
Photography: Caroline Moreau, Summer Day—Newport, RI

Quarterly Update & Economic Commentary—March 31, 2016

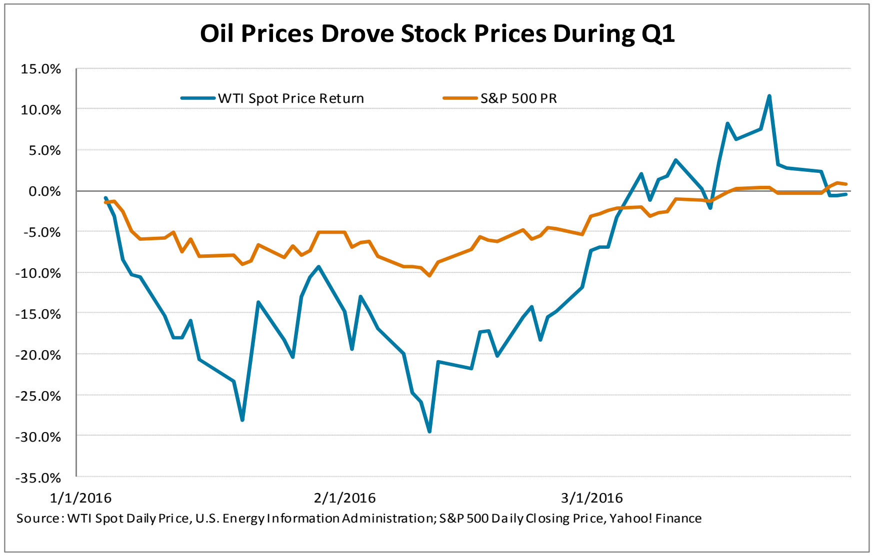
Quarter in Review

The first and second halves of the quarter were like night and day. The start of the quarter represented one of the worst starts in the history of the markets. Through February 11th – just six weeks into the year – the S&P 500 index dropped over ten percent. The market recovered as quickly as it fell, with the S&P 500 returning over 11 percent from February 11th through the end of the quarter. The strong finish helped the index finish the quarter in positive territory by 1.35 percent. In a change from the performance of the previous year, small and mid-cap stocks outperformed large cap stocks, while value outperformed growth. International developed stocks had a negative quarter; the MSCI EAFE NR USD lost around three percent. The emerging markets index had a strong March, finishing the month positive by over 13 percent and returning 5.71 percent for the quarter—one of the highest of the broad indices. The S&P 500 performance was led by the Telecom and Utilities sectors, which finished above 16 and 15 percent, respectively. Real estate investment trusts (REITs) and consumer staples also had a good quarter, with both finishing positive by over five percent. A key driver of these sectors' outperformance was their penchant for paying dividends; as interest rates fell, income seeking investors flocked to dividend paying stocks. The lagging sectors of the S&P 500 for the quarter were financials and health care.

Despite the U.S. Federal Reserve's decision to raise rates in December, interest rates fell drastically through the quarter. The drop in rates and the shift in investor sentiment helped fixed income investments perform well during the first quarter. The Barclays US Agg Bond index returned 3.03 percent for the quarter, which was slightly better than the higher credit quality Barclays US Govt Bond index's 2.28 percent return. The low quality spectrum of the bond market, known as high yield bonds, performed poorly at the beginning of the quarter but reversed course mid-quarter and finished positive by 3.35 percent. Following a disappointing 2015, global bonds rallied in the first quarter; the Bank of America ML Global Government Bond index finished the quarter positive by 6.78 percent.

Commodities generally had a strong quarter. Following six consecutive negative quarters, gold rebounded during the first quarter with a return of 16.54 percent, its best quarterly return since 1986. Silver and copper continued the metals trend as both had positive quarters, returning

12.03 and 3.13 percent, respectively. The energy sector, like equities, started the year on a down note but was able to rebound. The sector fell around 17 percent from the beginning of the year through February 11th but returned over 20 percent from that point forward, finishing the quarter positive at 3.51 percent



As the numbers indicate, the first quarter was volatile. The equity markets were largely driven by movements in oil prices. As oil prices fell, the markets fell and as oil prices rebounded, the markets followed suit. West Texas Crude Oil traded down to $26 per barrel on February 11th; it started the year at $37 per barrel compared with its starting point of $47 per barrel last year. The decline in oil prices compelled the sovereign wealth funds of oil exporting nations to liquidate some of their global stock positions to shore up their finances, which were being pressured by lower revenues from oil production. It has been estimated that over $200 billion of equities were sold from sovereign wealth funds in 2015, a figure which many expect to double in 2016 if crude prices stay between $30 and $40 per barrel. The decline in oil prices also put continued pressure on the high yield bond market and the financial sector. In the wake of the fracking revolution, many newly formed energy companies financed their operations with large amounts of debt; these companies have seen substantial decreases in revenue since the price of oil dropped, and many face the prospect of bankruptcy. Bankruptcy would not only result in lost jobs and corporate spending cuts in the energy sector, it would also cause loan losses to banks that provided credit to these companies. The exposure that banks have is significant in the absolute amount of dollars, but the chances of this situation causing another financial crisis are remote because of the relatively small size of the liability compared to the excess capital that banks are required to carry on their balance sheet.

