MARKET

PERSPECTIVES

STC Investment Committee

Bruce L. Swanson, Ph.D.

December 2015

After the V-shaped rebound in October, markets were mixed in November. Most foreign markets were modestly weaker, while domestic stocks were modestly higher on dollar strength brought about by a sharp escalation in expectations for a December interest rate hike. The swing in expectations was driven by a revision in third quarter gross domestic product (GDP) from 1.5% to 2.1% and by a continuingly tightening labor market. The dollar advanced 4% against the euro and 2% against the yen.

Markets were less influenced by geopolitical and terrorist headlines than economic releases in November. These statistics showed the adverse effects of continued global weakness in the manufacturing, energy and materials sectors. These same economic releases also showed the adverse effects of US wage growth on corporate profits. Chinese industrial profits declined for the fifth straight month, while US corporate earnings declined on a quarter-over-quarter basis for the first time since 2009.

In commodities, fears of oversupply and a stronger US dollar pressured base metals lower while gold fell 6.5% for the month. Energy prices were particularly weak with crude oil down 10% on the global inventory surplus. The GSCI commodity index fell 9% in November and is down 37% over the trailing 12 months. Overall, the MSCI All Country World Index lost 0.8% in November (-0.6% for the year). US equities were modestly positive, despite the imminent December rate increase, on the expectation that subsequent rate hikes would be modest, with some analysts calling for "one and done." Growth stocks, smaller stocks and financial sector stocks outperformed; inexplicably, energy stocks were little changed despite the double digit commodity price decline. Year-to-date, the Russell 2000 value index has outperformed the Russell 200 growth index by nearly 1200 basis points, -2.3% versus +9.4%.

International developed markets were down 1.6% in November, but remain modestly positive for the year. Internationally, both small cap and growth stocks continued to be strong relative outperformers. Inexplicably, EAFE (Europe, Asia and Far East) small cap index was up 0.7% for the month and 8.8% for the year; EAFE value index was down 2.5% for the month and 3.8% for the year versus a 4.9% gain for EAFE growth index.

While European economic reports were encouraging, with consumer confidence at a four year high, equities fell 1.8% on euro currency weakness. Despite technically slipping into recession with a second consecutive negative quarter of GDP, neither the central bank nor investors were overly concerned, with the market down only 1% despite the yen weakness. Japan remains the top performing major market in the world for 2015 at +9.2%. Emerging market equities gave back much of their October gains in November, declining nearly 4% as investor outflows continued, bringing the year-to-date decline to 13%. Russia continued to buck the trend, being positive for the month and +16.1% thus far in 2015. Emerging market local-currency debt continued to struggle on outflows and the strong dollar, losing 2.2% for the month and 13% on the year.

High quality bond yields moved higher, but only slightly, on hopes that the Federal Reserve Board's (Fed) path to rate normalization will be gradual, with most longer-dated Treasury yields up only 5 basis

Continued on back.

points. In contrast, high-yield corporate bonds fell an additional 2.2% for the month as the market was hard hit by the plunge in commodity prices and fears of higher interest rates and default rates. While interest sensitive real estate investment trusts (REITs) were little changed, master limited partnerships (MLPs) plunged 8%, bringing year-to-date losses to 30%. The difference, aside from energy prices, reflects the MLP sector's dependence on the high-yield credit market, whereas REITs tend to be investment grade issuers.

Current Positioning

There are only small incremental changes to those outlined in the previous monthly letter written only two weeks ago. Probably the most interesting development is that we are seeing pricing anomalies and other signs of stress already appearing across the entire fixed income complex, from the most liquid foreign exchange market (unusually high compensation for swapping yen for dollars) to the high-yield credit market (unusually wide spread between cash bond yields and those of the credit derivative index). Yesterday, a large, well-respected investment manager announced that its high-yield mutual fund that promised daily liquidity would be unable to return investor funds for perhaps a year. This is the first mutual fund to "freeze" investors since the Great Financial Recession. These developments could portend a volatile 2016 should investor complacency be misplaced about the future path of Fed rate increases.

On a very short term basis, I think that some of this liquidity-induced stress has been exacerbated by credit-oriented hedge funds that have been liquidating positions to meet year end redemption requests from disappointed investors. We are taking advantage of this year end turmoil by removing some of our dedicated short-biased managers, including our short-biased high yield manager. At the same time, believing that some of the high-yield bond losses simply reflect liquidity-induced mark-to-market risk, we are boosting long-only exposure to high-yield bonds, while still remaining underweight the credit markets at an asset class level. There also may be opportunity in emerging market debt funds after weakness in the sector.

SENTINEL
TRUST COMPANY

2001 Kirby Drive, Suite 1200

Houston, Texas 77019-6081

713.529.3729

sentineltrust.com