The first quarter of 2016 will go down as one of the more volatile ones in recent memory. U.S. stocks fell by double digits by mid-February, only to post a modest gain of just over 1% by the end of the quarter. Global equity markets saw a similar sell-off, followed by varying degrees of market recoveries. Across fixed income markets, yields fell in response to increased quantitative easing (QE) measures by Japanese and European central bankers. By the end of the quarter, nearly 60% of global government bonds were trading below 1%, including 30% ($7 trillion of notional value) below zero. It goes without saying that we are navigating uncharted waters across fixed income.

By the end of the quarter the market had moved to a “risk-on” footing with higher-risk loans performing well, commodities rebounding and emerging market equities outpacing many developed-country equity markets.

As we have pointed out on multiple occasions, the recent volatility has simply marked a return to historically more normal levels of volatility after multiple years of very low levels. It was, in fact, the period from 2012 to 2014 that was abnormal. In our opinion, this period of volatility suppression was caused by a Federal Reserve that was actively pursuing QE (aka bond buying) strategies, with the stated goal of increasing asset prices. With the transition away from QE and the first rate hike in December, the markets have been adjusting to a world with less stimulus from monetary policymakers. Of course, this is a long and drawn-out process as other central banks—namely the Bank of Japan and the European Central Bank—try to fight deflationary tendencies and sluggish growth in their economies. But it is principally the Fed that acts as the global metronome, setting the rhythm for global markets. The bottom line is that all central banks matter, but the Fed matters most of all.

Last quarter we concluded our investment outlook with the following:

“Thus the basis for a positive investment climate in 2016 hinges on a couple of key assumptions. First, if fundamentals do turn out to be improving, then stabilization in currency and commodity markets is likely to form. We believe that if this comes about over the coming quarter, then investors will likely start dipping their toe back into emerging market equities. With stability in these areas, a more constructive view of the stability for growth in key developed markets such as the U.S., Europe and
AS WE HAVE POINTED OUT ON MULTIPLE OCCASIONS, THE RECENT VOLATILITY HAS SIMPLY MARKED A RETURN TO HISTORICALLY MORE NORMAL LEVELS OF VOLATILITY AFTER MULTIPLE YEARS OF VERY LOW LEVELS.

Japan is likely to be reinforced. After several months of selling global equities and other risk-based assets, investors are likely to shift gears and begin putting money to work. In short, if investors have been preparing for a worst-case outcome—Chinese-induced global recession—and this does not come about, then a return to positive market returns is likely to develop, potentially abruptly.”

Though we were going against the grain early in the quarter, this view ultimately prevailed and, we would argue, can continue as we progress through 2016. In our opinion, investors have been principally focused on the risk of two policy errors—first, that the Federal Reserve would raise interest rates too fast and too far, and second, that policymakers in China would choose or be forced into a major devaluation of the yuan. We have viewed these as legitimate risks but didn’t agree with the probability assigned by the markets. As the risk of both eased in February and into March, the markets were able to rally and recover from the declines.

Before turning to a deeper look at economic data and market performance during the quarter, a brief review of major indexes for the quarter and one year is provided below.

<table>
<thead>
<tr>
<th>Index</th>
<th>1st Quarter</th>
<th>52 Weeks</th>
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</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>1.35</td>
<td>1.78</td>
</tr>
<tr>
<td>Dow Jones Industrials</td>
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<td>2.08</td>
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<tr>
<td>MSCI EAFE (International)</td>
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<td>-8.27</td>
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<tr>
<td>MSCI EM (Emerging Markets)</td>
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</tr>
<tr>
<td>Bloomberg Commodity</td>
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<tr>
<td>Barclays Global Bond (Global Bonds)</td>
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<tr>
<td>Barclays U.S. Aggregate (Taxable Bonds)</td>
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<td>1.96</td>
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<tr>
<td>Barclays 5-Year Muni (Tax-Free Bonds)</td>
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<td>2.82</td>
</tr>
<tr>
<td>HFRI Fund of Funds Composite Index</td>
<td>-2.51</td>
<td>-5.12</td>
</tr>
</tbody>
</table>

