Monthly Market Commentary

A Summer Holiday for Markets

August 2016

- Markets in August were subdued, with a partial rebound in energy prices and mixed fixed-income performance.
- Risk appetite and renewed U.S. dollar strength was a key driver of fixed-income returns, which were led by U.S. high-yield bonds and external (foreign-currency denominated) emerging-market debt.
- We remain bullish, and the fundamentals of U.S. risk assets seem better than most. Defensive equity sectors still look expensive, as do government fixed-income securities.

Economic Backdrop

Equity markets took a holiday in August. Low volatility and reduced trading prevailed as wary investors sought further clarity on the impact of the Brexit vote while also trying to predict central banks' next steps. Oil prices surged mid-month, then partially retreated, on the hopes that an early-September meeting between major oil producers Russia and Saudi Arabia would result in an agreement to freeze production. Fixed-income markets were mixed.

The Federal Reserve (Fed) hinted at its annual August conference that U.S. economic conditions may finally be stable enough to support another interest-rate increase before year end due to consistently solid labor-market performance and a firming outlook for inflation expectations; although a tepid August jobs report makes a September rate hike unlikely. Meanwhile, the Bank of England (BOE) undertook expansive monetary stimulus, pulling its benchmark interest rate down to the lowest in its 322-year history while simultaneously reinstituting a bond-buying program in an effort to cushion its economy from Brexit vote aftershocks. The European Central Bank (ECB)'s July meeting minutes acknowledged new headwinds following the Brexit referendum and hinted that further stimulus might be necessary to stabilize the region's economy. The Bank of Japan (BOJ) — which doubled its exchange-traded-fund purchase program in late July in a moderate easing effort — meets next month and is expected to take further action as it continues its struggle against deflation.

A respectable 151,000 new jobs were created in the U.S. in August. Unemployment remained at 4.9% — a level considered full employment — and wage growth exceeded inflation. While August's jobs report was fair, gains for the month were far less impressive than the 275,000 added in July, and may not be enough to persuade Fed officials to raise interest rates at their meeting in September. Manufacturing contracted in August for the first time in six months as new orders backslid. Consumers continued to drive the economy: consumer spending expanded as a result of robust vehicle sales and spending on services in July. Personal income also rose in July due to a boost in wages and salaries.

Reactions to the Brexit vote varied among U.K. businesses and consumers, but the news was mostly an improvement. Following a dismal July, manufacturing leapt into expansion territory in August by its largest increase in twenty-five years. Enthusiastic U.K. consumers largely shrugged off the Leave vote: economic growth climbed by 0.6% in the second quarter and 2.2% in the year ending 30 June due to record-breaking household spending. Retail sales came roaring back in July, led by non-food, textiles, clothing and footwear stores. The housing market continued its winning streak in August, as home prices rose to their highest level since March. On the minus side: activity in the services sector fell at its fastest pace in seven years in July, moving into its first contraction since 2012; new business inquiries and sentiment in the sector (which accounts for almost 80% of the British economy) declined sharply. Consumer prices also tumbled in July due to lagging prices in recreation and culture services.

Post-Brexit economic data in the eurozone were also mixed. August brought slow-but-steady expansion to the region; service providers saw their best growth in new orders in four months; although new orders in manufacturing declined. Producer prices jumped in July at their fastest rate since August 2012 and lending also gained 1.9% in July. However, economic sentiment deteriorated more than expected in August; confidence in services and retail trade also dropped, suggesting that Brexit could reverse the modest economic recovery underway in the region. Inflation edged up to 0.2% year over year in August, unchanged from July and still far short of the ECB's desired 2% rate; it has not breached 0.3% since March 2014. Second-quarter economic growth was diluted following the referendum, as expected. The four largest countries in the region (France, Germany, Spain and Italy) all experienced contraction; while Greece and Latvia showed improvement.

Market Impact

Global fixed-income markets declined in aggregate during August, and U.S. high-yield bonds enjoyed another month as the strongest performing segment, followed by foreign-currency-denominated (external) emerging-market debt. U.S. dollar-hedged (which seeks to reduce U.S. dollar-related volatility) global non-government debt was modestly positive, as were U.S. mortgage- and asset-backed securities. Local-currency denominated emerging-market debt was marginally positive, and U.S. investment-grade corporate fixed income also advanced slightly. Dollar-hedged global sovereign securities declined during the month, and both U.S. Treasurys and Treasury Inflation-Protected Securities (TIPS) dipped. Unhedged global sovereign debt was the worst performer in August.

Global equity markets, as reflected by the MSCI AC World Index (Net), advanced modestly during the month. Colombia — last month's poorest performer — rotated into the lead, followed by China, Ireland and Qatar. Thailand, Korea and the Netherlands had strong returns, as did Hungary and Russia. The Czech Republic delivered the poorest performance, while South Africa, Denmark, Peru and Chile were also deeply negative. Global sector performance was led by financials, followed closely by information technology; industrials also did well, and energy turned in a positive performance. Traditional defensive sectors struggled, with utilities and healthcare declining sharply, while telecommunications and the consumer sectors were also down for the month.

