MARKET
PERSPECTIVES

STC Investment Committee

Bruce L. Swanson, Ph.D.

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Risk assets enjoyed a strong third quarter despite sporadic volatility brought about by hopes and fears of central bank initiatives and as China tail-risk fears of recession and deflation eased. High-yield debt and emerging markets were stand-out performers.

July saw global equity markets rally 4.3% as investors found the mix of political and economic news much to their liking. Technology and growth stocks took the lead. In the United Kingdom, Theresa May was selected to be Prime Minister. In Japan, Prime Minister Abe's coalition secured victory in the Upper House, boosting reform hopes. Economic conditions were ideal, as international growth was reassuring, particularly 6.7% gross domestic product (GDP) growth from China. A soft GDP release in the U.S. pushed back fears of a near-term Federal Reserve Board (Fed) rate increase. Credit markets were strong despite a 14% fall in oil prices on inventory fears. The dollar was weak, particularly against the Yen as the Bank of Japan stood pat.

Following July's rally, the summer doldrums arrived in August, with headline markets little changed and characterized by declines in both volatility and trading volumes. Treasury market weakness prompted divergent sector moves, with U.S. financial and technology sectors up 2% - 3% and REITs and utility stocks down 3% - 5%. U.S. economic news was mixed, with weak job growth offset by positive developments in a GDP revision, new home sales and capital spending. The dollar recovered from mid-month lows as investors boosted odds of a December interest rate increase. While agriculture and precious metals fell, the 8% recovery in oil prices supported the high-yield market.

Both traders and market volatility returned from vacation in September. While the month witnessed modest gains for global equities, the banking sector was hit by company-specific news from Wells Fargo and Deutsche Bank. OPEC surprised markets by announcing its first planned production cut since 2008; oil rallied 8%. While Treasuries were little changed, long-dated Treasuries fell almost 2% as central banks in Europe and Japan seemed less dovish. Economic news was generally positive as U.S. growth was revised upwards and consumer confidence surged to the highest level since 2008. Europe saw a pick-up in growth and inflation and China outperformed on strong imports and credit growth, however unsustainable those may be. The Fed conceded the potential logic of a rate increase at this time, but analysts suggested that a December timeframe represented a political compromise after a 7:3 vote to hold rates constant in September.

Viewing the quarter in aggregate, global equities gained 5.7%; with international equities, particularly those in emerging markets, benefitting from a dovish Fed, a weaker dollar, and seemingly resilient international growth, especially in China.

U.S. equities were the global laggard for the quarter, returning 4.4%, with the bell-weather S&P 500 index gaining 3.85%. Technology stocks (+13%) and small cap stocks (+9%) stood out, while investors responded to what were only very modest losses in Treasury bonds (-0.3% to -0.5%) by aggressively rotating out of overvalued defensive and interest-sensitive names in the consumer staples (-3%), telecom (-6%) and utility (-6%) sectors. Financial stocks were only in-line performers despite the move up in interest rates.

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Emerging market equities spiked 8.8%, doubling the U.S. performance. Asia led, with China up 14% as a surging residential real estate market has supported growth. Korea and Taiwan were also up double digits. While Brazil gained 11%, Latin America and Eastern Europe/Middle East were hit by political concerns: Turkey on the failed coup against Erdogan and Mexico as the odds of a Trump presidency increased, causing the Mexican peso to fall almost 5%. Frontier markets returned only 2.7%, perhaps due to their heavy consumer staples exposure.

Foreign developed markets also outperformed the global index, gaining 6.7%, led by 9% - 10% gains in Germany, Spain and Japan. Italy lagged (+2% on banking fears). The dollar declined 1% - 3% against most developed currencies as the Fed remained dovish, but gained 2.3% against the post-Brexit pound as the divorce realities set in. Commodities were weaker, but crude oil retraced a 14% decline to finish unchanged.

While global equities were strong, the bigger news may have been in the credit markets, where high-yield bonds matched equities and the more speculative CCC-rated bonds returned 8.6%. These gains were achieved without the benefit of rising energy prices, as the commodity index fell almost 4%. Up until September 2016, high-yield bonds returned 15%, with the more speculative segment up nearly 30%. At the Valentine Day lows, 1/3 of the high-yield market traded at distressed levels (more than 1000 basis point spread). At quarter-end, it was less than 10%.

October Month-to-Date and Portfolio Positioning:

We may be at the beginning of the end for the era of artificially low interest rates. I have been wrong for so long that I certainly hope so! Just because global growth will not return to the debt-fueled pre-global-financial-crisis bubble years doesn't mean that we are condemned to a low-growth, deflationary world with recession just around corner. While growth estimates continue to be marked down, inflation expectations have ticked back up (from 1.3% in early July to 1.6% today) and there is nothing that would call for what we have witnessed in the form of sustained unorthodox monetary policies and the resulting interest-rate distortions.