A STEALTH BEAR MARKET

In our meetings with clients and investors, we have understandably had many conversations about the frustrating market returns over recent quarters. The inception of this challenging period dates to the spring of 2014. It was at this point that the Federal Reserve actually started normalizing policy. This is a differing outlook from the conventional view that the Fed normalized policy this past December with
its first rate hike. The conventional view fails to take into account the initial steps of normalization: the tapering of QE and the reversal of the so-called forward guidance. As a result of the Fed’s policy shift toward less accommodation in early 2014, the market has been in what we would term a stealth bear market. Many global markets have been in an outright bear market during this time, while even in the U.S., certain sectors have declined significantly and the average stock has declined much more than the indexes, which have been held up by a few large blue-chip companies.

In our opinion, it is clear that tightening started shortly after the Fed began slowly reducing its bond purchase program in December 2013. The chart below, a creation of the Atlanta Fed, shows a shadow rate designed to project the real impact of all monetary policy in the U.S. and the effective rate that could be implied by those policies (the green line). By considering just the effective interest rate guidance of the Fed (the blue line), one can’t observe the stimulus of these other so-called nonconventional policies. As one can see, the green line began its journey below zero in mid-2009, and it wasn’t until the spring of 2014 that it reached its maximum nadir, at -2.99%. As the QE taper ran its course through 2014, actual tightening was underway. The result is that from the period of peak stimulus in April 2014 through the current time, with effective interest rates back in positive territory, the shadow rate has moved from -2.99% to +0.25%. This is a large and sustained move away from easing, especially considering the lag effect that results from policy change. From this perspective, it is much clearer why the markets have been struggling—we haven’t seen a simple 0.25% rate rise but, really, the impact of tightening of more than 3.00% that has played itself out mostly in currency markets.

**Wu-Xia Shadow Federal Funds Rate**

![Chart showing Wu-Xia Shadow Federal Funds Rate](chart.png)

Sources: Board of Governors of the Federal Reserve System and Wu and Xia (2015).

After recurring statements throughout 2015 that it intended to raise rates, the Fed had boxed itself into a corner and was forced to take the first step at its December meeting, raising the short-term interest rate by 0.25%. But it has now backed off a more aggressive rate-increase path in 2016, citing global financial market volatility as its rationale for a more subdued pace. This comes even though the Fed’s two official
mandates are trending much closer to their stated objectives. First, employment has remained strong, even in the face of tepid economic growth, and by almost any account we are nearing full employment in the United States. Inflation, as the other mandate, is also showing signs of life, with core CPI rising by 2.4% in the most recent month, a four-year high. Fed Chair Janet Yellen denies setting policy to allow for a period of higher inflation to make up for the recent period of below-desirable inflation. But it may just be that the financial market volatility is giving the Fed a convenient excuse to pursue this as a consequence rather than a goal.

Many market analysts have raised questions about the Fed adding an unofficial third mandate by looking at financial market conditions. In our opinion, it is reasonable for the Federal Reserve to observe market conditions. Monetary policy impacts with a lag while markets are leading. This time differential makes setting policy extremely difficult. But it does seem reasonable to heed the market’s forward-looking guidance in order to set policy that takes months or quarters to fully apply. On this count, the Fed’s easing off from tightening reduces one of the major risks for 2016 and, in our opinion, was substantially responsible for the market recovery that started mid-quarter. If current policy is sustained, then we believe global economies can exceed expectations and the current market rally can have some distances to run.

