2016 First Quarter
Market Review & Outlook

While most global asset classes finished the first quarter of 2016 little changed from where they began the year, this muted performance belies the tremendous volatility experienced over the past three months. The year began with a sharp and broad-based market sell-off, seemingly driven by a number of different factors:

- The Federal Reserve finally raising interest rates off of the zero bound at their December meeting, thereby confirming a tightening bias and removing some "support" for risk assets.
- A continued collapse of the oil price to a 12-year low of $27, a level that was unthinkable just a short while ago.
- Growing fears of a U.S. recession, in part due to the impact of collapsing oil prices on the U.S. shale patch.
- China more aggressively devaluing the yuan, reigniting the instability fears that first surfaced in August 2015.

Indexes	Q1 2016	1-Year*	3-Year*	5-Year*
S&P 500	1.4%	1.8%	11.8%	11.6%
MSCI EAFE (in US$)	-3.0	-8.3	2.2	2.3
MSCI EM	5.7	-12.0	-4.5	-4.1
Barclays Aggregate	3.0	2.0	2.5	3.8
Barclays High Yield	3.4	-3.7	1.8	4.9
S&P Global Natural Resources	9.3	-14.7	-8.2	-8.2
MSCI US REIT Index	6.3	4.1	10.5	11.9

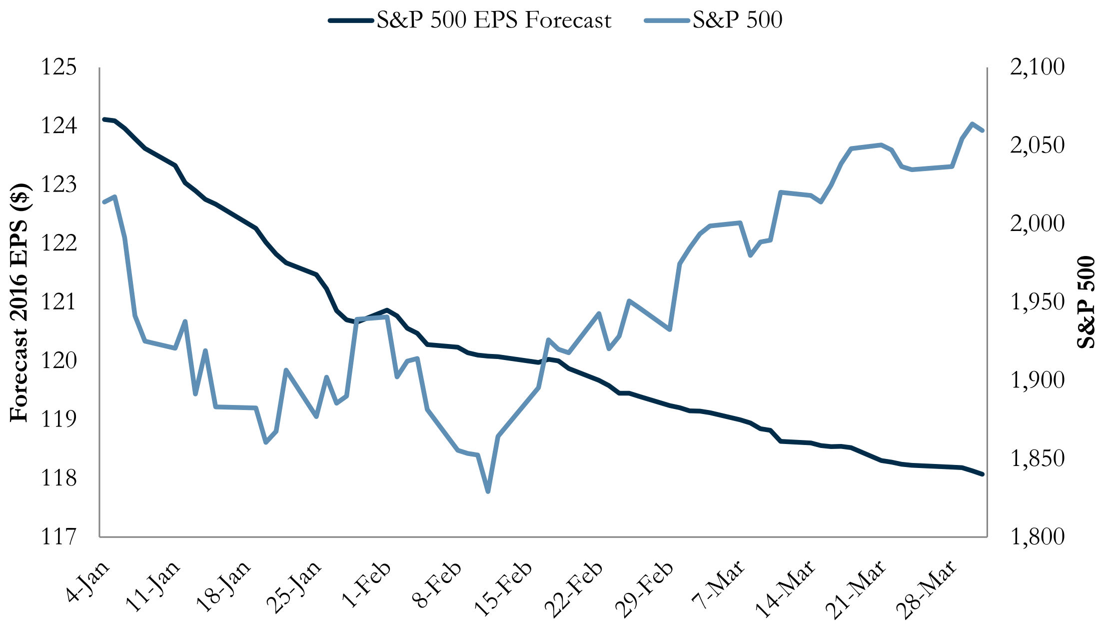
** As of March 31, 2016*

All of this contributed to the worst start to a year ever for the U.S. equity market. By mid-February, most U.S equity indices were down over 10% and international stock markets weren't doing any better. Oil had fallen another 30%, continuing to weigh on a high yield bond market that had declined almost as much as equities.

But then something changed. Risk assets of all types staged a dramatic "V-shaped" recovery in mid-February to recoup all of their losses and, in many cases, actually finish the quarter in positive territory. Had markets simply fallen too far too fast and become "oversold"? Perhaps. Had underlying fundamentals dramatically improved to justify such a sharp reversal? Not in our eyes.

