MARKET
PERSPECTIVES

STC Investment Committee
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This year's first quarter returns appeared uninteresting on the surface, but actually masked a great deal of volatility under the surface. A difficult January was followed by a terrific February and then a muted March. Looking forward, we would like to share our outlook for the markets and how we are currently positioning portfolios.

Market Outlook and Portfolio Positioning:

Domestic Equity
We are below target for U.S. stocks. Returns will be sub-par for the next five years, perhaps annualizing only in the 3%-4% range, well below historical norms. This return estimate is derived from our bottom-up equity research work showing domestic equities as 25% overvalued. If we subtract 5% from normal expected returns of 8-9% for the next five years, one could arrive at our 3-4% average annual figure. Returns could fall short of even these levels, as our work is based on consensus earnings estimates which assume company profit margins will expand from already record levels. Other valuation metrics, such as the market capitalization to gross domestic product ratio, suggest that the market is 10% more overvalued than at the dot-com peak and 50% higher than the historical average. While elevated valuations will be the primary driver, equity market volatility is likely to increase as the uncertainty around the timing and speed of Fed interest rate tightening draws closer. Our equity composite has benefitted from the recent increase in oil prices which has resulted in positive year to date performance versus benchmarks. We have been selling into strength, bringing our 20% energy weighting closer to 15% of the portfolio.

International Equity
We are neutral on international developed stocks. While the U.S. has a lower trailing price-to-earnings ratio, the rest of the world has superior earnings growth prospects given the room for margin expansion. This leaves international equities fairly valued in local terms and undervalued in dollar terms. Returns should be more in line with historical averages as the 2015 rallies in Japan (up 14%) and the Eurozone (up 19% in local terms; 5% in dollars) have closed some of the valuation gap versus domestic stocks. Our portfolios benefitted from a tactical overweight earlier this year, but we brought non-US equities back to target levels in late February and are now very modestly underweight.

Emerging Market Equities
We are positive, but cautious, on emerging markets stocks. They now sell at a 12-year valuation advantage relative to the rest of the world on a book value metric. However, concerns over energy exposures, the hangover effects from the multi-year private sector debt binge, and the 10% gain over the last month keep us from a large overweight.

Hedge Funds
We are overweight hedge funds for both defensive and opportunistic reasons. Defensively, they are less correlated to bond and stock returns. Opportunistically, they do well in the periods of high market volatility we expect in coming months. While hedge fund exposure remains near maximum levels, the mix is tweaked in favor of uncorrelated strategies in an effort to be more defensive.

Fixed Income
Municipals remain an underweight given concerns over low benchmark Treasury rate levels, although exposure is boosted modestly as relative valuation seems to have improved. While high-yield valuations in terms of spreads are reasonable (even after subtracting 40 basis points to adjust for the energy sector exposure) their vulnerability to increases in interest rates is a concern should liquidity dry up at the same time. Fixed income in general remains a concern as we expect the Fed to increase interest rates this year.

Cash
For the expectations stated above: low stock performance, negative bond performance, and increased volatility; we remain overweight cash as the ultimate market hedge.

Continued on back.

Additional Thoughts about Coming Months:

1 | In our opinion, Chairman Yellen's Fed perpetuates the unfortunate Greenspan/Bernanke tradition of excessive monetary accommodation and asset bubble enabling. While the Fed finally discarded explicit forward guidance by dropping the word "patient," the subsequent dovish tone makes it less likely that June rate hike forecasts will prove accurate. September now seems the more likely date, although many market observers disagree and do not see the initial Fed rate increase until 2016, despite the proximity to the election.

2 | Roughly 20% of all government bonds and more than 33% of all Eurozone bonds now trade at a negative yield. It is not irrational for investors to buy corporate bonds at a negative interest rate as a bond with a negative interest rate can increase in value if interest rates become even more negative. That phenomenon is the classic definition of a bubble: knowingly buying a highly overvalued security on the hopes of being able to sell it higher.

3 | Chinese stocks have gained 20-30% this year despite the slowing economy. The underlying return driver was a very low initial valuation level, aided by retail speculation. Just as good companies do not equate to being good investments, a country's economic prospects often do not directly correlate to a stock market opportunity. Brazil embodies this emerging market trade-off: attractive valuations are offset by challenges in growth, politics, terms of trade and foreign debt dynamics.

4 | It is plausible that, given current and forecast interest rate differentials, the dollar could overshoot its fair value and continue its rally. However, further strengthening is not a given: Fed tightening considerations are not straightforward, dollar valuation levels are already elevated against both the Yen (undervalued by 20%) and Euro (by 10-15%) and everyone seems to be a dollar bull.

5 | We are neutral on gold, but would not argue with anyone owning it at these levels: it is attractively valued versus the stock-market on an historical basis and seemingly a good hedge against the possibility of a dovish Fed behind the curve. While gold is down 38% from its peak, gold miners are down 74%, making them more attractive than bullion itself.

6 | Spot prices for West Texas Intermediate crude have increased 5% since year-end, but 2017-2019 future prices declined by similar amounts. While unsure whether near-term prices will re-test their recent lows, we expect out-year prices to exceed the mid-$60 futures market prices. The likelihood for increased out-year production from Iran and Iraq is a potential negative, particularly if Saudi Arabia maintains its new market-share strategy.

7 | Finally, it is hard to see why US growth should suddenly pick up, when after six years of massive Fed accommodation US gross domestic product growth has not exceeded 3% in any year. This is the longest streak of historically low GDP growth in American history. Now, Fed policy is turning into a headwind. Longer term, the US faces a challenging economic outlook. Sub-par growth should be expected as our deleveraging process has hardly begun - not simply the debt super-cycle, but the entitlement super-cycle as the US ranks among the bottom of the developed world in terms of fiscal sustainability. While we usually think of the use of debt as artificially or temporarily supporting consumption, today's economy has been supported by entitlement spending and retirement promises. Absent some sort of supply-side grand political bargain, as entitlement promises become less credible, consumers will be forced to boost their savings rates, thus lowering the growth of consumer spending.

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