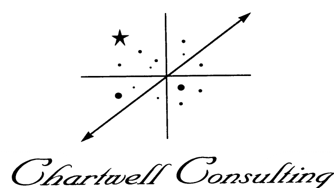

CHARTWELL REVIEW

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SHOCK AND AWE

We turned the page on a weak 2015 and stepped on some investment landmines –

- The S&P 500 suffered through its worst start to a new year, down 12% during the first six weeks of 2016;
- US Small-cap stocks plummeted into bear market territory, down 18% by February 11th, and off 26% since their highs late last June;
- The British, German, and Japanese stock markets also plunged into bear markets, off 11% (UK) to 21% (Japan) in just six weeks, and down between 22% and 29% since their highs during last year's 2nd quarter;
- Oil (WTI), which had already fallen to $37/barrel by year-end (off 39% from its 2015 high), dropped another 27% by mid-February;
- High yield bond *spreads*, after rising 235bps in 2015, jumped another 200bps during the first six weeks of 2016, to 900bps, as investors aggressively sold credit risk and bought government bonds around the world.

Following the Shock, the Awe began on February 12th -

- Gold, which hit a 6+ year low at the end of December, rose over 17% during the first quarter. This was its biggest quarterly gain in more than a generation;
- US Large-cap stocks jumped 13% and US small-caps rose 17%. The UK, German and Japanese stock markets each rose 12-14% through the remainder of the quarter;
- The WTI crude oil price climbed 38%, to finish the quarter unchanged at $37/barrel;
- US High yield bond spreads re-traced back to 7.05%;

Before we start high fiving, US small-caps remain 14% below 2015 highs, the DAX and NIKKEI are each 19% off last year's highs, and oil is 40% below its 2015 peak. At 1.78%, the 10-year Treasury is 70bps below its 2015 high. Almost $7 trillion of global government bonds carry negative yields.

Figure 1: Index Benchmarks

Market Index	Trailing Returns *				
	1Q 16	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	1.4	1.8	11.8	11.6	7.0
U.S. Top-cap Stocks	0.7	2.6	12.0	11.8	6.9
U.S. Mid-cap Stocks	2.2	(4.0)	10.4	10.3	7.4
U.S. Small-cap Stocks	(1.5)	(9.8)	6.8	7.2	5.3
Non-US Stocks (**EAFE**)	(3.0)	(8.3)	2.2	2.3	1.8
Non-US Stocks (**Emerg**)	5.7	(12.0)	(4.5)	(4.1)	3.0
3 mo. T-Bills	0.1	0.1	0.1	0.1	1.1
U.S. Aggregate Bonds	3.0	2.0	2.5	3.8	4.9
High Yield Bonds	3.3	(4.0)	1.8	4.7	6.9
Global Aggregate Bonds	5.9	4.6	0.9	1.8	4.3
Consumer Prices	*0.7*	*0.9*	*0.8*	*1.3*	*1.8*
Bloomberg Commodity	0.4	(19.6)	(16.9)	(14.1)	(6.2)
FTSE Nareit All REIT's	5.9	4.1	9.2	11.4	6.1
Global 65/35	*2.2*	*(1.6)*	*4.8*	*5.4*	*5.8*

Figure 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	1Q 16	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
U.S. Large-cap	(0.3)	(1.8)	10.2	9.9	6.3
U.S. Mid-cap	0.3	(6.5)	8.4	8.2	6.4
U.S. Small-cap	(0.8)	(8.7)	6.8	7.1	5.6
International Lg. Cap	(1.7)	(7.6)	2.4	2.3	2.2
International Sm. Cap	(0.4)	(0.1)	5.5	5.3	4.8
Emerg. Mkt. Equity	3.9	(11.3)	(4.3)	(3.3)	2.7
Balanced/Hybrid	0.9	(2.5)	4.8	5.6	4.9
General Bond	4.4	1.5	0.6	1.9	4.6
High Yield Bond	2.0	(4.4)	1.0	3.9	5.9
Equity Hedge Index	(1.7)	(4.5)	2.6	1.8	2.7

*Annualized trailing returns for periods ending 3/31/16

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Economies, Economics, Prices, and Policy

	3/2016	3/2015
CPI - All, trailing 1-year	0.9%	(0.1)%
CPI - headline, y-o-y	2.2%	1.7%
Real GDP Growth, 1-year *	2.4%	2.4%
Employment (000's)	151,320	148,333
Employment / Population %	59.9%	59.3%

** lagged by one quarter*

The final estimate of 4th quarter **real GDP growth** was upwardly revised in March to an annual rate of 1.4% (Figure 3). Nominal GDP growth was a very low 2.3%. The biggest swing factors in the quarter were negative contributions from business fixed investment (declining capital spending), exports declining more than imports, reduced inventory growth, and reduced government spending growth (yeah!). The bright spot throughout 2015 was the 9% rise in real spending on housing.