**POPULISM AND THE POTENTIAL FOR TRADE WARS**

Over the coming quarters, the markets will be confronted with what is shaping up to be one of the more unusual presidential election cycles in our lifetimes. The strong possibility of a contested Republican convention and a Democratic race that is tighter than many expected, and with the uncertain legal overhang for the front-runner, create the potential for a summer of surprise. Broadly speaking, we think individual investors have been highly sensitive to the election process, but at the moment we don’t think markets in general have been impacted by the drama. This is partly due to the fact that there has been little movement in the official forecast of the election outcome. The betting markets continue to place a very high probability on a divided government, with nearly 70% odds for a Hillary Clinton victory (vs. only 12% for Donald Trump). Meanwhile, though early in the process, the odds remain that Republicans will control both the Senate and House in 2017. This outcome of a divided government would be the most benign for markets. But something tells us that the road to this outcome could be full of twists and turns.

However, a bigger trend is underway. Even if the conventional wisdom holds in the election cycle, the so-called Trumpists have garnered much more support than most professional pundits predicted, and Bernie Sanders, a stated socialist, is giving Clinton a much tougher time than she anticipated. What is at work, and what are the ramifications if it continues? We think a major populist wave is underway.
Moreover, the trend is much broader than just the U.S. The move toward more extreme parties—both on the left and the right—is advancing in Europe as well. The unpredictability of the Brexit vote in the U.K. this summer, along with elections in Germany and France in 2017, provides plenty of potential for uncertain outcomes and changes in policy.

The populist movement is likely fueled by major trends in the global economy. First, the stagnation of median wages in the developed world provides an environment of anti-capitalism. The Occupy Wall Street movement after the 2008 financial crisis exemplified this environment, with the 99% versus the 1%. The income-inequality issues stem not only from policy, which has been generally favorable to capital versus labor, but also from deep-rooted structural changes in the underlying economy. As technology and robotics combine to displace millions of low-skilled jobs, the disenfranchised workers are unable to re-create their income in the service economy or via the gig economy (i.e., Uberization). Meanwhile, sustained high profit margins mean that the 1% who own the majority of equity and real estate investments earn a higher and higher proportion of the global pie.

A second, but no less important, trend is the slowdown in global growth potential. Many economists are focused on the reasons that potential growth seems to have waned over the past few decades. One clear driver is demographics. As the population ages across much of the developed world, the transition from a productive workforce to a higher proportion of retirees means the need for new products and services declines. A second factor is the transition underway in China and many parts of the emerging world. The early 1990s set off an unprecedented period of growth within the emerging world. The ascension of China into the World Trade Organization, along with the fall of the Berlin Wall, pulled billions of people into a capitalistic system. This drove growth and expansion in parts of the world that had seen little of either for decades, if not centuries. This initial period of activity is now waning and the traits of a new era are not yet fully visible. The initial period was based on a wave of globalization that allowed for labor to shift to regions of lower and lower cost. This provided an era of abundance in goods and cost disinflation, if not outright deflation. Now that this has mostly run its course, the global economy will need to shift from a period of globalization to one of productivity gains, most likely led by innovation. As with any transition, the timing and volatility of this period remain uncertain.

Finally, we can’t ignore the impact of geopolitics. The European project is an important component of this. The progression of a more coordinated Europe from the end of World War II through the early part of this decade provided a level of certainty in the region. This era ended with the European debt crisis, as citizens realized that a union based on a common currency and vague political constructs can’t survive without a fully fiscal and secure structure. The eventual outcome of the European Union remains uncertain, but the trends are not looking good. Finally, terrorism and migrant issues around the world provide a common area of concern for politicians who are intent on using nationalistic rhetoric to further their prospects.

Given all of the above, it is clear how a populist movement has been able to gain traction. The average citizen around the world has seen limited benefit from a period of global expansion and feels threatened by terrorism and security concerns while feeling disenfranchised by the global elite. How many election cycles it will take until the passion and volatility of the current era run their course remains unknown. Thus far, world leaders have refrained from using monetary or fiscal policies (e.g., tariffs) to overtly try to gain the upper hand against other countries. Global trade has remained a positive force, and generally speaking central banks have refrained from true mercantilist policies. But whether and when this changes will be an important driver of future economic performance.
Incorporating the above into an investing perspective is clearly important and could be a key for investors over the coming decade. We think there are at least three key themes that will matter. First, for much of the last 25 years, simply having exposure to emerging countries helped portfolios. Going forward, it will pay to be much more selective. Second, though many parts of the world will continue to add infrastructure, much of the growth will be in consumer-facing industries. Finally, risks from policymakers will continue to be present, as the world is closer to a win-lose situation than the win-win environment of recent decades. It will pay to be alert to geopolitical risks.

