MARKET
PERSPECTIVES

STC Investment Committee

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February Report

Equity markets were little changed over the course of a volatile February that saw a continued plunge in prices into mid-month, which was nearly offset by a V-shaped second-half recovery. Investors remained concerned about the risks that weak financial markets and poor corporate-earnings prospects would have a self-fulfilling negative effect on the real economy. Credit markets were weak, with high-yield energy bond yields peaking intra-month at 18%. Compounding concerns, investors feared that not only were monetary policies insufficiently powerful, but negative interest rates were having deleterious effects on banks and their transmission channel to the economy, particularly in Europe, where bad loans may be insufficiently recognized.

Financial markets continued their mystifying lock-step dance with oil prices, as a 15% recovery in oil from mid-month lows boosted overall markets. Just as oil recovered to be little changed over the month, so did global equities, ending down only 0.7% in February, but extending year-to-date losses to 6.8%. Markets recovered with the expectation that the Federal Reserve Board (Fed) would cite international financial conditions as yet another excuse not to raise rate interest rates. Not surprisingly, the dollar was weak against most currencies with the exception of the British pound, which fell more than 2% to 7-year lows on "Brexit" fears. At the other extreme, the Japanese yen spiked 7.5%, reflecting both deleveraging and a flight to quality.

US equities were unchanged, with little variation across capitalizations and styles. There were pronounced sector moves, with the materials sector up 8% and the financial sector down 3%, adversely affected by concerns over bad energy loans (after JP Morgan raised its energy loan loss estimates by 60%), a pushback in the timing of Fed rate increases and global banking system contagion. For the year, US equities remained down 5.7%, with smaller capitalization (-8.8%), particularly small-cap growth (-11.5%) being underperformers. Utilities added to their 2016 lead, now up 7.7%, while both the healthcare and financial services sectors were down 9-10% through February. International developed-market equities were down 1.8%. Europe, particularly Italy (-5.2%), was hit by banking concerns and anxiety over the upcoming June 23 referendum with respect to the UK remaining in the European Union. Japan's equity market fell 2.7%, both despite and because of the very strong yen. Emerging market equities continued their modest outperformance in February, falling only 0.2%, as investors were encouraged by a Fed seemingly on hold with respect to near-term rate increases. Brazil was the strong performer, up 6.7% as materials prices strengthened, with iron ore up 11%. India fell 7.4% on fiscal deficit concerns. Despite the recovery in materials and oil prices, commodity indices were down 1.5-2% as natural gas prices plunged over 25%.

Government bonds of all types were strong performers in February, as investors sought protection while looking for additional policy accommodation from global central banks. While longer-term Treasury yields fell 15 to 20 basis points, the best-performing bond markets were overseas, as the weak dollar boosted US dollar returns from developed and emerging-market bonds. The international global-bond index returned 3.5%, no doubt helped by the large spike in the yen. Even dollar-denominated emerging-market bonds returned 2%. Municipal bonds were also positive, but lagged the strong Treasury market. The high-yield corporate-debt market was bifurcated, with continued underperformance of the lower-rated issues, as the CCC index lost 2% in contrast to a 1.2% gain from the (higher rated) BB sector. Viewed another way, high-yield energy-sector bonds lost 7% as the rest of the market gained 1%.

Continued on back.

March Market Activity

As investors, we often think of time in terms of market moves. In that context, mid-February seems like a long time ago! Risk assets, including equities, commodities and credit markets, extended their V-shaped recovery into late March based upon the combination of declining oil production, greatly diminished recession fears, less bad news from China and short-covering. To give a sense of the violence of March's continued snap-back rally:

- World equity markets have rallied an additional 5%, with emerging markets up 10%, led by Brazil's +25%.
- Crude is up 17% on data suggesting that US production will start to decline more rapidly; it had only declined 6% in the past year.
- The dollar was weak on dovish Fed guidance and increased risk appetite, falling 3% against the Euro and even more against emerging market currencies, with the Brazilian real rallying 9%.
- Credit markets were particularly strong, with the global high-yield index gaining 4%, boosted by the energy-price spike (US high yield) and the weak dollar (international high yield). Safe-haven Treasuries and municipals were weak, with 7-10 year Treasury bonds giving back some gains and losing 1%.

Once again, the Fed surprised markets, which were not expecting a rate increase, but were certainly prepared for hawkish guidance, given the stabilization of financial markets, the weakness of the dollar and stronger than expected economic releases. Instead, the Fed doubled down on dovishness, formally reducing the number of projected 2016 rate increases from four to two. Most observers found that language most peculiar given that core inflation (excluding food and energy) gained 0.3% in January - the biggest gain in 4 years, with prices up 2.2% over the last 12 months. In addition, even the troubled manufacturing sector showed signs of stabilization with the Institute for Supply Management Index still below 50, but at 49.5, the highest reading since September.

Where does this leave us? With US equities now little changed in 2016 and the high-yield market actually up 3%, in many respects, we are back where we started the year, if not perhaps in even a bit more challenging position. First, with the sharp market rally, domestic equities are once again more than 20% overvalued. Given that companies are expected to show a decline in first quarter profits of almost 6%, it will take time for corporate earnings to "grow into" these high valuations. Financial stocks retain their outlier valuation attractiveness, but the biggest gains from utilities, materials and retail sector positions may be behind us. High quality consumer stocks have been a great place to be, but their popularity as quasi-bond substitutes makes them an overvalued and over-owned sector. We are reducing emerging market exposure on strength out of a belief that a Fed rate increase in June is much more likely than the market expects. Such a move would likely cap market gains, particularly in the dollar-sensitive commodity and emerging market sectors. With the recovery in long-only risk assets, our macro views are little changed from year-end. A Fed that we believe is more likely to act than the market expects suggests that it may be appropriate to reduce risk exposures on strength.

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