Figure 3: Breaking Down Real U.S. GDP

% Change from Preceding Period
(seasonally adjusted at annualized rates)

Factor	4Q '15	3Q '15	2Q '15	1Q '15
Real GDP Growth	1.4	2.0	3.9	0.6
Nominal GDP Growth	2.3	3.3	6.1	0.8
Final Sales	1.6	2.7	3.9	(0.2)
Personal Spending	2.4	3.0	3.6	1.8
Private Investment	(1.0)	(0.7)	5.0	8.6
- Fixed, Businesses	*(2.1)*	*2.6*	*4.1*	*1.6*
- Fixed, Residential	*10.1*	*8.2*	*9.3*	*10.1*
*- Chg. In Inventories **($bn)***	*$78*	*$86*	*$114*	*$113*
Export growth	(2.0)	0.7	5.1	(6.0)
Import growth	(0.7)	2.3	3.0	7.1
Government Spending	0.1	1.8	2.6	(0.1)

The Blue Chip consensus estimate of **1st quarter GDP growth** started the year at an optimistic 2.5%. It's currently down at 1.3%. The Atlanta Fed, which has a better prediction track record, is forecasting 0.4%. They were at +2.5% in mid-February, but recent data indicates our economic growth momentum has almost stopped.

You'll recall domestic employment growth stunned to the upside in the 4th quarter, with the private sector adding 827,000 new jobs. The first quarter saw that number reduced to 628,000 (still above 200k per month).

The Fed reportedly focuses on non-farm payroll numbers excluding construction and retailing. This line item added just 372,000 jobs in the first quarter, following 638,000 adds during the 4th. By recent historical standards it was a weak quarter, as quarterly gains have averaged 525,000 during the last four years.

Wage growth continues to be mediocre, but positive. In nominal terms, median weekly earnings in March were 0.4% higher than December, and up 2.0% for the last twelve months. With inflation remaining low, real weekly wages at the end of March were 1.9% higher than the same period last year.

Stable prices, i.e., low inflation rates, are the Fed's second directly mandated responsibility -

- ⇨ **"Headline" CPI** was up every month this quarter, ultimately rising 0.7%. The index was up only 0.9% during the past twelve months, continuing to reflect the downward pull of food and energy prices.
- ⇨ **Core CPI** (ex-food & energy) rose a strong 1.1% during the first quarter, and is up 2.2% over the past year. This is its highest level in over 4 years.
- ⇨ The **Producer Price Index** for final demand goods and services declined by (0.1)% during the past year. PPI final demand, ex-food & energy, has risen 0.9%.

In nominal terms, US retail and food service sales for March 2016 were up only 1.7% compared to one year ago. However, total first quarter sales were 2.8% ahead of 1Q15.

Industrial production growth was very disappointing in Q1, following weak outcomes during Q4. Overall industrial production fell at an annual rate of -2.2%, having declined at a -3.4% annual rate during Q4. The level of activity in March was 2.0% below year earlier levels. At just +1.2%, annualized capacity growth has been constrained by low energy and mining capex. Nonetheless, capacity utilization decreased -0.5% to 74.8%, a rate that is 5% below its long-run average.

Painting a dim picture of the world economy, the International Monetary Fund this month trimmed its global growth forecast and called for "immediate" action to reduce the increasing risk of recession.

The IMF said it expects the global economy to expand 3.2% this year, up from 3.1% in 2015 but below its 3.4% estimate in January. It anticipates 3.5% growth in 2017, down from its 3.6% projection in January. The IMF, which has pared its forecasts for several straight quarters, made similar cuts to its U.S. forecast, estimating the nation's economy will grow 2.4% this year and 2.5% in 2017.

