly and is expected to result in a real GDP report of +1.0%, give or take. This is below our base case +2%, and will require some catch up as we go through the year, but we see no reason to alter this, as we think there is enough juice left in the economy to continue the +2% pace. The consumer has been the bulwark of U.S. economic growth during this recovery. Consumption expenditures have grown from 60% of U.S. GDP to close to 70% over the past 50 years. This is close to an all-time high and is obviously an important ingredient in future growth. With employment gains averaging 200,000 monthly, low energy prices, low interest rates, and wages beginning to grow above the 2% rate they have been mired in, we expect the consumer to continue a leadership role. Anything that threatens the consumer’s ability or willingness to spend would be a negative, and there are several things that could do so. Median incomes are below trend, retail sales are spotty, the savings rate is below previous norms, and the impact of the rise in wealth is questionable. These are all things that must be watched.

The other area that we expect to add to economic growth is housing. We all know the impact the so-called housing bubble had on our economy earlier this decade, but that bubble has burst and should now be ready to reverse. Housing starts peaked in 2005 at an annual pace of over 2 million, troughed at 500-600,000 in 2009-11, and are now running at just over 1 million. Virtually all the housing data noted by economists are favorable for a return to growth. Interest rates, mortgage payments relative to income, housing affordability, demographics, all indicate renewed growth. Yet residential investment is well below expected levels. Clearly there is much room for improvement. These factors should allow the economy to grow at the accelerated rate necessary as the year progresses.

With the U.S. (+2%) and global (+3%) economies growing at below trend rates, and recession not in sight, we continue to expect modestly positive equity returns, with mid-single digit returns the most likely. As long as uncertainty and volatility are high this pattern could well be interspersed with spasms to the downside, as we have had recently. Many of the risks we face are the same as we have enumerated before, except it is later in the game and most are no closer to resolution. To the usual geopolitical suspects should be added concerns about the outcome of the June 23rd UK referendum on continued European Union (EU) membership, questions about the Federal Reserve Board’s actions on interest rates, and the U.S. presidential election. All of these breed uncertainty, which the financial markets abhor. This comes at a time when the equity market is selling at 17x - 18x 2016 estimated earnings, with earnings themselves suspect. At this valuation level, the “market” is at the upper end of fair value – not yet extended but getting close. The equity risk premium is not far from the lows of the past 10 years. Aggregate earnings for the S&P 500 are expected to be down about 8% for the quarter being reported now, and estimates for the full year are being chipped away. This, of course, refers to the aggregate "market." We don't buy the "market," but rather buy shares of individual companies, and any individual company can have characteristics very different than the "market." With the US stock market approaching all-time highs again, it is difficult to find good, growing businesses that remain attractively priced. Many sectors are fairly to expensively priced, but there are some areas that provide fertile ground. The broad investment community's focus on short-term financial results and lack of patience for shortfalls does create very good opportunities for disciplined, fundamental investors with a longer-term horizon (such as ourselves) to exploit.

Fixed Income Review and Outlook

At the end of last year, the Federal Reserve Open Market Committee raised the federal funds rate, for the first time since 2006. The Fed took the first small step to normalize rates based on the strength in the U.S. economy. Heading into 2016, Fed Chair Janet Yellen announced her expectation to raise rates four times this year, based upon economic growth projected at 2.4% combined with inflation projected to rise closer to the Fed's 2% target.

To borrow a phrase from noted poet Robert Burns, "The best-laid plans of mice and men often go awry."

Fear gripped the financial markets during the first month and a half of 2016, as investor concern grew over the impact that stagnant economic growth across the globe would have on the fragile U.S. economic recovery. As a result, investors flipped the switch into full "risk-off" mode, as market volatility spiked higher and some asset classes that typically exhibit low correlations began to move in lockstep. Commodities (oil), stocks (S&P 500 Index) and U.S. Treasury yields (10-year Treasury note) all simultaneously fell to reach new 52-week lows by February 11th. At the same time, spreads on investment grade corporates widened by more than 50 basis points in just a few weeks. During the first quarter, Treasury yields fell by an average of 50 basis points across the majority of the yield curve (from 3 years to 30 years) as investors worldwide sought safety. Also on February 11th, the 10-Year Treasury Note Volatility Index (a measure of bond market volatility), reached its highest level since its 2014 inception and stood at a 50% higher volatility level than on New Year's Eve less than two months earlier. Only rates for Treasury securities with less than one year until maturity were unaffected.