The volatility of the price of oil and its high correlation to equity markets were arguably the top stories of the quarter, but central banks were a close second. The Fed had two scheduled meetings during the first quarter, both of which produced dovish readings from the market and no additional rate increase. Despite the committee's cautious tone, individual members have repeatedly spoken to media outlets in their belief that additional rate hikes in 2016 are warranted. The committee now seems to be signaling that there will be, at the most, two additional rate increases this year, which generally aligns with the market consensus.

The European Central Bank (ECB), on the other hand, shocked markets when it announced the magnitude of its additional stimulus. It is said that the ECB "fired a bazooka" to stimulate the Eurozone economy. The ECB initially lowered its deposit rate into negative territory in January and dropped it even further in the March meeting. Europe's central bank also added an additional 20 billion euros to its asset purchase program and announced a new series of longer-term refinancing operations starting in June. The only action some may argue was weak was the lowering of the main refinancing rate by five basis points to zero.

Theoretically, negative rates are supposed to entice banks to lend more because excess reserves are charged a fee for just sitting on the sidelines as opposed to earning interest income from central banks. Banks stand to lose in this environment as they see profits decline as a result. Negative rates have been deployed in other countries as well, including Japan, Switzerland, Denmark and Hungary; as this has never been attempted by central bankers before, the practice is the center of much controversy.

China's economy continues to be a focus of concern and contributed to the equity sell-off to start the year. The unease surrounding China is due primarily to its growing pains as it transitions from a manufacturing based economy to a services based economy. The official manufacturing Purchasing Managers' Index (PMI) came in at 49.0—a reading below 50.0 indicates a decline in factory activity. This was the seventh straight month of decline. The services PMI fell to 52.7 in February but remains in expansion mode and has been a bright spot for China's economy.

Economies around the globe continue to rely on central bank stimulus to produce modest economic growth and low inflation. The U.S. economy on the other hand continues to be doing just fine, albeit with continued support of low rates from the Fed. Job growth has been strong and wages are ticking up. The February data did show that hours worked fell, which could be a problem if it becomes a trend, but we feel it is transitory. Core CPI, a measure of inflation that excludes volatile food and energy prices, increased by 2.3 percent year-over-year through February. If oil prices continue to rise or at least stabilize at higher levels, headline inflation readings should also move higher and closer to the Fed's two percent target. However, the Fed has also signaled that it may be willing to let inflation overshoot and rise over two percent.

A Look at the Numbers

Name	1st Quarter Performance (%)	YTD Performance (%)
DJ Industrial Average TR USD	2.20	2.20
S&P 500 TR USD	1.35	1.35
S&P MidCap 400 TR	3.78	3.78
S&P SmallCap 600 TR USD	2.66	2.66
NASDAQ Composite TR USD	-2.43	-2.43
MSCI EAFE NR USD	-3.01	-3.01
Barclays US Agg Bond TR USD	3.03	3.03
Wilshire US REIT TR USD	5.20	5.20
IA SBBI US 30 Day TBill TR USD	0.05	0.05

Forecast in Brief

The markets will look to economic readings in the U.S. to judge the strength of the U.S. economy and whether or not the Fed will raise rates further or maintain the dovish status quo.
As the weather begins to warm up, so does the season for home buying. The season is expected to be relatively strong once again this year, as the improved economy, higher consumer confidence and low mortgage rates will drive buyers, and the continued imbalance of a lack of sellers compared to buyers should continue to drive prices higher in desired areas, tempting home owners to put their house on the market. A strong housing market typically bodes well for other areas of the economy.

Oil prices will continue to be a main focus and driver for the markets. Precipitously falling oil prices are not good for financial markets but stable prices in the $40-$50 dollar range may bring stability in the short-term. Low oil prices are good for consumer spending and consumer confidence. Oil prices below $50 will continue to put pressure on many oil producers, especially those in the U.S., and oil producing countries, but it will not result in the sort of upheaval that markets feared when the price was below $30. Because of the different parties involved in the production of oil, predicting energy price changes is a difficult task, but recent weeks suggest that the price may have found somewhat of equilibrium around $40 per barrel.