The fund largely attributed the weaker outlook to China's slowdown, the negative effect of falling oil and other commodity prices on emerging markets, and weak productivity growth and aging labor forces in advanced economies such as the United States.

Advanced economies are now projected to grow about 2% in both 2016 and 2017, down slightly from the IMF's estimate in January.

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Yields Drop; Fixed Income Markets Rally

Sovereign interest rates fell 30-50bps in most developed countries, including the U.S. The bellwether 10-year US Treasury yield dropped by 50 bps to only 1.78%. The 5-year Treasury yield dropped 55 bps, and the 30-year declined by 40 bps to 2.62%.

The rally in government bonds resulted in the Global Aggregate Bond index returning 5.9% on an unhedged basis, and 3.3% if hedged. Japan joined Switzerland with negative 10-year yields. German Bunds now trade through US Treasuries by 1.6%, while Italy and Spain trade 35-45bps through the US yield (go figure).

Through Feb. 11th, bonds rallied as risk aversion mounted. US Treasuries were up 3.7%, and long-dated US bonds maturing in 20+ years rose a whopping 10.75%. You might have guessed this would turn around as stock markets rallied out the quarter. But it really didn't. Rate declines held, and 20+ year Treasuries were up 8.5% for the quarter. Long industrial bonds returned 7.6%, and long-term US$ sovereign bonds returned 8.4%. Many attribute this to a general re-pricing in the markets of the number of Fed rate hikes expected in 2016.

The US Dollar's ascent ended (paused?) in Q1. On a trade-weighted basis versus major currencies, the US$ depreciated 3.3%, after appreciating 10.5% in calendar 2015. The Euro rose 4.6% and the Yen rose 6.8%. The Pound fell 2.5% on Brexit concerns.

With rates falling, long-duration bonds outperformed. Long-dated Treasuries, Long Credit bonds, and TIPs topped the performance charts in the quarter (Fig. 4).

After a weak 4th quarter, domestic investment grade (IG) credit markets posted positive returns in the first. Credit spreads widened very slightly, as all of the first six week's damage was reversed. During the past year, the story is quite different. AA spreads are up 30bps, and BBB spreads almost 60bps higher. Higher spreads have held back 1-year performance of IG corporate bonds.

The primary HY bond index trades at a credit spread 200+bps higher than a year ago. Yield of the HY index is 8.2%. But, this figure masks a deeply bifurcated market: CCC bonds yield an average of 15%, while even weaker credits trade at 44% y-t-m. In contrast, BB bonds yield "only" 5.7% (still almost 2% above BBB's).

Three weeks into 2016, external currency EM debt was down 2% while local currency debt had sold-off by 4%. EM debt then staged one of the largest rallies in years. Since bottoming in January, external debt has returned over 7% while local debt has returned an astounding 15%. Overall, EMD($) returned just over 5.9% for the quarter, while EMD(Local) returned a striking 11%. A confluence of factors has helped EM debt reverse course:

- Dovish actions and rhetoric of central banks
- A rebound in commodity prices
- Stability in the Chinese renminbi

Figure 4: Primary Bond Sector Returns (%)

Index	1Q '16	1 Year	3 Years	5 Years
US Aggregate Bond index	3.0	2.0	2.5	3.8
US Gov't/Credit: 1-3 Yrs.	1.0	1.0	1.0	1.1
US Treasury: Long	8.2	2.8	6.1	9.7
US Inflation-Linked	4.7	1.4	(0.7)	3.2
Mortgage-Backed (MBS)	2.0	2.4	2.7	3.3
CMBS	3.6	2.6	2.9	4.5
Asset-Backed (ABS)	1.4	1.7	1.4	2.5
Inv. Grade Credit, 1-10yr	2.7	1.9	2.5	4.2
Inv. Grade Credit, 10+yr	7.1	(1.2)	4.1	7.6
US High Yield Credit	3.2	(4.0)	1.8	4.7
Municipal Bonds	1.7	4.0	3.6	5.6
Global Aggregate, ($ hdgd)	3.3	2.4	3.7	4.6
Global Credit, ($ hdgd)	3.3	0.9	3.3	5.1
Emerg. Mkts Bonds (US$)	5.9	5.9	2.8	6.1