Investor sentiment throughout the financial markets had changed so drastically by mid-February that Fed officials were fielding questions on the possibility of negative interest rates (where banks are essentially charged to store cash with the country's central bank) instead of when to expect the next interest rate hike. Several European central banks, as well as the Bank of Japan, have already utilized this extraordinary monetary tool. Both the current and former Fed Chairs (Alan Greenspan and Ben Bernanke) publicly weighed in on the issue and declared that although negative interest rates were not precluded from use, such a scenario was highly unlikely in the United States, a view with which we concur. By the time the Fed convened in mid-March, global financial markets had begun to stabilize as asset prices bounced back from their February lows. European fiscal authorities contributed to this recovery by delivering interest rate cuts, increasing bond purchases and providing subsidies to institutional lenders in order to fight deflationary pressures.

Despite improving market sentiment, the recent market turbulence influenced the Fed, and Chair Yellen came out with dovish comments following its March meeting reducing the number of fed funds rate increases planned for 2016 from four to two. In addition, the Fed reduced its economic growth outlook for the year from 2.4% to 2.2%, citing the impact of slowing world growth on the U.S. economy. Based on the futures market, investors now believe there is an equal chance (50%) that the Fed will keep rates unchanged or raise rates just once by 25 bps in 2016. In contrast, when the year began the market was pricing in a 50% chance of a rate hike at the March meeting and a greater than 90% chance by December.

With this as background, the Barclays Aggregate Bond Index returned 3.02% in the first quarter and all of the major bond sectors posted positive returns as investors flocked to less risky assets. The Treasury yield curve "bull-flattened", as Treasuries maturing in three or more years saw yields fall by 45-55 basis points, while yields on short-term Treasuries changed only slightly. Investment grade U.S. corporates led all sectors, followed by Treasuries with both outperforming the Barclays U.S. Aggregate Bond Index. Agencies and Mortgage Backed Securities (MBS) both posted positive returns, but lagged the benchmark.

In this environment, we are maintaining portfolio durations between 90% and 95% of our targets. Our bias is towards investing in a slightly narrower maturity range, since the current flatness of the yield curve offers little incremental reward for taking on the additional duration risk of longer maturity bonds. In addition, given the recent strength of the rally in Treasury securities, we may look to replace some of these positions with agency or corporate credit securities that can both earn incremental yield over Treasuries and realize price appreciation as spreads return to normalized (lower) levels.

Portfolios maintained a barbell strategy that involves holding a mix of short-maturity bonds along with intermediate-term bonds, in order to obtain an overall short portfolio with relatively less sensitivity to increases in short-term interest rates. One additional modification to our strategy is driven by the recent spike in bond price volatility. Higher bond volatility increases the yield (lowers the price) of any bond with an embedded option like a call option because the right for an issuer to call a bond takes on greater value. We seek to take advantage of this scenario by purchasing callable bonds that offer greater yields relative to comparable bullet bonds (without call options).

We continue to overweight corporate securities with solid balance sheets and a comfortable level of free cash flows available to service the debt. During the quarter, we took advantage of the spread widening (lower prices) to add to corporate bond positions from available cash and matured or called securities. Although spreads have partially tightened from February 11th levels, we still see attractive opportunities in corporate bonds, particularly in select financials and energy-related issuers where the highest quality names were punished indiscriminately along with the weakest ones. This has created opportunities to pick up high quality corporates selling at temporary discounts.

There is limited incremental yield gained from purchasing Mortgage Pass Through securities at current prices, so we do not anticipate adding new positions. Collateralized Mortgage Obligations (CMOs) comprised of mortgages issued by government-sponsored enterprises (Fannie Mae and Ginnie Mae) offer better value. We continue to seek out structured paper priced below par which does not become significantly more interest rate sensitive in a rising interest rate environment.

The Barclays Municipal Bond Index returned 1.67% for the quarter. Municipal securities were relatively immune from the volatility that affected most fixed income sectors, as the yield spread of municipal securities relative to Treasury securities remained fairly constant. Since municipal bonds are priced relative to Treasury securities, the absolute yield of municipal securities fell along with Treasury yields, which means prices rose and made finding attractive securities to purchase more challenging. We continue to like taxable municipal securities which add to portfolio diversification in non-taxable accounts. Non-taxable munis rated AAA are currently trading at 95-105% of Treasury yields, plus the investor often earns a higher after-tax return from municipal bonds relative to equivalently-rated corporates, so they remain an important component of taxable client portfolios.