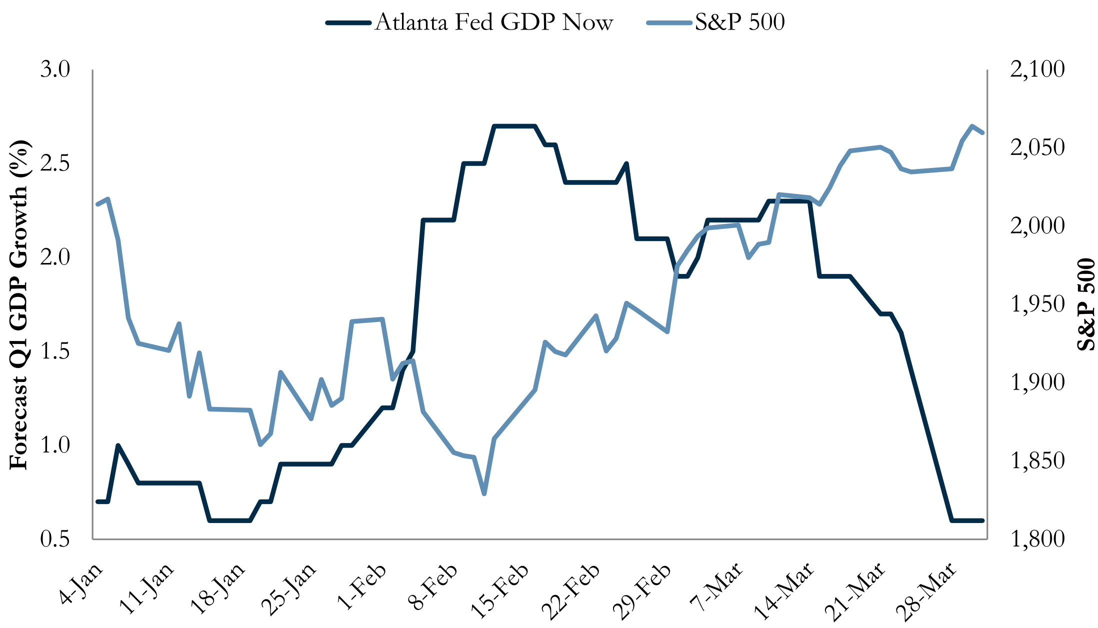
We will comment more on corporate earnings trends later, but analysts continued to downgrade their estimates throughout the quarter in what has shaped up to be a pretty awful period for U.S. company earnings. Analysts lowered Q1 estimates for the S&P 500 by -9.1% over the past three months, the largest decline in a quarter since Q12009. And the downgrades were not just confined to the energy sector. Nine out of ten sectors recorded a percentage decline that was greater than their five year average[1].

[1] Source: Factset



Source: Bloomberg

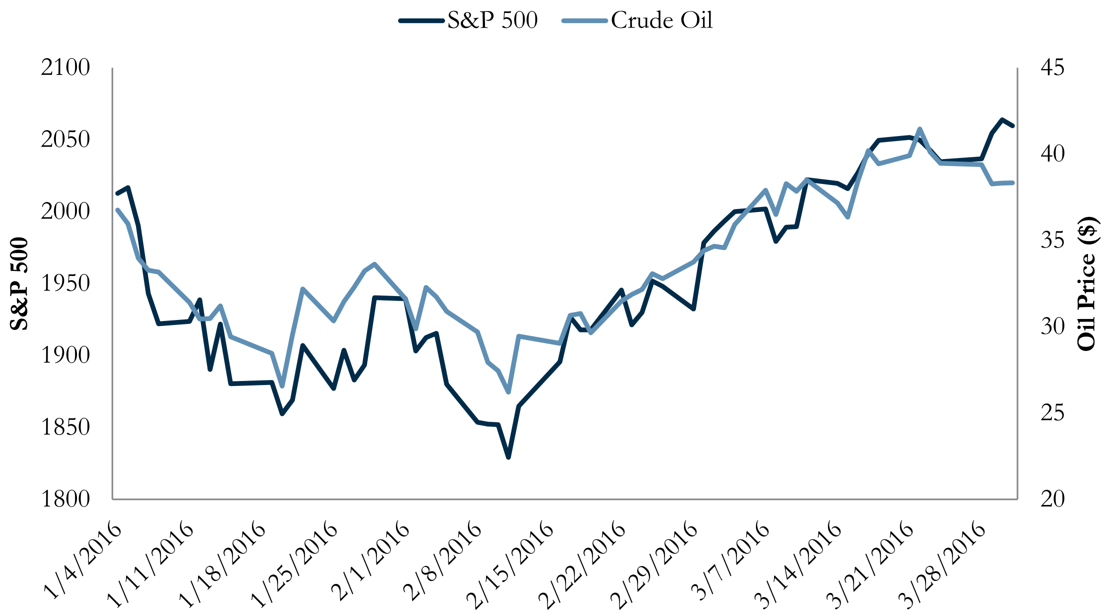
Similarly, U.S. economic data continued to deteriorate throughout the quarter, as estimated by the Atlanta Fed GDPNow forecasting model[2]. In fact, first quarter GDP estimates began to turn down just as the stock market began to rally. The latest estimate for U.S. first quarter GDP is now just 0.3%.