Index Data

- The Dow Jones Industrial Average Index advanced by 0.26%.
- The S&P 500 Index increased by 0.14%.
- The NASDAQ Composite Index rose by 1.18%.
- The MSCI AC World Index (Net), used to gauge global equity performance, advanced by 0.34%.
- The Barclays Global Aggregate Index, which represents global bond markets, declined by 0.49%.
- The Chicago Board Options Exchange Volatility Index, a measure of implied volatility in the S&P 500 Index that is also known as the "fear index", increased in the month, moving from 11.87 to 13.42.
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, jumped from $41.60 a barrel at the end of July to $44.70 on the last day in August, setting an intra-month high of $48.52 on 19 August.
- The U.S. dollar strengthened relative to sterling, the euro and yen, and ended August at $1.31 versus sterling, $1.11 against the euro and at 103.4 yen.

Portfolio Review

U.S. equities advanced, with small companies outpacing the modest gains of their larger counterparts. Large-cap strategies performed well on a benchmark-relative basis as deeper value and volatility continued to recover, while stability and momentum lagged. An underweight to defensive sectors, particularly telecommunications, served as a key contributor to performance. Small-cap strategies underperformed primarily due to stock selection financials, healthcare and industrials. International developed-market strategies performed in line with their benchmark in a low-return environment. An underweight to Germany served as a slight detractor that was more than offset by an overweight to the Netherlands as cyclicals performed well in both countries. Selection in U.K. industrials and consumer staples, as well as sidestepping some beleaguered materials-sector benchmark constituents, was additive. Overall selection was poor, however, in Japan. Emerging markets delivered an impressive advance, and our strategy performed well primarily on the merits of an underweight to South Africa and selection, especially in China. Political instability and natural disasters took a toll on South Africa's economy, while China outperformed the rest of Asia by a wide margin in a market that favored technology companies.

Core fixed income performed well as non-government sectors generated positive excess returns amid strong demand for yield. Short-term yields rose and long-term yields declined, supporting a yield-curve flattening bias, and an overweight to corporate bonds — specifically financials — was positive as risk appetite rebounded. An overweight to commercial mortgage-backed securities (MBS) was additive, and an underweight to dollar-denominated Turkish bonds supported relative performance as they produced negative returns. An overweight to non-agency mortgage bonds enhanced returns as they continued to recover from a tough start to the year. An overweight to asset-backed securities (ABS) detracted as investors rotated into higher-yielding sectors. The high-yield market continued to rally, and performance was supported by an allocation to structured credit, a substantial underweight to basic industry (which includes metals and mining) and selection with the retail sector. An underweight to energy detracted as the sector rebounded, while overweights to healthcare and media also weighed on performance. In emerging markets, overweights to Colombia and Argentina, along with an underweight to the Philippines, were top contributors, while overweights to Indonesia and Brazil were the top laggards.

Manager Positioning and Opportunities

U.S. large-cap orientation continues to favor mean-reversion value and forward-looking growth strategies over core and stability given our belief that economic fundamentals are better than those implied by market sentiment. One of our largest active positions is an overweight to technology given its attractive risk-return proposition in a low-growth economic environment, and we are underweight staples on growth and valuation concerns. Among small caps, we believe valuations look reasonable and favor stability-growth and deeper-value strategies. Our largest active position is an underweight to financials, which remains challenged by low interest rates, and we are overweight industrials and energy on valuation grounds. Within international developed markets, financials also remains the largest underweight, and we have also retained an underweight to consumer staples as valuations are elevated. Overweights to technology, energy and consumer discretionary remain. In emerging markets, we remain overweight Latin America but an overweight to Brazil has been reduced slightly. We favor the consumer and financial sectors in Mexico and retain exposure to Argentina, a frontier market. We remain overweight to Turkey (despite its political woes) and to Russia, with an eye to idiosyncratic opportunities, such as retail stocks with solid earnings growth and cheap valuations. We retained our underweight to Asia, although exposure to Chinese technology stocks has increased. We also retained overweights to Taiwanese technology stocks and to Indian consumer-discretionary stocks.

Core fixed income's duration posture will likely remain slightly short to neutral its benchmark and adjust accordingly, especially if and when rates make new lows. The magnitude of our yield curve-flattening bias has been reduced with the U.S. Treasury yield curve narrowing, but still remains. We plan to continue adding financial exposure selectively given the sector's firm fundamentals, and remain slightly overweight industrials. Overweights to ABS and commercial MBS will remain as they offer competitive yields, especially on a risk-adjusted basis. We will also retain an allocation to non-agency mortgages given strong housing-market fundamentals. Within high yield, allocations to structured credit and a small overweight to leisure remain. We also have a significant underweight to basic industry and a smaller underweight to energy. In emerging markets, we added to a local-currency debt overweight, widened an external debt underweight, and maintained an allocation to corporates. Our largest active positions are overweights to Indonesia, Brazil, Argentina and Mexico, as well as underweights to China and Singapore. Our largest currency overweights are to the Indonesian rupiah, Brazilian real and Philippine peso; our largest underweights are to the Hungarian forint, Singapore dollar and Chinese yuan.

