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INVESTMENT WATCH

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## Financial Market Volatility: Fundamentals versus Fears

The year began on a difficult note as concerns about Chinese economic growth, further declines in oil prices, credit concerns in the high yield market, worries about the stability of the Euro and a highly charged political environment weighed on investors' outlook. Fears that any or all of these might signal an impending U.S. recession led to a sell-off in equity markets and further declines in interest rates. However, much of this selling was based on emotion rather than fundamentals and as the quarter progressed and economic data supported somewhat uneven but positive economic growth, the financial markets rebounded. The S&P 500 fell over 10% in the first 6 weeks of the year, but ended the quarter in positive territory. Within the equity market, investors favored more defensive and income oriented sectors such as Utilities, Consumer Staples and Telecom. This was very different from last year, where the best performers were more speculative names. Interest rates fell for most of the quarter as investors looked to reduce equity risk in favor of the relative safety of Treasury bonds. Even as the equity market rallied later in the quarter, interest rates remained near the lows.

As has been the pattern over the last several years, economic growth was likely slower in the first quarter of this year than in the fourth quarter of last year. However, the economy seems poised to accelerate out of the first quarter and to continue to expand at a moderate, but somewhat uneven pace the rest of the year. The consumer, which accounts for two-thirds of economic growth, remains in solid shape. The U.S. economy added 628,000 new jobs in the first quarter and has averaged 246,000 per month over the last six months. The unemployment rate ended the quarter at 5.0%, up a bit from the beginning of the year as better prospects led people to re-enter the labor force. More recently, we have seen an increase in labor force participation as well as an increase in the number of people moving directly from being out of the labor force to employment. Wages continue to grow modestly and consumer balance sheets remain healthy. Even with the more recent move to higher oil prices, the consumer is still benefiting from significantly lower energy costs than last year, and consumer confidence has remained steady. With more people employed, wages rising and the positive impact from lower oil prices, the consumer can continue to help drive economic growth in the 2% range.

The manufacturing sector has been under pressure in part due to reduced activity in the energy sector; however, there have been some signs of stabilization more recently. In addition, the housing sector continues to show moderate improvement. Home price increases near the 4-5% range are helping to drive not only more real estate transactions, but increases in home renovation and improvement projects. This provides additional support to the fundamentals of the economy and its ability to continue to expand at a moderate pace.

Even as the fundamentals of the economy remain solid, there are plenty of sources of market angst that will likely persist this year. To start the year, we saw another significant decline in oil prices, which fed investors fears of a global recession. The U.S. supply of oil is taking longer than many expected to decline, but with significant cuts in rig counts over the last year, we are now seeing actual declines in production. Production outside the U.S. continues at its high pace as OPEC stubbornly maintains current production targets despite the impact on its member economies. For the first time, we are seeing some dissension from OPEC members, who would like to cut production, but unless Saudi Arabia takes the lead, true cuts are not likely. Having said that, demand for oil is still increasing, which will also help to reduce the current imbalance between supply and demand. This should hopefully lead to a more stable price going forward.

Once again, it is important to note that lower energy prices are a boon to the vast majority of the global economy that are users rather than producers of energy. Even within the energy sector, improvements in cost structure and productivity will allow many energy companies to be more profitable at much lower energy prices than even 12 months ago.

The Federal Reserve continues to be a source of volatility for the market. Financial markets often react more to the anticipation and expectation of action by the central bank than to the actual event. Over the last few years, the Fed has sought to increase transparency into its decision making process, by scheduling press conferences after some meetings, providing greater insight into the data underlying its decision-making process and having more public speeches made by Fed officials. However, it seems as if this push for transparency is creating even more investor confusion about the future path for monetary policy. While the market was not surprised that the FOMC voted to keep rates steady at both its January and March meetings, a number of speeches by Fed officials before and after the meetings suggested greater policy disagreements than the votes would show. Ultimately it is up to Fed Chairwoman Janet Yellen to direct the path of monetary policy, and she seems to be in the more cautious camp. Adding to the uncertainty this year is the long held policy of the FOMC to avoid changes in interest rates close to a Presidential election. Coming into 2016, the FOMC indicated they could raise rates up to 4 times over the subsequent twelve months. That has since been reduced to two rate hikes; but at this point the financial markets are expecting no more than one rate increase, and even that is a toss-up. In the absence of any unexpected global economic disruption and with the U.S. near full employment, the future path of interest rates will likely be driven by changes in inflation expectations.

By contrast, as the Federal Reserve struggles to normalize interest rates, global central banks seek alternative means to stimulate economic growth. After years of quantitative easing and zero interest rates, many central banks, including the Bank of Japan and the European Central Bank, have moved to negative interest rates in order to generate sustainable positive growth. With negative interest rates, there is a cost to holding cash and this is expected to provide an incentive for consumers and businesses to spend and invest. Early results from the negative interest rate policy have not been positive. In Japan, negative rates have led to hording of cash outside of the banking system through the use of increased gift card balances as well as storing cash at home. In both Europe and Japan, the currencies have appreciated relative to the U.S. dollar, reducing the region’s competitiveness. It may take some time to see how this policy plays out, but it is clear that while the U.S. central bank considers normalizing interest rates, global central banks will continue to pursue progressively easier monetary policy and both strategies are likely to lead to volatility in the financial market.

It is our belief that the chances of a U.S. recession remain low given the strong labor market, modest wage increases, and the potential for a modest improvement in manufacturing and a stable to improving housing market. Economic growth is expected to remain in the 2% range however; as we saw in 2015, growth is likely to be somewhat uneven from quarter to quarter. Company earnings are also expected to show some weakness in Q1 as currency headwinds, slower growth in China and the overhang from equity volatility and economic concerns weighed on consumer purchases. Much like with the economy, many of the headwinds are expected to subside as we move through the year and earnings prospects for U.S. companies are expected to improve. However, volatility will likely remain, driven by concerns about Chinese growth, a potential exit from the E.U. by Great Britain, geo-political risks and a highly charged political season. While we still maintain a bias towards higher interest rates, we believe it will be much more difficult at this point for the Fed to fully normalize interest rates, and therefore believe it makes sense to modestly move our fixed income exposure out in maturity. It is important to maintain discipline and focus on the fundamentals of the economy and the companies in which we invest. We remain focused on distinguishing between the underlying foundation of the economy and the short-term emotions of investors. We are poised to act when we see signs of a change in the outlook for the U.S., but until that time we expect to remain close to fully invested.