MARKET PERSPECTIVES

STC Investment Committee

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Recovering from the third quarter plunge, markets saw a V-shaped recovery in October across all regions, with developed markets back in the black for the year. Even though the (preliminary) third quarter GDP was only 1.5% and the corporate earnings picture was the worst since 2009 (showing two consecutive quarters of negative earnings growth), investors turned bullish. The "risk-on" sentiment was brought about by hopes of continued monetary accommodation and by an apparent stabilization in China in terms of news flow and market moves. Globally, markets were cheered by optimism that the Federal Reserve (Fed) might be on hold into 2016, a dovish statement from European Central Bank President Draghi that quantitative easing could be extended and further interest rate cuts in China.

Global equities gained 7.6% for the month of October, recapturing much of the 9.5% third quarter decline and moving the broad global index to +0.7% for the year to date. Gains were broadly based, with US equities gaining 7.9%, international developed markets up 7.6% and emerging markets up 7.0%. In the US, large-cap growth stocks such as Microsoft, Amazon and Google continued to be the place to be, as the NASDAQ gained 9.4%. For 2015, the largest growth stocks have outperformed small-cap growth stocks by 14 percentage points. The Russell 3000's 2.0% year-to-date rise has lagged the 3.0% return of developed-market peers, but both have outpaced emerging markets by double digits as emerging market equities have declined nearly 9% in 2015.

November Month-to-Date Developments and Current Positioning

Equities have generally held value into late November, with stocks actually stronger after the November 13 terrorist attacks in Paris. However, the bond, credit and non-dollar currency markets have given up some or all of their October gains as the odds of a December Fed funds rate increase have moved into the "highly likely" range. A double-digit fall in crude oil prices (and silver) was only partially caused by the dollar rally. Higher Treasury yields, wider credit spreads and lower energy prices were bad news for master limited partnerships, which fell 9.5% month-to-date (and 24% in 2015).

The economic picture thus far confirms our belief that, while the traded goods/manufacturing sector has been weak globally (particularly for manufacturers tied to China or a strong US dollar), the US service sector remains quite strong, as confirmed by the most recent economic reports showing a 271,000 surge in non-farm payrolls and a positive revision of third quarter gross domestic product to 2.1% (up from 1.5%). The unemployment rate for the short-term unemployed is below full-employment levels and is approaching pre-Lehman bubble levels.

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In contrast to the complacent view that the December Fed funds rate increase will be wrapped in the softest possible wool, with 2016 rate increases expected to total less than 100 basis points, my own view remains that the Fed is behind the curve. I believe inflation will quickly reach the 2% threshold and that interest rate and capital market volatility will only increase in 2016. A Goldman Sachs research piece revealed that 90% of past rate hikes were at least 70% discounted in the market, with the only two that were less than 50% discounted causing extreme market turbulence. Given that history, expect 2016 to feature a lot of confused Fed officials trying to explain how they can raise rates much faster than expected without destabilizing markets (or not raise rates without destabilizing the bond market). Mine remains very much a non-consensus view, but one that looks more likely after the recent payroll numbers.

From a portfolio positioning standpoint, the big October rally suggests reducing exposure to domestic equities. I believe it appropriate to shift away from energy stocks on valuation concerns, as equity investors are assuming higher energy prices than the futures curve. For example, the sector is flat in November despite a 10% drop in crude; many of our stocks are up 25% this quarter despite unchanged crude prices. Funds are being redeployed into consumer discretionary, particularly into the retail sector, which is cheap and out of favor but could be volatile through the holiday shopping season.

Some reduction in international equities also may be appropriate, with the apparent appeal of the extreme Euro weakness in November (down 4% against dollar) being offset by political uncertainties likely to result from refugee/terrorist developments. Some tweaking in favor of international value managers also seems appropriate, after a long period (94 months) of outperformance by growth managers.

With high quality municipals continuing to outperform Treasury bonds, there is diminished value in the asset class, particularly in the 1-3 year maturity range where municipals yield only 70-75% of Treasuries, down from 80-85% a month ago. Excellent relative value remains in the longer maturities (15 years or greater), but the interest rate risk is greater and municipal interest rate time spreads are roughly 50 basis points below normal levels.

Within our hedge fund vehicles, we are in the process of both trimming our Asian credit exposure (after the bond rally in China) and eliminating exposure to our dedicated short Asia equity manager. We are also eliminating exposure to our short US credit manager after market weakness.

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