We thought since mid-year that central banks would eventually admit that "the emperor has no clothes" and recognize both the limitations of monetary policy and the unforeseen consequences of negative interest rates. This is happening, not surprisingly, in Europe and Japan - two markets where negative rates have had a deleterious effect on the banking system and the overall economy. Notably, both central banks have backed off from further rate cuts, with the European Central Bank targeting credit spreads and the Bank of Japan setting a floor on 10-year bond yields.

Fed Chair Yellen's dovish bias "doubles down" on a dual Fed mandate that already creates a structural bias in favor of higher inflation and a weaker dollar. We envisioned this a year ago in pretending to draft a late 2016 press release for the Fed stating that "we could tolerate a period of above-target inflation because we experienced below target levels in recent years." Setting aside the very questionable logic, that is precisely what the Chair said in mid-October in arguing for the merits of letting the economy "run hot," further eroding what little credibility this Fed still possesses.

While global equities are modestly lower, the bigger news may be the continued deterioration in the longer (20 year+) Treasury market, where the 2.85% month-to-date loss piled on to the third quarter's loss. Whether the weakness in the long-dated Treasuries reflects Fed Chair Yellen's embrace of above-target inflation or is simply a knock-on effect from higher long rates overseas remains to be seen, but it is noteworthy.

While developments have supported our view that global growth and inflation rates, while subpar, are fairly benign, the likelihood of self-inflicted policy mistakes and election surprises could hit financial markets in a world that has yet to deleverage from the global financial crisis. This context is important, because the third quarter rally in risk assets has reduced the number of attractive opportunities, particularly in high yield and emerging market equities. U.S. equities have become even less attractive, while the outperformance of financial stocks has reduced expected gains from stock-picking. It is difficult to identify a single asset class where expected returns are in line with historical norms.

U.S. equities were down in line with global markets, but the impact of higher interest rates was apparent with financial stocks up 1.8% and continued declines in long-duration defensive stocks such as real estate investment trusts (-4%), telecom (-6%), utilities (-2%) and consumer staples (-2%). Healthcare stocks have declined more than 3% as odds of a Clinton Presidency have increased.

While still much preferring foreign stocks to those in the U.S., I have taken some profits overseas, particularly in emerging market equities as they have returned 16% for the year, more than double that of either U.S. or international developed equities.

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Europe and Japan represent difficult calls as valuations have become less attractive following big rallies since the second quarter, with Japan up 10%. In Europe, I still worry about negative publicity in front of the Italian referendum in early December, even if the immediate downside risk has been removed (no risk of triggering new elections). On the other hand, Europe represents the best leveraged play on global growth, given its capacity underutilization. In Japan, I worry about currency risks following the Yen's 19% gain through September and a central bank seemingly on the road to debt monetization, something generally very bearish for a currency.

We have also become significantly underweight in the corporate high-yield market. The reason is entirely a function of exceptional performance as the risk/reward going forward looks unattractive after the high-yield market has gained 16% in 2016, with CCC-rated issues up more than 30%. While high yield municipal spreads have similarly tightened, we prefer them to their corporate high yield counterparts, particularly after declines of 1.5% over the past month or so.

In contrast to the credit market, while underweight, we have been adding to our municipal bond exposure following their underperformance versus Treasuries and losses of close to 1% in intermediate maturities over the last month. The likelihood of a Clinton Presidency adds to their potential after-tax appeal, as the candidate has proposed a 4% surtax on income.

I do not have a sure-fire way to play a predicted election outcome, as (Brexit aside) markets generally do a good job of reflecting available information. At present, the betting odds suggest an 80% likelihood of a Clinton victory, with a slight edge in favor of a Democratic Senate. Such an outcome could still be considered a stalemate. The President would have considerable leeway in foreign affairs, trade, and appointments, such as the Supreme Court, but Senate Republicans could filibuster. Plus, any tax changes would still have to run through the Republican House. In contrast, since a Democratic sweep is unlikely (about the same odds as a Trump victory), its surprise occurrence would be a negative shock to markets.

I am more likely to respond to excessive market moves in one direction or another, particularly at the sector level. For example, I would likely buy the Mexican peso after an expected plunge on a surprise Trump victory. (Trump's actions would be constrained, the peso is already cheap and government finances are in good shape, with decreased spending and debt/GDP of only 40%.) While a Clinton victory would generally be good for hospitals and bad for drug makers, the volatile biotech sector might be a buy should it fall on the news (assuming no Democratic sweep), as healthcare has overtaken financials as the worst-performing sector this year (small-cap biotech down 18%) and the acquisition market remains active. Should gold give back more of its gains (it is down 7% since early August) following a Clinton victory, it might be an interesting play on lower real interest rates even with a December rate increase. A Democratic sweep would increase the after-tax appeal of municipal bonds, as the candidate has proposed a 4% surtax on income.

2001 Kirby Drive, Suite 1200

Houston, Texas 77019-6081

713.529.3729

sentineltrust.com