Source: Bloomberg

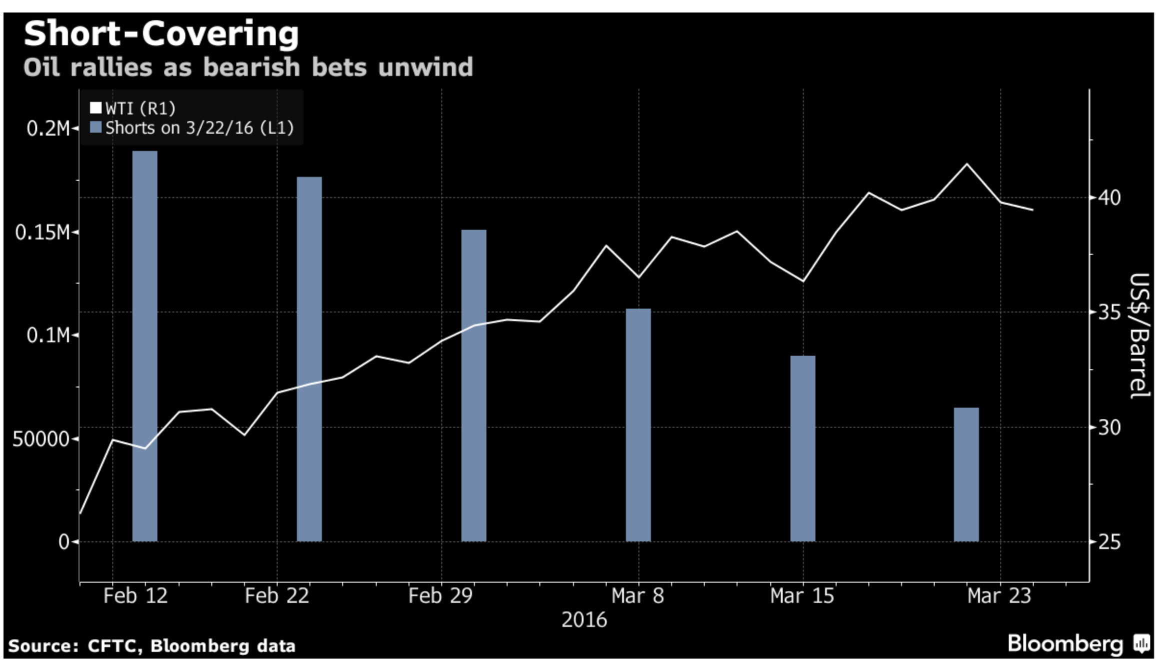
So if not earnings or economic fundamentals, what caused such a sharp rebound? Perhaps the answer lies in the asset most correlated to U.S. equities of late – oil. As many have noticed, markets seem to be all about oil these days, good or bad. In fact, the year-to-date correlation between oil and the S&P 500 is striking.

[2] The Atlanta Fed GDPNow model attempts to estimate U.S. GDP in real time based on the release of economic data that is used in the official GDP calculation. It has proven to be an extremely accurate forecasting tool since its inception. It is available on the Federal Reserve Bank of Atlanta's website: www.frbatlanta.org.



Source: Bloomberg

The collapse in oil prices from over $100 per barrel in mid-2014 has been dramatic, with potentially wide-ranging economic implications. Thus, it does make some sense that oil prices would be viewed as a particularly important risk factor of late. Furthermore, the speed and magnitude of oil's recent collapse is on par with the worst periods in history, suggesting that a rebound at some point was inevitable. Oftentimes, when everyone is so seemingly bearish on an asset expecting it to fall, the opposite actually happens (at least in the short-term). Indeed, when examining market positioning over this period, oil's surge off the bottom appears to be driven largely by short-covering (i.e., the unwinding of bearish bets) more than anything else.



While technical factors clearly played a role, a fundamental driver of oil's rebound appears to be market hopes of a pending production freeze agreement amongst some of the world's major oil producers at a meeting scheduled for April 17th in Qatar[3]. For a number of reasons, we continue to believe that an agreement to freeze oil production is unlikely; and even if there is some sort of agreement, the impact on oil production will likely be muted:

- All talk of freezing production has focused on freezing at the current level of output, which happens to be an all-time high.
- Freezing production at all-time highs will do little to alleviate the current supply/demand imbalance in the oil market, at least in the near-term. Production *cuts* would likely be a different story, but there has been no discussion of actually reducing output thus far.
- Most of the countries scheduled to attend the April 17th meeting are already producing at full capacity anyway, and couldn't increase production even if they wanted to. The possible exception is Saudi Arabia.
- The two other major OPEC producers who do have the capacity to increase production, Iran and Libya, either will not be attending (Libya) or have stated that they will not consider a production freeze (Iran).
- The U.S. shale industry, whose rise has been *the* major factor in the recent oil market turmoil, will not be represented either. Furthermore, there is no governing body of the shale industry to negotiate and enforce anything on their behalf anyway.
- These countries simply don't trust each other to abide by the rules of any agreement.

Another potential catalyst for the rebound in oil and other risk assets was continued stimulus (and dovish guidance) from global central banks. Mario Draghi fired his latest monetary stimulus "bazooka"[4] on March 10th and the Bank of Japan surprised markets by moving to negative interest rates on March 18th. Meanwhile, the Fed used their March meeting to walk back their own projected pace of interest rate hikes from four in 2016 to just two (markets are pricing in even less). While the past six weeks may serve as yet another reminder that central banks will do "whatever it takes" to support risk assets, we do believe that they are finally beginning to run out of ammunition.

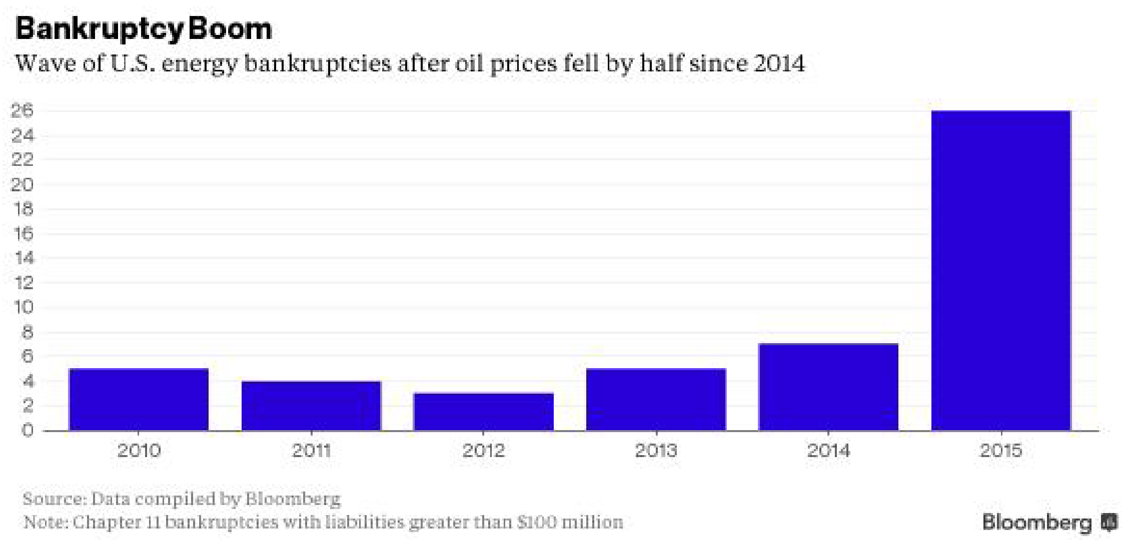
[3] All thirteen OPEC members with the exception of Libya are expected to attend the meeting, along with a handful of other major oil producers such as Russia.

