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OBSERVATIONS AND PERSPECTIVES: IS IT TIME TO LIVE "*HAPPILY EVER AFTER*"?

Stocks have rallied back into the green for 2016, recovering completely from the January collapse. The market breadth is convincing. Last year, we highlighted that "risk-on" assets were in fact at risk. One reason we held this view was the serious lack of breadth in the broad stock market. While the FANGS (Facebook, Amazon, Netflix, Google and Starbucks) were dazzling in their meteoric returns, the average stock was in negative territory for 2015. In fact, over 400 of the stocks in the S&P 500 lost ground in 2015, a terribly low level of market breadth.

Not anymore. The recent rally has pushed more than 93% of stocks in the S&P 500 above their 50-day moving average, a key indicator of price strength. It rarely gets stronger than this and the reading is mostly healthy sign for investors. Strong breadth means all stocks are participating in a rally, not just a few. This action is the opposite of the weak breadth that characterized the early part of last year when fewer stocks were making new highs while the S&P 500 was.

Despite all this, it's not time to just go live happily ever after. Historically, the market trades sideways for a while after reaching these levels of breadth. Riskier investments may need to cool off a bit from recent levels. In fact, the S&P 500 has still not reached its previous highs or moved above the top of its downtrend channel.

The Best Opportunities Right Now

In an environment where investors are being rewarded for taking on risk, we built positions in February in a number of asset classes. We made investments in master limited partnerships (MLPs), for example, which soared recently on the sharp recovery in oil prices. We made bigger bets in high yield corporate bonds, which had widened to spreads over Treasuries that have historically represented terrific buying opportunities. These holdings have proven quite profitable also.

When we make buys, we constantly weigh every opportunity by the upside potential, based on recent price trends, and the risks, based on historical volatility metrics. MLPs, for instance, have shot up in price, but demonstrate sharp moves up or down and therefore represent a smaller part of our overall portfolios.

Our best ideas right now are in the emerging markets bond space[1]. Swooning commodity prices and China's economic slowdown created serious headwinds for many emerging markets (EM) countries such as Brazil, Russia, India or Turkey. The Shiller P/E for EM stocks dropped below 10X in January – something that has only occurred six times in the past 25 years. When values have fallen this low, those stocks have rallied by 188% over the next 5 years, according to a recent study. Looking to the bonds of emerging markets countries, the spreads widened to over 500 basis points, well above historical averages.

Emerging markets bonds can be volatile, but pay a substantially higher yield than developed bonds with the same exact credit rating. The higher yield offered in EM means investors need to hold the bonds for shorter time periods to neutralize for volatility. Further, there is opportunity for price appreciation as spreads narrow, as they have been since late January.

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[1] There are three main EM debt asset classes: corporate US dollar denominated debt, sovereign US dollar denominated government bonds and local currency bonds.

The S&P 500® is an unmanaged composite of 500 large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks.

The cyclically adjusted price-to-earnings ratio, commonly known as Shiller P/E, is a valuation measure usually applied to the US S&P 500® equity market. It is defined as price divided by the average of ten years of earnings (moving average), adjusted for inflation.

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