

## Markets Show Resiliency... Again

### Market Update

Equity markets got off to a very volatile start in the first quarter of 2016. January marked the worst start for domestic equity markets since recordkeeping began in 1897. The declines continued and picked up steam in February with all major equity indices falling into official correction territory by registering 10%+ declines from beginning of the year levels. However, as a reminder that volatility works both ways and as another example of the market's resiliency, stocks rebounded sharply in the back half of the quarter, with a few indices actually ending the period with small gains. The S&P 500 Index advanced by 0.8% and global stocks (as measured by the MSCI All Country World Index) were higher by 0.2%. Conversely, the NASDAQ Composite Index, the Russell 2000 Index and international stocks (as measured by the MSCI EAFE Index) all lagged, posting quarterly declines of -2.7%, -1.9% and -3.7% respectively.

Despite the bounce in equity markets, bonds outperformed stocks in the first quarter with the U.S. Barclays Aggregate Bond Index posting a gain of 3.0%. Bonds benefited from a measurable contraction in interest rates given the expectations for lower global growth and low inflation readings combined with the "flight to safety" trade as investors looked for shelter from the equity market volatility in government bonds and other high quality fixed income investments.

The early quarter decline in equity markets can be attributed to a multitude of factors that left investors overwhelmed with the amount of risks and uncertainties. A review of these risks includes – a slowdown in global growth, forecasts of an end to the economic recovery in the U.S., heightened fears over a "hard-landing" in China, a very adverse market reaction to the introduction and expansion of negative interest rates in several developed international economies such as Japan and the Eurozone, concerns that central bank support may be losing its effectiveness, and the continued slide of energy and other commodity prices which weighted heavily on financial markets as well as a number of sectors of the economy.

While a number of these risks are yet to be resolved and will likely be present for some time to come, stocks rebounded in the second half of the quarter as investors

gained more clarity on a number of uncertainties and markets digested the known risks with the backdrop of lower valuation levels. A number of developments added to increased clarity in the back half of the quarter – including – an improvement in economic data in the U.S. which quieted pronouncements of a near-term recession, oil prices stabilized on news of a possible production freeze between OPEC and non-OPEC members and lower output in the U.S., additional easing measures from global central banks, commitments for reforms and rare comments by the Chinese central bank in support of their economy relieved some worries about China, and the Federal Reserve struck a much more accommodative tone in regards to their near-term intentions for additional interest rate hikes.

### Economic Update

Global growth remains subpar and has recently slowed in the U.S. as well. U.S. GDP advanced at a tepid 1.4% in the final quarter of 2015 and estimates for the first quarter of 2016 are tracking below 1%. However, the weakness can be directly attributed to a fairly narrow sub-set of our overall economy. Manufacturing and exports have been notable drags driven primarily by the collapse in the commodity complex and the strength in the U.S. Dollar. While these issues remain formidable headwinds, we were encouraged to see some abatement in these pressures as the quarter progressed. The U.S. Dollar weakened which is beneficial for corporate profits and exports, oil and other commodity prices stabilized and there has been some modest improvement in manufacturing data.

The labor market continues to be the star of the economic picture. The unemployment rate remains at 5%, monthly employment gains averaged a solid 210,000 in the quarter and there has been a slight improvement in the labor force participation rate. In addition, consumer confidence, retail sales, housing data and auto sales all point to a still healthy consumer which is the main driver of our economy.

### Portfolio Positioning

We ended the quarter with our equity allocation at the mid-point level across Investment Policies. However, we

did take a number of steps in January and February to reduce equity exposure with a focus on mitigating risk and capital protection. The rationale for the more conservative positioning was the backdrop of weakening economic fundamentals, heightened risks related to the Chinese economy, the widening impact of the oil and commodity collapse on the banking sector and financial markets, as well as the expectations for near-term pressure on corporate earnings. Given the confluence of risks we felt the probability of the January/February correction escalating into a deeper decline was elevated. As such, we felt the prudent course of action was to reduce risk in portfolios.

We began to gradually increase our equity exposure as the quarter progressed and as we gained more transparency on the risks and uncertainties. That improved transparency came in the form of better economic data in the U.S., a snapback in commodities which relieved some financial market stress, and a supportive tone from Chinese and other global central banks. We feel the current mid-point equity positioning is reflective of a balance between the broader risks, the known positives and the potential for continued improvement in economic fundamentals and market stability.

Within our fixed income allocation, we remain diversified across strategies and maintaining a short duration or limited sensitivity to interest rate movements remains a key theme. An area of focus in the quarter was shifting to higher quality bonds and strategies while reducing exposure to more credit sensitive areas of the fixed income market.

#### **First Quarter Performance Attribution**

While we feel our moves to reduce risk earlier in the quarter was a prudent step, this did cost us in terms of short-term relative performance as the equity market started its ascent prior to our full redeployment back to the mid-point range of equity exposure. After navigating a volatile environment well in 2015, our performance results for the first quarter were generally below expectations. However, the short-term results have had a negligible impact on longer-term performance.

While our fixed income allocation produced positive returns and provided a buffer against the volatility experienced in the quarter, the broad bond market index (as measured by the U.S. Barclays Aggregate Bond Index) proved to be a difficult comparison. The U.S. Barclays Aggregate Bond Index performed well in the quarter due to its longer duration stance (or greater interest rate sensitivity) as yields compressed significantly and the index also benefited substantially from its heavy weighting to safe-haven U.S. Treasury bonds. Going forward we

struggle to see long-term value in either U.S. Treasuries which offer low yields or long maturity bonds which expose investors to the potential for exceedingly negative outcomes in a rising interest rate environment.

Our bias towards large-cap value stocks was beneficial to performance results as this asset class outperformed both small-cap stocks and more growth oriented equities. In addition, our overweight position to sectors such as utilities and telecommunications produced very favorable results as investors showed a strong preference for the higher dividend yields and relatively lower volatility profiles offered by these segments of the equity market.

#### **Closing Thoughts**

The equity market decline in January and February as well as the host of negative macro-economic developments were unnerving to say the least. The debate about a possible near-term recession in the U.S. was the most concerning issue in our view and deserves some discussion/commentary. Many investment banks issued reports in February that the risks of a U.S. recession had increased fairly dramatically since the beginning of the year. In fact, some firms assigned probabilities as high as 45% in favor of a recession. However, our view is significantly less dramatic. While we acknowledge the recent slowdown in economic growth, we have been through multiple periods of slower growth since the economic recovery. We are reminded that many of these periods happened to occur in the first quarter of the year. We are much more apt to conclude that this is a period of slower economic growth as opposed to something more severe given the strength in key areas of our economy, such as employment, the consumer and the service sector. The recent improvement in economic data helps to validate this view as well.

Only time will tell if the recent trends of rising equity markets, improving fundamentals, and calmness in financial markets will continue in the near-term or if we return to a period of elevated volatility. However, we end the quarter encouraged by the improvements we have seen in a number of areas and confident in how our portfolios are positioned.

***We welcome all Roof Advisory Group clients to attend our inaugural interactive online webinar discussion scheduled for 1:00 pm EDT on Thursday April 14<sup>th</sup>. The purpose of this webinar is to provide a more in-depth overview of the most recent quarter, financial market conditions, portfolio positioning, as well as our firm's outlook going forward. Invitations to register for the webinar are currently being emailed to our valued clients.***