[4] The ECB announced that it would cut interest rates further into negative territory (-0.4%), increase its bond buying program by 20 billion euros per month, and begin buying high quality corporate bonds in addition to government bonds.

Market Outlook

Oil and Bank Redetermination

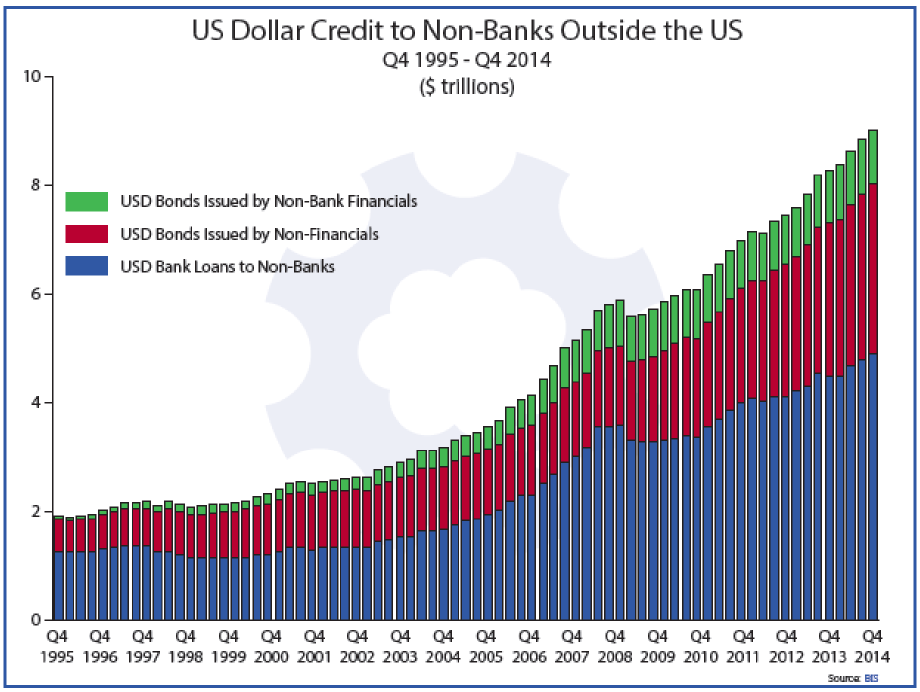
Continuing with the oil theme, April will bring the latest round of U.S. banks' "borrowing base redetermination" as it relates to their oil and gas loan exposure. In short, oil and gas companies typically need to borrow large amounts of money to finance their ongoing operations. Banks often use a company's proven reserves (e.g., the amount of oil they own that is still in the ground) as collateral for these loans. Because commodity prices are volatile, banks reassess the value of this collateral twice a year – once in the spring and once in the fall. Given the dramatic fall in oil prices, the risk is that banks will significantly reduce the value of their borrowers' collateral, thereby reducing the amount of money they are willing to lend. Many energy companies that were highly leveraged to begin with, have become even more so to make up for the decline in revenues resulting from the collapse of oil prices. Thus, if suddenly cut off from access to bank capital (even if it is only a slight reduction), many companies may find it difficult to survive. This could spark a new wave of bankruptcies in the U.S. shale patch, which would have wide-ranging implications from financial market contagion to job losses. Needless to say, we will be closely watching how aggressively banks look to cut their existing exposure to this distressed area of the market.