Market watchers will continue to scrutinize every word and action of Fed members. In the coming months, we believe the chance of a rate increase is minimal. Fed Chair Janet Yellen has struck an increasingly dovish tone lately, but other committee members have voiced support for an increased pace of rate hikes. Pressure on the Fed to increase rates will mount as the economy continues improving, unemployment falls lower and inflation builds momentum. Unfortunately, the Fed's decisions seem increasingly beholden to stock market performance rather than to its dual mandate to target unemployment and inflation.

We do not expect to see additional increases to the monetary stimulus programs currently in place in other developed areas like Europe and Japan. The negative interest rate policy being instituted in these countries is already extreme and is hurtful to banks. Taking negative rates further negative would cause additional pain which could lead to other unintended consequences and end up being counterproductive. These economies remain on shaky ground and in many cases are in need of fiscal reform. Japanese Prime Minister Shinzo Abe is rumored to be pushing for additional fiscal stimulus to help jumpstart their economy.

On June 23rd, Great Britain will vote on whether they should leave the European Union, a possibility that the media has dubbed "Brexit." If the vote is "Yes," it would take several years to implement, but financial markets will almost certainly react immediately and violently to such a decision. Most analysts expect a close vote that will ultimately favor staying in the European Union; however, an increase in volatility is expected leading up to the vote and investors may flock to traditional safe havens like the dollar and gold. Should Brexit become a reality, one of the main concerns is the setting of a precedent by which other countries may begin to leave as well.

China's economy is undoubtedly slowing but the degree of the slowdown is still uncertain. Most developed countries have undergone similar growing pains as they transitioned to a service-based, consumption-driven economy, though China's importance on the global stage and its unique brand of state-run capitalism make this period for China difficult to predict. The Chinese government has demonstrated its willingness to intervene in the markets if things become dire, though there is a concern that such action has decreasing effectiveness. Other emerging markets bounced back during the second half of the quarter—especially the commodity-rich countries. The emerging markets continue to look attractive from a valuation perspective, but it is important to be selective and willing to accept some additional volatility. The markets will be watching Brazil, where President Dilma Rousseff may get impeached; the uncertainty may cause an up-tick in volatility but a new government may lead to a rally in Brazilian stocks.

As earnings season kicks off in mid-April, expectations are for year-over-year earnings to decline for the fourth consecutive quarter, which has not happened since 2008-2009. A majority of the earnings decline is a result of a drop in earnings in the energy sector. In addition to the impact from the fall in energy prices, the stronger dollar has also hurt the earnings of companies that generate revenue overseas. According to FactSet, all ten sectors of the S&P 500 have seen their earnings revised downward throughout the quarter. Our view is that earnings will come in slightly better than expectations as a result of the turnaround in energy prices and the weakening dollar during the second half of the quarter.

ISIS maintains its threatening posture to the U.S. and Europe. Despite the terror organization's significant territorial losses in Syria due to Russia's aid of the Assad regime, ISIS managed to carry out a number of new attacks in Europe, namely in Belgium and Turkey. In addition to the tragic loss of life, these attacks serve to foster severe anti-refugee sentiments throughout Europe (no matter that almost all of the terrorists in France and Belgium were European citizens). German Chancellor Angela Merkel is facing significant backlash after championing refugee relief efforts in Europe. Merkel has been the de facto leader of the European Union for some time now, and if Merkel's party were to lose its majority in the next federal elections (held no later than the Fall of 2017), then it could pose a significant threat to the European Union project.

The U.S. presidential campaigns have been dominating the non-financial news channels for almost a year. In a well-functioning democracy, we would be learning about different candidates' nuanced views on important policy initiatives. Instead, the campaign has been a race to the bottom rung on the ladder of dignity. The Republican National Committee (RNC) convention is not until July, but it should soon become clear whether Donald Trump, the current Republican front runner, will earn enough delegates to win the nomination or if it will be determined at the convention. As of the end of the quarter, Trump's momentum was waning and it was becoming less likely that he would achieve the magic number of 1237. Hillary Clinton has all but locked-in the Democratic nomination, however, Bernie Sanders is continuing to fight and bring Hillary further to the left to attract more of the base.

The first quarter was a great example of why being comfortable with your allocation and staying the course is important. The market fell quickly but rebounded almost as quickly which is why investors who panic and sell or try to time the market end up doing more damage than good.

We continue to stress how important it is for clients to understand the risk profile of their asset allocation and make sure that it is appropriate for their situation. If anything in your financial situation has changed, please let us know so that we can determine whether a change in your portfolio is necessary.

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