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OBSERVATIONS AND PERSPECTIVES: ARE WE OUT OF THE WOODS YET?

We've had a year's worth of trading moves already in 2016. Seven weeks into the trading year and global markets, from commodities to stocks, went on a tear to the downside. Most recently, many market benchmarks have reversed course, posting solid gains. The big question now is whether this newer move is sustainable. Are we out of the woods yet?

The sharp falls this year have been painful and swift: the widely-watched S&P 500, a stock market index tracking 500 companies in various industries with a large amount of market capitalization, shed nearly 10% at one point. However, that dip is nothing compared to the bear markets that began in earnest well over a year ago. Since their peaks of 2014, high yield bonds have tumbled more than 20%; emerging markets stocks have collapsed almost 40%; broadly, all stocks outside the U.S. have sunk nearly 25%; oil has plunged nearly 80%.

Clearly, then, the selloff in many more "risk-on" assets did not just start with the New Year; we have been in the midst of a stealth bear market that accelerated with the New Year. The cause of today's extreme uncertainty: the Federal Reserve's grand experiment to adopt zero interest rate policy (ZIRP) and quantitative easing (QE) to stave off global calamity, post the 2008 financial crisis. This crisis policy, which lasted far longer than originally planned, goosed financial assets and powered a bull market that ended in May 2015.

The Risks of NIRP

That sinking (interest rate) feeling may return, however. Five central banks around the world, including Japan, went from ZIRP (zero interest rate policy) to NIRP (negative interest rate policy), a clear signal that many economies are really not doing well. If the U.S. adopts negative interest rates, there will most definitely be consequences. Bank earnings will be impaired. Income for those in retirement and trying to live off an income from savings will be hit hard. Pension fund liabilities will be vastly underfunded. The appetite for riskier and riskier assets will rise as investors reach for higher income and better returns. Balance sheets for corporations would balloon as managers borrow aggressively for projects that may or may not be beneficial in a more normal rate environment.

What Will it Take to See a Stronger Recovery?

Markets often seem powered by a bungee cord. In fact, those assets which were pounded the most over the past six to eighteen months are leading the recent charge to the upside. Most notably, oil prices have started to find a bottom. The relative improvement in this commodity is providing support for prices of high yield bonds, which have exposure to energy related firms, and master limited partnerships (MLPs), the pipelines which transport oil and gas around the country, as well as funds that invest in infrastructure globally.

Whether this rally is long-lasting remains to be seen. The believability may be elevated if:

- The breadth of the rally increases.
- Concerns over a NIRP policy (discussed above) fade.
- Oil prices stabilize.
- China's economy steadies.
- Economic and earnings data in the U.S. improve.

Positioning for the Future

In addition to high yield bonds and infrastructure, we are starting to see bottoms and trends upward in select emerging markets bonds and emerging markets stocks – again, asset classes that have suffered far greater declines than the broad S&P 500 and may be putting the worst behind them.

Our portfolios began the year positioned quite conservatively. Our performance has been resilient during this difficult period of heightened volatility, no small feat.

In order to best participate in upside potential, we have begun positions, or are poised to establish investments in assets that have started to establish upward trends, including high yield bonds, emerging markets debt, infrastructure and certain emerging market country stocks.

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