The Dollar

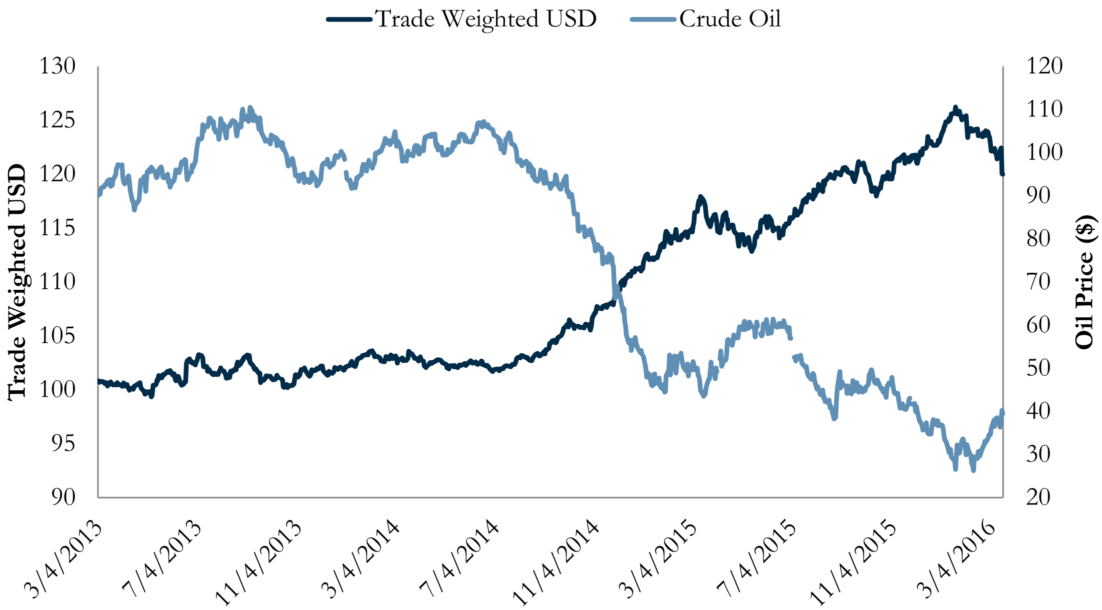
Another potential reason for the sharp mid-quarter recovery in risk assets was a pull back in the dollar. The dollar has been appreciating rapidly against every other major currency since the Fed began "tapering" QE 3 in mid-2014. The combination of (relatively) strong U.S. economic growth and the potential for higher U.S. interest rates as a result, sucked in capital from all over the world and pushed up the value of the dollar. Sustained dollar strength creates significant problems for the rest of the world due to its role as the world's reserve currency. Foreign countries and companies use dollars to transact with each other (let alone directly with the U.S.), and therefore a more expensive dollar can depress economic activity abroad.

Furthermore, in the aftermath of the Global Financial Crisis, the Fed's monetary stimulus (e.g., Quantitative Easing) pushed down U.S. interest rates and the value of the dollar. With U.S. investors looking for higher yields (due to low domestic rates) and foreign companies looking for inexpensive funding (cheap dollar), the result was an explosion of dollar-denominated borrowing by foreign companies, particularly in emerging markets.



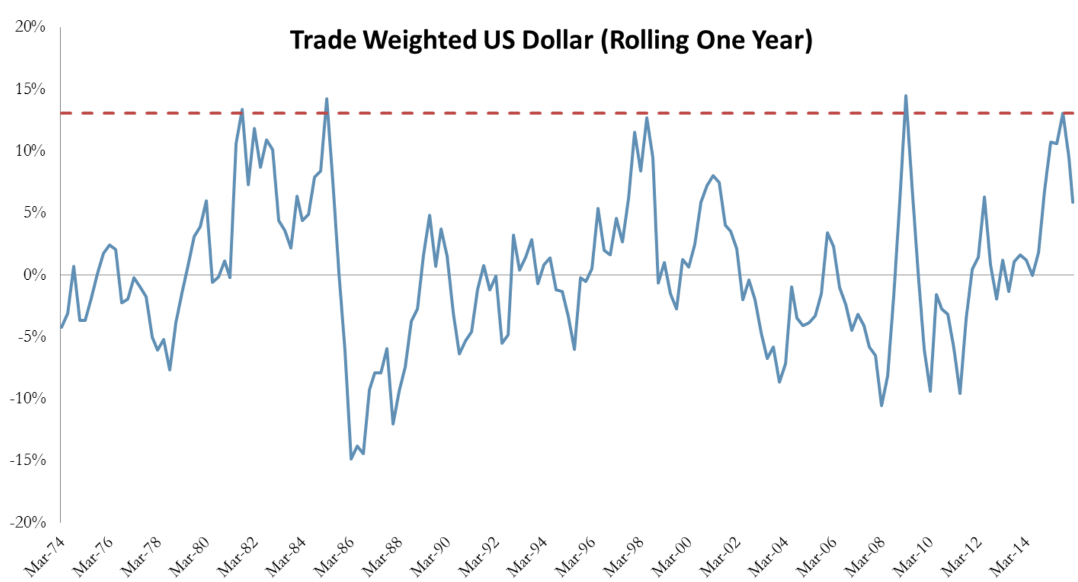
For many companies this created a mismatch between local currency revenues and dollar-based liabilities. While the dollar was weakening this was not a major issue. But dollar strength directly results in an increase in debt-servicing costs. In other words, for non-U.S. companies with dollar-denominated debt, a rising dollar is akin to rising interest rates. Thus, in our opinion, a strong dollar became one of the most important systemic risk factors in global markets.

After increasing rapidly from June 2014 through December 2015, the dollar pulled back in the first quarter of this year. This likely contributed to the rebound in oil and other commodities starting in mid-February. As most global commodities are priced in dollars, a stronger dollar makes them more expensive to the rest of the world (depressing demand) and vice versa. Thus, it is no coincidence to a see a strong negative correlation between the dollar and the price of oil, for example.