Figure 5: Primary US$ Bond Yields

	Mar-16	Dec-15	Sep-15	Mar-15	*1-Year Change*
US Treasuries	(%)	(%)	(%)	(%)	*(%)*
3-month	0.21	0.16	0.01	0.03	***0.18***
2-year	0.74	1.06	0.63	0.56	***0.18***
5-year	1.22	1.77	1.38	1.38	***(0.16)***
10-year	1.78	2.25	2.06	1.93	***(0.15)***
30-year	2.62	3.01	2.88	2.54	***0.08***
BarCap Aggregate	2.16	2.59	2.31	2.06	***0.10***
BBB Credit	3.86	4.34	4.14	3.49	***0.37***
AA Credit	2.22	2.63	2.37	2.01	***0.21***
Agency MBS	2.35	2.34	2.61	2.40	***(0.05)***
Emerging Mkts ($)	5.87	6.43	6.46	5.57	***0.30***
US High Yield	8.18	8.75	8.04	6.63	***1.55***
UST30y-UST2yr	1.88	1.95	2.25	1.98	***(0.10)***

Figure 6: Sovereign Bond Yields, selected countries

10-year yields (%)	Mar-16	Dec-15	Sep-15	Mar-15	*1-Year Change*
United States	1.78	2.25	2.06	1.93	***(0.15)***
Germany	0.16	0.64	0.59	0.21	***(0.05)***
Switzerland	**(0.39)**	**(0.07)**	**(0.10)**	**(0.05)**	***(0.34)***
Britain	1.54	1.99	1.81	1.61	***(0.07)***
Poland	2.86	2.92	2.85	2.30	***0.56***
Italy	1.22	1.63	1.73	1.31	***(0.09)***
Spain	1.44	1.85	1.90	1.27	***0.17***
Greece (new bonds)	8.77	8.34	8.46	11.16	***(2.39)***
China (5 year)	2.55	2.67	3.09	3.44	***(0.89)***
Japan	**(0.09)**	0.28	0.34	0.37	***(0.46)***
Australia	2.50	2.75	2.61	2.36	***0.14***
Russia	9.09	9.52	10.98	11.78	***(2.69)***
Brazil	13.67	16.41	15.47	13.12	***0.55***
India	7.49	7.76	7.54	7.76	***(0.27)***

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US Stocks Correct, then Rebound

The US stock market recovered smartly from its worst start to a New Year since forever. After dropping pretty much every day for six weeks, they rang the bell after the February 11th close, and all stock sectors began to rise.

Still, it was really quite a challenging quarter, despite the wonderful ending. Large-cap stocks barely returned their dividend (Fig. 7). Mid-cap stock portfolios did well, but only if they were value-biased. Small-cap stock portfolios did not fare well, *especially* if they were growth-biased. The overall small-cap sector slipped into bear market territory during the first half of the quarter (off 26% from its high last June), and remains there even after its furious rally.

Figure 7: U.S. Equity Market - Size/Style Returns

			Trailing	
	1Q '16	1-yr	3-yrs	5-yrs
Growth				
Large Cap	0.8	5.7	14.7	13.4
Mid Cap	0.6	(4.8)	11.0	10.0
Small Cap	(4.7)	(11.8)	7.9	7.7
Value				
Large Cap	0.7	(0.7)	9.2	10.1
Mid Cap	4.0	(3.4)	9.9	10.5
Small Cap	1.7	(7.7)	5.7	6.7

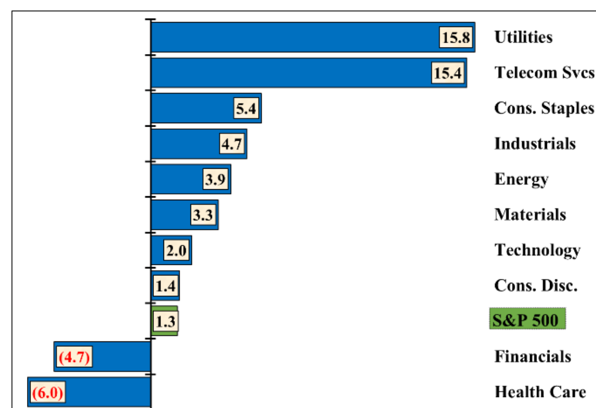
Size/style performance ranged from a high of 4% for mid-cap value to a low of nearly -5% for small growth. Per Figure 7, longer-term returns still disproportionately favor growth stocks across the entire size spectrum, despite the first quarter's reversal. And, the size factor continues to favor larger-caps versus smaller over both short and long timeframes. Both of these outcomes are inconsistent with investor's long-term experience.

