MARKET
PERSPECTIVES

STC Investment Committee

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Through June of this year investors may have been totally confused, but at least were making money across the board. However, in September, stronger U.S. economic reports drove risk assets down sharply on fears of increased Federal Reserve tightening. Investors were losing money, but at least thought they knew why. October produced even greater losses across risk assets, particularly in energy - this time on fears of a slowdown in U.S. and global growth. Perhaps the lesson is that when asset prices reach overvalued levels, they become vulnerable, as all news is potentially adverse, whether growth is too high or too low (or Ebola spreads).

The combination of disappointing growth in Europe and China and improving growth in the U.S. caused the dollar to spike and risk assets to fall in September. The U.S. second quarter growth rate was revised up to 4.6%; in contrast, the European Central Bank cut rates 10 basis points and China's industrial production growth fell to a 5-year low. World equity markets fell 3.5%, slicing year-to-date gains in half. With a 0.7% decline, Japan was the relative outperformer. Emerging markets were down 7.4% on slowing growth and election concerns in Brazil, which fell 19.4%. Equities were not the only loser: Treasuries -0.5%, high-yield debt -2.1%, world bonds -3.3%, REITs -6.2% and commodities -6.2%.

The first two weeks of October were eye-opening, with losses building upon September's. The move downward in the 10-year Treasury yield was striking, declining from 2.53% to 2.14% since June-end on international growth fears; the yield actually plunged to 1.85% intra-day. Broader equity price declines even pushed U.S. equities into the red for the year. International developed markets were down 9% for the year. Despite the boost from lower interest rates, junk bonds continued their slide from frothy levels, falling an additional 2% intra-month.

Although I have remained in the "new normal" (growth will continue to disappoint) camp since the start of the recovery in 2009, my central thesis was that inflation would reappear as unemployment fell and the Federal Reserve would begin a tightening cycle in mid-2015 that would prove to be more aggressive over time than anticipated. Given the magnitude of the sudden collapse in bond yields and energy prices (and a 30 basis point decline in long-term inflation expectations), the market is signaling me to reconsider my view.

Preliminarily, I think that global growth fears are overdone. In the U.S., I see none of the excesses of debt accumulation or excessive capital or consumer spending that might precede a recession. A key factor behind the unusually slow domestic recovery has been the government sector, mostly from slow discretionary spending, but also from anti-growth regulations and rhetoric. Near-term, government should be less of a drag going forward. I believe China's growth will continue to secularly disappoint, but that may be a greater problem for industrial, commodity-dependent, markets than for China itself. Given the labor-intensive nature of the service sector, job creation can be maintained even at lower levels of headline growth. Europe is

Continued on back.

faced with the challenge of deleveraging in a low growth, low inflation environment within a currency union structure where the leading economy (Germany) insists on a hard-currency internal devaluation solution. While fiscal austerity is behind them (except France) and structural reforms have occurred in some countries and companies, it is hard to see a near-term pick-up in growth from these low levels. I think the recent fall in the Euro should prevent a Eurozone recession and believe the Euro offers good value at these levels, particularly given the dovish Federal Reserve Board's concerns over an excessively strong dollar.

From a near-term positioning standpoint at the asset class level, we are boosting risk-exposures from July's highly defensive levels: cash is reduced from the upper band of 15% to 12%, with the 3% deployed to listed equities. Given the record high spread in valuations between the U.S. and Europe, I continue to prefer non-U.S. equity markets as, despite the market decline, U.S. equities remain 12% - 15% overvalued. Our recommended hedge fund overweight is maintained, with a slight shift from uncorrelated to directional strategies. Municipal bond weights are unchanged at below-target levels, as modest spread widening offsets some of the negatives in the low level of benchmark rates.

Our more significant changes are within asset classes, where we are meaningfully adding risk in our domestic equities portfolios and within the tactical fixed income space. Setting Treasury rate levels aside, credit spreads on high-yield debt have widened to attractive levels. Since there was little corresponding move in higher yielding municipal bond spreads, it makes sense to boost taxable credit exposure from our low current levels. We are purchasing additional leveraged loans and are likely to allocate to a "go-anywhere" taxable credit fund.

Since the best opportunities in domestic equities are in financials and energy, two of the "riskiest" sectors, our "solution" is to remain underweight domestic equities at the asset class level, but to be aggressive within the asset class. Despite our plans to mitigate risk through aggressive covered call selling, our calculated equity returns are likely to be quite volatile.

Indeed, volatility well may be the watch word for the coming months!

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