Source: Bloomberg

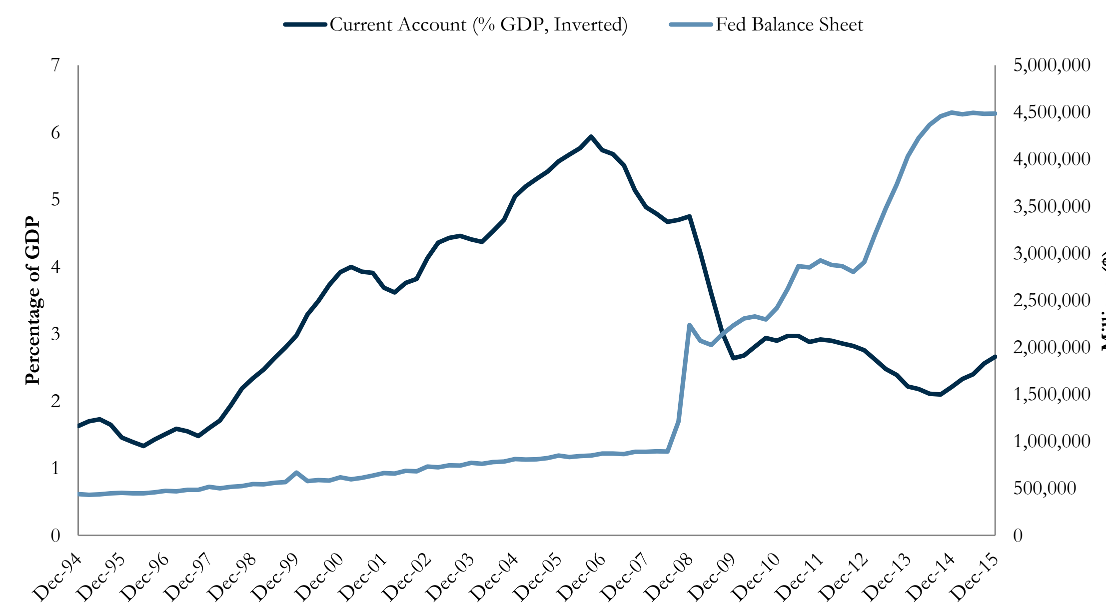
Perhaps the most critical question moving forward is – has the dollar now peaked, or is this simply a pause within a longer-term dollar bull market? The magnitude of the dollar's recent rise was pronounced, but so was the pace. The year-over-year increase from September 2014 to September 2015 was about as fast as anything we have seen historically. Thus, it certainly makes sense that the dollar was due for a pull back to some degree.



Source: Bloomberg

All of the conditions that led to the dollar's initial rise, however, remain in place. In addition to the economic and interest rate differentials cited earlier, which influence the *price* of the dollar, another key aspect that we believe is often overlooked is the *supply* of dollars. Again, this dynamic relates back to oil. As the sole supplier of the world's reserve currency, the rest of the world relies on the U.S. to "supply" them with dollars by purchasing foreign goods and sending dollars abroad. Thus, the U.S. trade deficit (and current account deficit) is an approximation of how many dollars we are sending out to the rest of the world for them to use.

The biggest swing factor in the U.S. trade deficit is our oil imports. The rise of the U.S. shale industry has led to a collapse in oil imports, as more of our ongoing demand for oil can now be met by domestic production. Furthermore, the shale boom led to a dramatic increase in global oil supply, contributing to the collapse in prices. So the U.S. is now importing much less oil, at a much lower price, and therefore sending much fewer dollars out to the rest of the world. For a while, the Fed plugged this gap by "printing" dollars via QE (many of which found their way overseas as discussed earlier), but now that has run its course and with oil imports still suppressed, the supply of dollars out in the rest of the world is starting to shrink materially. Dollar liquidity, due to both price and supply, remains one of our largest concerns moving forward.



Source: Bloomberg

Negative Interest Rates

While the dollar bull market has gained some reprieve with the Fed walking back their tightening projections (i.e., raising rates less quickly), foreign central banks are still going full steam in the opposite direction. This is yet another reason why we believe the dollar bull market may have further to run – the most the Fed can do at this point is *not* tighten, while foreign central banks continue to ease at an unprecedented pace. The latest incarnation of this is negative interest rates.

After seven years of Quantitative Easing (QE) and Zero Interest Rate Policy (ZIRP) have failed to sufficiently revive the global economy, central banks are now turning to Negative Interest Rate Policy (NIRP) as the next evolution of monetary stimulus. Even the basic concept of negative interest rates is very difficult for many to comprehend – why would anyone *pay* for the right to *lend* someone else money? What are central banks trying to accomplish and why would negative interest rates be any more effective than everything else they've already tried? What are the potential unintended consequences?

The Danish Central Bank (DNB) was actually the first to move to negative rates in July 2012, even though the size of the Danish economy prevented this from registering as a significant event in the minds of global investors. In a far more momentous decision, the European Central Bank (ECB) pushed their policy rate below zero in June 2014, and followed that up with an additional cut three months later. Earlier this year, the Bank of Japan (BoJ) became the latest major central bank to throw their hat in the ring, shocking global markets by moving to negative interest rates on January 29th, merely one week after BoJ Governor Haruhiko Kuroda testified before Japanese parliament that he was planning no such thing.

To us, the move to negative interest rates smacks of desperation. Central banks are running out of monetary stimulus ammunition at a time when fiscal authorities remain unable or unwilling to share the load. In theory, negative interest rates are merely an extension of rate cuts that have been ongoing now for over seven years. But in practice, it is our belief that moving from zero to negative rates is far more impactful, and potentially disruptive, than a typical interest rate cut.

