MARKET
PERSPECTIVES

STC Investment Committee

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April 2016

March Report

March saw the continuation of the V-shaped market recovery that began in early February almost to the day that crude oil prices bottomed. This continuation was based upon a combination of economic and policy developments in the form of a near-term stabilization of China's economy and currency and a remarkably dovish March Federal Reserve Board (Fed) policy announcement. Consequently, the dollar was weak, falling nearly 4%, after Fed Chair Yellen surprised markets by explicitly referring to "global considerations" as a reason to delay the interest rate normalization plan.

The Fed announcement was particularly unexpected given that it came after the release of domestic economic data that came in stronger than expected in terms of wage gains, hours worked and the manufacturing Purchasing Managers' Index. To give some sense of the magnitude of the Fed's surprise, in March the dollar fell 5% against developed market currencies (except the yen, which had already spiked) and 6% against emerging market currencies (with the Brazilian Real and Russian Ruble gaining 10%). For the quarter, the dollar was down roughly 5% against a broad currency basket, except for the UK pound which fell 2% on Brexit fears.

While officially denied, conspiracy theorists saw evidence of a new form of central bank coordination, with the US agreeing that a weaker dollar was in the best near-term interest of the global economy and capital markets, even though deferring rate increases may not be appropriate for the US on a standalone basis. This allowed China to depreciate its currency against its Asian partners, without aggravating its capital outflow problem, by following the dollar lower. While the Fed moves strengthened the euro, the European Central Bank (ECB) offset this strength by broadening its corporate bond buying and by subsidizing bank lending with long-term negative cost funding. At the same time, the ECB suggested that it planned no interest rate cuts going forward, which gives the Fed the clearance to raise rates later this year without making the spread between dollar and euro rates too wide.

Consequently, equity markets posted strong gains in March, with the global index up 7.6% and in the black for the year. US equities gained 6.8% for the month, bringing first quarter returns to +1%. In March, small-cap value stocks modestly outperformed large-cap growth. Energy, materials and technology stocks gained nearly 10%, while healthcare lagged, returning 3%. Utilities tacked on an additional 8%, bringing first quarter gains to 16%. International equities returned 8.2% in March, virtually eliminating their loss for the year. Emerging markets were the star performer for the month (+12.8%) and the quarter (+5%). The UK performance was restrained by "Brexit" concerns, gaining only 4.8% for the month. Japan, last year's leader, has been this year's laggard. Its 4.7% March return left it down 6.5% for the quarter, as the yen's strength has called into question the outlook for corporate profits and inflation goals.

Emerging markets were the place to be, led by Brazil's 30% gain on hopes for the impeachment of President Rouseff. More generally, while the commodity price rally and manufacturing strength in India provided some fundamental support, much of the gain was brought about by Fed accommodation and the weaker dollar, which drove investors to an oversold, bargain-priced sector as fund flows to emerging markets hit a multi-year high in March. While China's 12% gain actually underperformed the index, investors were reassured by public statements from Chinese leaders and a renewed burst of fiscal stimulus.

Commodity prices benefitted from the weaker dollar and reduced economic tail risks, with commodity indices up 4-5% in March. The energy complex was strong, with spot crude oil and natural gas prices both up 14%, while gold held on to its 16% gain for the year.

Continued on back.

The Treasury market rallied 0.2% as the Fed lowered its economic growth forecasts, and even its inflation forecast, for 2017 despite January's core inflation being the highest in four years. Against this backdrop of even more negative real interest rates, a Fed on-hold, a buoyant labor market and a strong equity market, credit markets were hot, with the US high-yield market up 4.4% for the month and 3.3% for the quarter. Not surprisingly, given the strength in commodity prices and investor flows, both CCC-rated high yield bonds and local currency emerging market debt gained more than 10%.

Three weeks into April, many of the March themes have continued as domestic equities are up 2%, international equities are outperforming, the high-yield market remains on fire (up another 3%) and energy prices (+13%), commodities (+8%) and master limited partnerships (+9%) are leading the rally. One noteworthy shift is apparent in the interest rate area, as Treasury bonds are down 0.4% and the dollar is stronger, particularly against non-commodity currencies.

Looking back, the judgement call to add to risk assets near February lows seems a more obvious call than the answer to what we should do today. Back in February, economically sensitive stocks were so attractively priced that one only needed the removal of downside economic tail-risks to generate handsome returns, admittedly with a considerable assist from Fed policy, commodity strength and hedge fund short covering. Nevertheless, it was more that removal of tail risks than any upgrade to economic growth or corporate profit forecasts that drove the rally in risk assets. Positive developments in those two fundamental areas will be required for the rally to build a foundation to continue. This is especially the case given the US equity market trades at a 40% premium to one long-term valuation metric (market capitalization to gross domestic product), and a 20% premium based upon our internal stock-by-stock valuation work.

In last month's letter, we suggested that consumer staples, materials, utilities and retailers were less likely to continue to advance going forward in April. While materials have continued to rally on the back of commodity gains, the utilities (-5%), staples (-2%) and retail sectors (-2%) have indeed lagged. Combined with the 4%+ rally in financial stocks thus far in April, our domestic equity opportunity set is continuing to narrow.

In fixed income, municipal bonds have significantly outperformed benchmark Treasuries thus far in April, by as much as 100 basis points in the 7-year maturities. This erodes the prior valuation appeal of municipal bonds. The corporate high-yield bond market is a difficult call at present after the 6.5% year-to-date gain. If the damage is limited to the energy and materials sectors (88% of recent defaults are in those sectors), then the temptation is to take on illiquidity risk in the form of structured debt (collateralized loan obligations), which is attractively valued in a market well-supported by low short-term interest rates and moderate gross domestic product growth. The problem is that these are the types of securities most susceptible to downdrafts given the lack of broker-dealer capital for market making. Despite the overall rally in risk assets, merger arbitrage strategies have lost money as a number of high profile deals have blown up due to unexpected tax and other regulatory surprises. As a result, merger spreads have widened across the board. Even as funds flow into the space, there appears to be an investible opportunity, as the volume of new deals continue, driven by slow organic growth. We also see negative benchmark real yields and BB borrowing rates back down to May 2015 levels. Funds will come from reduced exposure to the US convertible area, with investors fearing that primary issuance will remerge on the back of tighter credit spreads and expensive stocks prices.

While it is tempting to evaluate equities relative to risk-free rates that are negative in real or often nominal terms, we continue to believe in the power of absolute valuations and make both security selection and asset allocation on that basis. While quantitative easing in the developed world has brought forward asset values, that has been a poor substitute for structural reforms that might have promoted economic growth and associated corporate profitability. Given an environment of elevated equity prices and negative real interest rates, it is hard to envision a policy response that might protect markets from either an inflation surprise to the upside or an economic one to the downside.

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