The performance range across sectors was large. Telephone and utility companies, collectively accounting for only 6% of the Russell 3000, each earned a substantial 15% return, while healthcare firms lost 6%. And, healthcare *growth* stocks lost more than 12%. Perhaps surprisingly, energy and materials stocks posted positive returns after natural resources prices rebounded sharply in March, but these remain easily the worst performing sectors during the past year.

The two highest capitalization sectors, technology and financial servies, were also among the weakest. The mega-cap banks, including JPMorgan, Wells Fargo, Citigroup and BofA, all posted double-digit declines and were four of the five largest losers in the S&P 500.

The top five positive contributors to returns in the quarter were Verizon, AT&T, ExxonMobil, Facebook, and Apple. Apple gained only 4%, but it has the largest weighting in any index, global or domestic.

Figure 8: US Sector Returns – 1st Quarter 2016



Many risk factors, including - size, style (value/growth), market sentiment (momentum), quality (margins, ROE, leverage), and volatility, are determinants of returns. The primary factors driving performance in Q1 shifted away from the primary drivers in 2015. Top positive Q1 factors were value (lower Price/Book, higher dividend yield), quality (higher operating margins, high ROE), and size. Of these, only operating margins and size were positives in 2015. Top negative factors in Q1 were price momentum and higher projected earnings growth, both of which were major positives in 2015.

With only modest market returns for the quarter, the S&P 500's trailing PE ratio stands at 19.4x, which is virtually unchanged from one year ago. Large- and small-cap growth stocks are trading at 7% higher PE's. The EAFE index of stocks is trading at a 14% *lower* PE.

Figure 9: One-year Trailing P/E Ratios – Mar. 2016

	Value	Blend	Growth
US Large	16.3	19.4	23.6
US Mid	22.1	22.4	22.8
US Small	19.8	23.4	29.0
EAFE		15.4	
Emerg. Mkts		13.7	

Market volatility since last June has been its highest since 2008. On the flip side (return), a number of strategists predict the S&P 500 will close the year at just 2050-2100. Including dividends, that would be less than a 2.5-5% total return, and two years running of weak stock returns. That outcome is historically very rare without a recession.

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International Markets – Calmer "C's" Ahead?

Global equity markets opened the year having to navigate through stormy "C's" – plunging *commodity* prices, a strong US *currency*, rising *credit* default concerns and a slower growing *China*. Equity indices posted steep losses through mid-February, but regained much ground in March, as oil (and other commodities) prices stabilized, and the appreciation of the US dollar paused after the Fed adopted a cautious stance on raising rates.

While US markets edged into positive territory, developed non-US markets did not climb out of the steeply negative hole they dug for themselves through mid-February. For the quarter, the World ex-US index fell 2.0% in Dollar terms, and was off a full 5.8% in local terms. Canada, the weakest performing developed market in 2015, jumped 11.3% in the first quarter as oil prices rebounded.

European equities retreated -2.5% in the quarter, amid generally downbeat trailing period economic data. In March, better news emerged. Optimism for increased growth was renewed as the ECB cut its deposit rates further into negative territory, expanded its asset-purchase (QE) program to €80B per month, and announced plans to include corporate bonds in the program. Larger European economies performed in line with the index, while some peripheral countries posted weaker results. The top performing countries were the Netherlands (3.4%), Portugal (3.2%) and Norway (1.7%).

The Pacific region's -3.7% quarterly loss was dominated by Japan. Despite a sharp and surprising Yen rally (following the Bank of Japan's interest rate cut moving rates into negative territory for the first time), the Japanese market dropped -6.5% in Dollar terms. The yen strength weighed heavily on the export sector, as did rising concerns regarding the persistence of weak global demand. Hong Kong also posted slightly negative results, falling -0.6%. Other Asian markets performed well, but could not overcome the weakness of the region's two larger markets. Australia rose 2.1%, New Zealand jumped 11.6% and Singapore rose 5.1%.