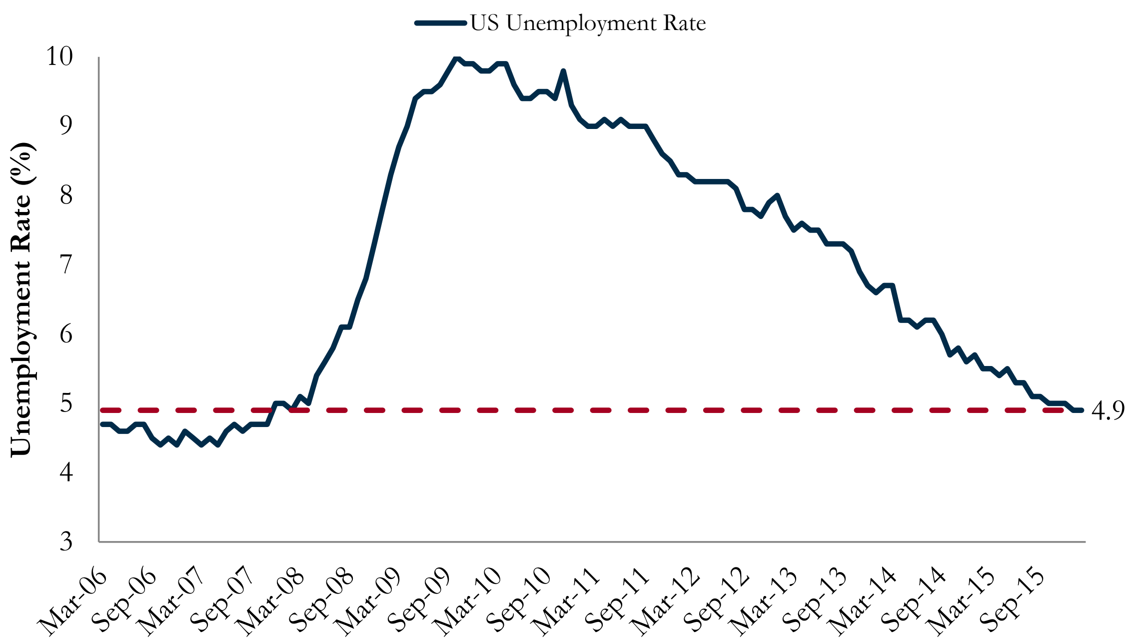
A central bank moving their policy rate into negative territory effectively means that they are now charging commercial banks interest for parking their excess reserves at the central bank. In other words, lowering the interest paid on excess bank capital apparently wasn't enough to stimulate sufficient lending, so central banks have now resorted to charging banks a penalty. There are a number of potentially very serious issues with this approach. For one, it strikes at the heart of banks' health and profitability. While modern banking has become exceedingly complex, at its core, banking is still the business of borrowing short and lending long to pocket the "spread" between the two rates (called the Net Interest Margin, or NIM.) While lower interest rates help borrowers, they hurt lenders (e.g., banks) by squeezing their profitability. As lending becomes less and less profitable, banks are incentivized to do less of it, not more. Even if banks do respond to the negative interest rate "penalty" by lending more, this may not be a good thing. Negative interest rates essentially tell banks "go lend money to credits that you currently deem too risky or else we will charge you a fee." If ill-conceived loans to risky borrowers were at the heart of the last crisis, it is hard to see how this is moving in the right direction.

Either way, bank profits and stability appear to be under increased pressure from the move to negative interest rates, which has led to a significant fall in the share prices of a number of major global banks. Earlier this year, the share prices of Deutsche Bank and Credit Suisse traded down to levels below the depths of the Global Financial Crisis. Lower rates have led to lower bank profitability, which has led to a fall in bank stock prices, which leads to renewed fears over bank solvency, which leads to risk-aversion, which leads to less borrowing and lending, in a vicious negative feedback loop.

Inflation

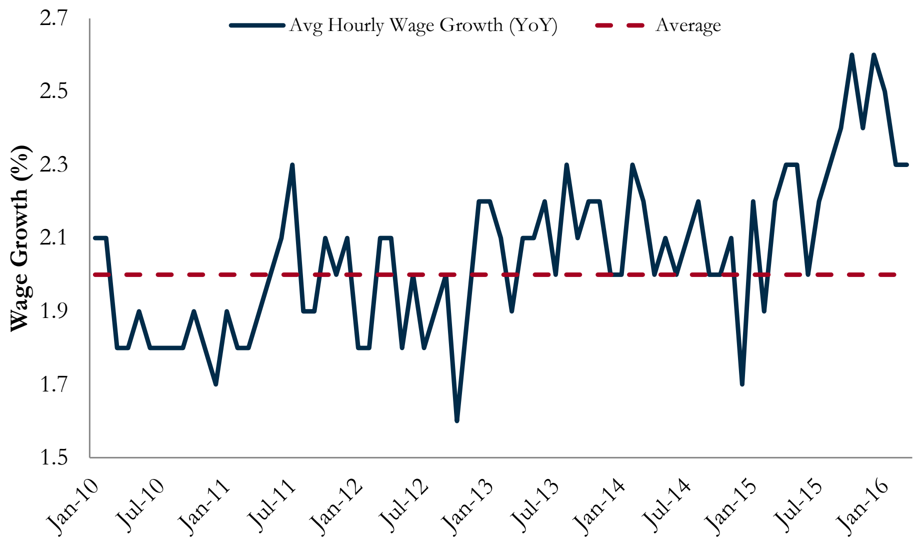
Overall, we remain more concerned about the risk of deflation than inflation. Many serious deflationary forces still exist (debt overhang, aging demographics, slowing global economy, etc.) and deflation is much harder to counteract than inflation. In the near-term, however, we believe that the U.S. may be at risk of an upside inflation surprise. It is important to remember that it is not the absolute level of inflation that matters to markets; it is the level of inflation *relative* to expectations. And current expectations are extremely low.