OUTLOOK AND PORTFOLIO POSITIONING

As referenced above, we have remained relatively constructive on global markets during this stealth bear market. Further, as we projected last quarter, a return to some level of stability in commodity and currency markets was the catalyst for the bounce in markets mid-quarter. And we are now pleased that we didn’t make material portfolio shifts in response to the sharp pullback.

That said, we can’t ignore the challenge the past few years have presented for many asset allocators and active managers, including SignatureFD. Our process remains sound, and we haven’t changed the time-tested practices that we believe are core to successful investing. We actively monitor and evaluate all of our investment decisions both in real time and after we sell our positions. On average, our portfolio decisions have been helpful over time. This “batting average” has not materially changed, but more recently the magnitude of the detractors has exceeded that of the contributors. The largest of these has been our decision to hold an allocation roughly in line with a global stock index rather than one tilted more heavily to the U.S. Over the two years from April 1, 2014, to the end of the quarter, the S&P 500 outperformed the global index by almost 15% and the Developed Market Ex. U.S. index by over 30%! In our view, this goes back to the point we made about the stealth bear market. Over the past few years, very few asset classes have outpaced the performance of large cap U.S. stocks, but quite a few asset classes have materially lagged. In short, this market environment has, frustratingly, provided very few alpha opportunities. In all cases, client portfolios are managed to be in line with unique and personal needs, but our core equity model was within 3% of the World Index (with below-market risk). By our calculations, around 75% of the delta between our portfolios and the S&P 500 comes simply from having any exposure outside the U.S.

We remain strongly convinced that much of the rest of the world will provide more attractive returns in the coming years. We aren’t outright negative on the U.S., and in fact even though valuations are relatively high domestically, they are not so expensive that it would hinder a gradual move higher if earnings improvement follows. It is just that outside the U.S., valuations are historically attractive. Of course, it is just the opinion of one group, and many future paths are possible, but a recent
comprehensive forecast of future 10-year annualized equity market returns prepared by BCA Research concluded the following potential for each major global region: 4.0%, the U.S.; 8.9%, Europe; 8.8%, Japan; and 14.1%, China.

What is the basis for a more optimistic outlook for the rest of 2016? Simply, an ongoing turn in economic data, which will eventually feed through to corporate earnings. In all major regions except for Japan, the economic surprise index has moved sharply higher, meaning that underlying data continues to exceed expectations. Moreover, forward-looking data like the Institute of Supply Management’s New Orders Index points to an acceleration in these trends and a possible recovery in global manufacturing. Finally, one must remember that economic data is usually most sensitive to trends more than absolute levels. For example, global capital expenditures by energy and mining companies were down almost 50% over the past three years. At this point in the cycle, an additional 50% reduction is not feasible, and in fact stabilization or even slight recovery could start soon. All of these trends point to the fact that though global growth came dangerously close to stall speed in the past few years, the major headwinds could be easing.

Finally, we have to acknowledge that there is no shortage of risks. Even with the evidence of modest improvements, the global economy remains fragile. Several indicators show that the risks of recession are elevated, and any significant shock in the coming quarters could be enough to tip things to recession. There also remains any number of political and geopolitical risks, including upcoming elections, the Brexit vote, terrorism, China and Russia.

On balance, we remain of the view that over the intermediate term, fears of policy error, financial crisis and global recession that includes the U.S. are overstated. Thus equities and growth-oriented assets remain in favor. Our portfolios are aligned with this view, and we continue to look for opportunities to capture. At the same time, we recognize the unusual nature of the situation, and we are monitoring risks closely. Please don’t hesitate to reach out with any questions or comments on this letter or any other matters.

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