Our View

Angst is the one thing everyone seems to share in common across the world. The U.K.'s vote to leave the EU is a major political and economic event that will likely weigh on international financial markets, not just for weeks and months, but perhaps for years. The leap into the unknown will likely dampen economic growth as business spending freezes until some clarity re-emerges on the country's trading relationships. Sterling's plunge immediately following the Leave vote, however, should provide a much-needed offset to the mostly negative impact of all the uncertainty, as U.K. exporters find themselves in a more competitive position.

The ability of the equity market to bounce back from the immediate shock is heartening, but it is hard to draw firm conclusions on how disruptive Brexit will be on future EU and eurozone economic activity. The fragility of the recovery going into this crisis is a matter of deep concern. The fact that bond yields did not bounce higher even as stock prices rallied post-Brexit is a divergence worth noting.

In our opinion, the U.S. remains the cleanest shirt in the laundry bag, staying resilient despite numerous shocks over the past seven years, including the period immediately following the Brexit vote. The first hints of wage pressure are coming through, with a moderate acceleration in wages and total labor compensation apparent on a year-over-year basis. As corporate margins get squeezed by the pick-up in labor costs, the pressure to raise prices will likely intensify.

This puts the Federal Reserve in something of a quandary, since the Brexit shock has seemingly upended any possibility of a near-term rise in the federal funds rate. Market-implied expectations for the next policy-rate move suggest December 2016 at the earliest. Yet, we admit to a growing uneasiness that the central bank may be a falling behind the inflation curve. We understand that the still-soggy global economy and the shock delivered by the U.K. vote argue for a very cautious process of interest-rate normalization. But if the upward trend in labor costs is sustained, a more aggressive response by the U.S. central bank eventually will be justified.

In the months immediately ahead, investors' attention will be focused on the U.S. presidential election. We want to make one simple point: markets hate the unknown. For good or ill, Secretary Clinton is the familiar, status quo candidate. Donald Trump, on the other hand, promises to shake things up. In a year where voter dissatisfaction is exceptionally strong in the U.S., we would not hazard a guess as to the outcome this early in the process. Investors need to be prepared for a bit of volatility in the months ahead, since the uncertainty level will likely remain elevated between now and the election. For now, we lean toward the optimistic side, mainly because U.S. economic and financial fundamentals appear relatively healthy.

One of the more surprising market responses to the U.K. Brexit vote is the sharp appreciation of the Japanese yen. This is the last thing that the country needs, since an ultra-strong currency exacerbates downward pressure on inflation. Corporate earnings have begun to roll over in response to the currency's appreciation. As Japanese yields sink further into negative territory across the curve, we wonder what kind of rabbit the BOJ can pull out of its hat, since the most recent interest-rate moves have failed to weaken the currency or boost the economy.

Investors' fears earlier this year of an imminent Chinese debt and currency meltdown have receded. China's economy mostly appears to treading water, much like the rest of the world. The government continues to use the old and familiar economic playbook: encourage growth fuelled by additional debt, prop up state-owned enterprises and allow its currency to fall. Economic and financial reforms are proceeding, but at an erratic pace. Chinese equities have not shown much spark, however, despite the "risk-on" environment for emerging-market assets that began in late January.

Globally, the points of general consistency in our investment outlook and positioning are that the stability alpha source and momentum appear expensive within equities, and that our fixed-income managers generally favor credit at the expense of duration.

Benchmark Descriptions

The Dow Jones Industrial Average is a widely followed market indicator based on a price-weighted average of 30 blue-chip New York Stock Exchange stocks that are selected by editors of *The Wall Street Journal*.

The S&P 500 Index is a capitalization-weighted index made up of 500 widely held U.S. large-cap companies.

The NASDAQ Composite Index is a market value-weighted index of all common stocks listed on the National Association of Securities Dealers Automated Quotations (NASDAQ) system.

The MSCI All Country World Index is a market capitalization-weighted index composed of over 2,000 companies, representing the market structure of 48 developed and emerging-market countries in North and South America, Europe, Africa and the Pacific Rim. The Index is calculated with net dividends reinvested in U.S. dollars.

The MSCI EMU Index (European Economic and Monetary Union) Index is a free float-adjusted market-capitalization weighted index that is designed to measure the equity market performance of countries within EMU. The MSCI EMU Index consists of the following 10 developed-market country indexes: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal and Spain.

The Barclays Global Aggregate Bond Index (formerly Lehman Brothers Global Aggregate Index), an unmanaged market capitalization-weighted benchmark, tracks the performance of investment-grade fixed- income securities denominated in 13 currencies. The Index reflects reinvestment of all distributions and changes in market prices.

The Chicago Board Options Exchange Volatility Index (VIX) tracks the expected volatility in the S&P 500 Index over the next 30 days. A higher number indicates greater volatility.

Disclosures

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