For starters, the labor market continues to tighten. While there are a number of reasons why the "official" unemployment rate overstates labor market health (labor market participation rate, job quality, etc.), we have now reached levels last seen prior to the Global Financial Crisis.



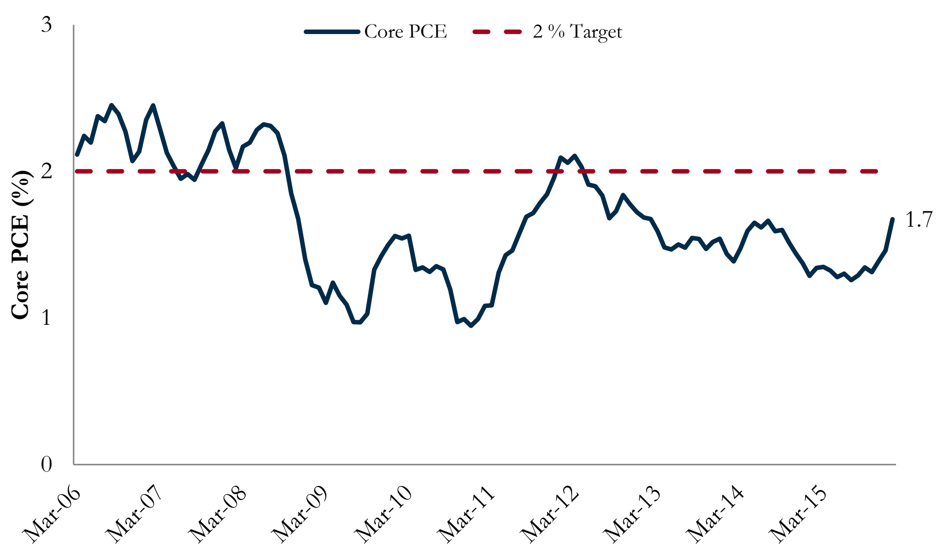
Source: Bloomberg

This labor market tightening is finally beginning to feed into wage growth. While still not robust by any means, wages are now growing at a faster pace than we have seen in recent years.



Source: Bloomberg

While still below the Fed's target of 2%, inflation (as measured by PCE, the Fed's preferred metric) is clearly trending upwards.



Source: Bloomberg

Lastly, as discussed earlier, the two major market dynamics of the past few years have been the strong dollar and collapsing oil prices, both of which are extremely *deflationary* for the U.S. The pace of the dollar's rise and oil's fall reached historical extremes in 2014-2015. Thus, there would be some upward pressure on inflation simply from the "base effect" of putting these dramatic moves behind us. Now, in the first quarter of 2016, both of these effects have actually reversed meaningfully (i.e., the dollar has fallen and oil has rebounded). While this combination was viewed very favorably by the markets over the past month and a half, if it eventually leads to an uptick in inflation, that view could change very quickly.

An upside surprise in inflation could lead to the market fearing that the Fed is "behind the curve." In other words, the Fed's forecasted pace of rate hikes (which they just reduced in March) will need to be re-accelerated. While this outcome is far from certain, it is a near-term risk that capital markets are *not* prepared for. If U.S. bonds sell off and interest rates rise, this could have major implications for risk assets around the world.

Corporate Earnings

As discussed earlier, corporate earnings expectations continued to deteriorate throughout the quarter, continuing (and accelerating) what is becoming a worrying trend. The first quarter of 2016 was the fourth consecutive quarter of year-over-year declines in S&P 500 earnings. The last time this happened was during the Global Financial Crisis (Q4 2008 through Q3 2009.) Furthermore, the magnitude of the downgrade of year-over-year earnings estimates was the largest since Q3 2009. While energy is certainly the largest part this earnings weakness and is often dismissed as an outlier in an otherwise healthy US corporate sector, the reality is that weakness is more widespread. Seven out of the ten S&P 500 sectors are expected to post year-over-year earnings declines in the first quarter. Even when excluding the energy sector entirely, S&P 500 earnings are still expected to fall -4.2% in Q1[5].

Declining corporate earnings are potential bad news for equity markets, but perhaps more concerning is the potential impact on the jobs market. When earnings start to decline, the first thing many companies try to do is raise prices. But in this economic environment it is very hard to see many companies having any real pricing power. If that fails, Plan B typically involves layoffs.

Positioning

Despite the sharp market rebound over the past six weeks, our positioning remains relatively conservative. We remain underweight in what we view to be the riskiest areas of the market; particularly those most exposed to dollar liquidity issues (e.g., emerging markets debt and equity). We do not believe the recent bounce in the energy and commodity complex is sustainable and remain underweight there as well. We continue to favor more conservative areas of the fixed income market. We continue to be very cognizant, however, of the risk of becoming too conservative in the face of aggressive central bank easing. Central banks have already proven quite capable of driving up capital markets in the face of deteriorating fundamentals, at least in the short-term. While we believe central banks are finally running out of ammunition, we can not rule out another leg higher in risk assets driven by monetary stimulus.

5 Source: Factset