Driven by strong performance in March following the Fed's announcement of fewer rate hikes this year, the broad Emerging Markets index went from "worst to first", jumping 5.7% in the quarter. Latin America was easily the best performing region for the quarter. Except for Mexico (up 8.5%), all countries in the region posted double-digit gains, led by Brazil (+28.5%). Gains appear to be fueled by investors betting on a change in political leadership amid the current crisis, growing expectations for a rate cut as the country struggles with a deep recession, and stabilizing commodity prices

The Emerging Asia index rose only 1.9%, as its largest economies China (-4.8%), India (-2.5%) posted negative results. Weak economic data, accelerating capital outflows, and further currency depreciation sparked a sell-off in China. Late in the quarter, the Peoples Bank of China cut bank reserve requirements by 50 bps to help stabilize the market, and other economic indicators began showing signs of improvement. Other countries in the region posted positive returns, led by Thailand (16.6%), Malaysia (13.2%) and Indonesia (11.2%).

Figure 10: International Equity Markets – Returns

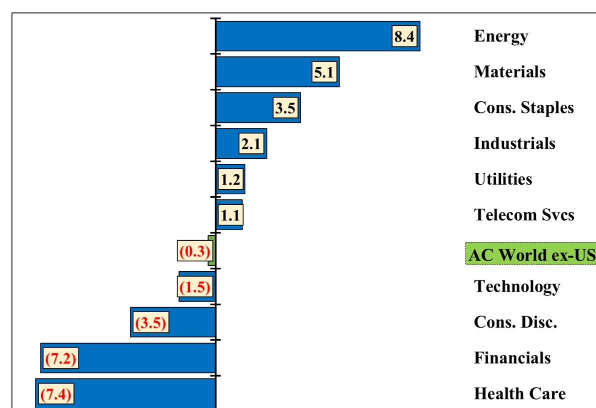
	U.S. Dollar Returns (%)		Local Currency Returns (%)	
thru 3/31/16	1Q '16	1-Yr	1Q '16	1-Yr
World ex-USA	**(2.0)**	**(8.4)**	**(5.8)**	**(11.0)**
- MSCI Growth	*(1.4)*	*(4.5)*	*(5.4)*	*(7.3)*
- MSCI Value	*(2.6)*	*(12.3)*	*(6.2)*	*(14.7)*
- Europe ex-UK	(2.6)	(8.3)	(7.0)	(12.6)
- Pacific, ex-Japan	1.8	(9.7)	(2.1)	(10.2)
- Japan	(6.5)	(7.1)	(12.7)	(12.9)
- United Kingdom	(0.2)	(3.0)	(2.1)	(4.4)
Int'l Small Cap	**0.6**	**2.0**	**(3.5)**	**(1.0)**
Emerging Mkts	**5.7**	**(12.0)**	**2.7**	**(7.7)**
- EM Asia	*1.9*	*(12.6)*	*0.3*	*(10.6)*
- EM Europe	*14.3*	*(4.4)*	*7.5*	*1.4*
- EM Lat Amer	*19.1*	*(9.2)*	*11.8*	*0.8*
- EM BRIC	*1.3*	*(15.3)*	*(1.0)*	*(12.4)*

Emerging Europe rebounded with a 14.3% return, as Russia (+15.8%) benefited from recovering oil prices. The best performing country in the region was Turkey, jumping 21.6%, and the weakest was Greece, which dropped -12.2% and is off -52% for the trailing one year.

In Q1, the US Dollar declined against every currency in the G10 except the Pound, and versus all major EM currencies. The "natural resource" currencies (Australia, Canada, Brazil, and Russia) were the best performers.

Four of the ten sectors posted negative returns in the first quarter. The two weakest sectors, financials and health care, contributed more than 100% to the quarter's loss. The three weakest performing sectors in 2015 - energy, materials and industrials, were among the stronger performing sectors during the first quarter.

Figure 11: Ex-USA Sector Returns (1st Qtr 2016)



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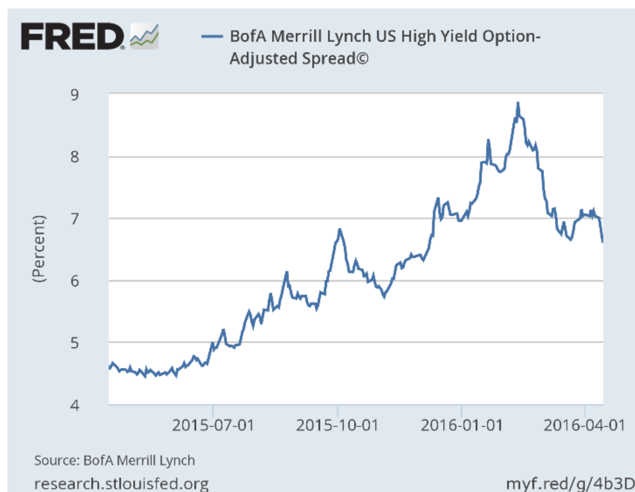
Back Page Perspectives: Where's the Value?

Option-adjusted high yield credit spreads measure the difference between current "junk bond" yields and Treasury yields, adjusted so maturities match. Spreads have been on a wild ride during the past year, peaking on February 12th at 9.20%. That was up from only 4.58% one year ago, and 6.95% at the beginning of 2016. As with stocks, high yield bonds completely reversed course in mid-February. The credit spread dropped back to 7.05% by quarter's end. Even so, that figure is 2% above the twenty-year average. There is no other US$ fixed income sector with this kind of "juice."



As we've discussed recently (okay, almost every quarter), stock valuation levels (Figure 9) remain above long-term averages, despite revenue and earnings growth experience being challenged, to say the least.

The stock market faces three headwinds: "mediocre" GDP growth, a "mixed" earnings outlook, and high valuations. And, strategists expect households, foreign investors, and pension funds to be net sellers of stock for the near term. Yet, one force is keeping the stock market from selling off - corporate stock buybacks. With limited appetite to invest in growth via capex, companies have found the best way to deploy excess cash is by returning it to shareholders through share buybacks and dividends. Goldman forecasts S&P 500 gross buybacks will rise by 7% in 2016 to $600 billion. That's alot of demand.

Looking at earnings, Dollar strength certainly affects the short-term global competitiveness of US companies. As such, there may indeed be at bit of light at the end of what has been a three-year long tunnel. The Dollar has lost some of its momentum during the past few months (Fig. 12), except against the Pound). Should this experience be extended, analysts think the earnings picture could begin improving in a V-shaped fashion later this year, especially if oil prices have finally hit bottom. And, at $26/barrel, oil may have indeed put in its low during the 1st quarter (it's trading over $43/bbl in April).

Figure 12: FX Changes: Dollar vs. Major Markets

	1Q '16	Past 1 Yr	Past 3 Yrs	Past 5 Yrs
Trade Weighted Index: Broad	**-1.6%**	4.3%	20.3%	25.1%
Trade Weighted: Major Currencies	**-3.3%**	**-0.6%**	19.4%	29.1%
vs. Euro	**-4.8%**	**-6.0%**	14.9%	26.0%
vs. Yen	-6.8%	**-6.7%**	19.6%	38.1%
vs. Brit. Pound	2.5%	3.1%	6.6%	12.8%
vs. Renminbi	-0.6%	3.9%	3.8%	-0.9%

We observe economic growth forecasts being lowered across the world, with declining yields becoming a global phenomenon. Led by Japan, $7 trillion in global government bonds, or 27% of the JPM Global Government Bond Index, has shifted to negative yields. It seems to us the market is discounting a significant rise in the prospects for a global recession, not just concerned with a few Fed rate hikes.

Which makes the balance between stocks and bonds particularly disconcerting right now – it's hard to tell who is right and who is wrong. Bond yields, especially those of developed market governments, look remarkably low. Yet, betting against them staying low has burned investors several times now.

Ultimately, we see the strategic choices in real terms. The bond market is pricing in a break-even 10-year inflation rate of less than 1.75%. That 1.75% figure happens to be the *lowest* realized 10-year inflation rate in more than 30 years. If the market's current bet proves wrong, again, then real yield long-term Treasuries (TIPS) should outperform nominal. For risk adverse long-term investors, this is a good place to start. Then, we'd look at overweighting some other riskier assets that have strategically important positive real yields, including -

- ✓ Higher dividend stocks;
- ✓ Investment grade corporate bonds
- ✓ Emerging markets bonds (overweighted to US$)
- ✓ High yield corporate bonds and bank loans (ex-energy, for the most part)
- ✓ ABS (a bet on individuals, with low duration, low credit risk, and higher spreads than MBS)

Diversification and security selection remain key.

Sell high, buy low. See you next quarter!

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