Brief Market Commentary
December 23, 2015

Market volatility has picked up again in the month of December with the CBOE Volatility Index reaching its highest level since late September. This Volatility Index, known as the VIX or the market's fear gauge, is based on options demand—investors tend to buy options more often in times of heighted volatility as they seek protection from declines. Another simple measure of volatility is to count the days market indexes rise or fall by 1% or more. The MSCI All Country World Index, a proxy for the broad global equity market, has experienced 10 such days out of a total of 16 trading sessions so far in December (four up and six down). Central banks' actions continue to influence financial markets while ongoing weakness in the price of oil has negatively impacted market sentiment. As of yesterday's close, the broad global equity market has declined by approximately -2.5% thus far in December and is down about -3.1% on a year-to-date basis.

Recent Global Central Banks' Actions

This past Wednesday, as almost universally expected, the Federal Open Market Committee (FOMC) raised the target range for its fed funds rate by 25 basis points, to between 0.25% and 0.50%. This is the first such tightening by the FOMC in nearly ten years and can be interpreted as a vote of confidence for the U.S. economy. In justifying the rate hike, the Fed's statement argued that there had been "considerable improvement" in labor market conditions and the FOMC is now "reasonably confident" that inflation will climb back to the 2% target in the medium term. Additionally, the statement stressed that the FOMC "expects that economic conditions will evolve in a manner that will warrant only gradual increases."[1]

The initial market response to the Fed's policy adjustment was a positive one as both developed and emerging markets stocks experienced gains while bond markets were little changed—suggesting this was a well-anticipated and well-communicated rate hike. This first rate increase obviously removes uncertainty around the start date, but does not remove the uncertainty around the path of rate hikes going forward, which represents a potential source of future market volatility. However, we expect that the FOMC will continue to err on the side of caution, seeking to raise rates in a slow manner that doesn't excessively unsettle the economy or markets. And as a result of a very gradual tightening cycle, interest rates are likely to remain low by historical standards for the foreseeable future.[2]

At its policy meeting earlier this month, the European Central Bank (ECB) delivered a rate cut and stimulus package, but fell short of expectations of more-aggressive easing measures. The ECB cut the deposit rate to minus 0.30% from minus 0.20% and extended its quantitative easing program until March 2017. ECB President Mario Draghi also indicated that the bank stands ready to use additional measures to bring inflation back to target if need be. However, in terms of market reaction, the euro appreciated while stocks and risk assets sold off globally, underscoring investors' disappointment.

More recently, the Bank of Japan (BOJ) surprised markets by announcing new steps to augment its easing program. The bank said it would maintain its annual asset purchases of ¥80 trillion ($660 billion), but would lengthen the average maturity of the government bonds it purchases. The BOJ also said it would start buying ¥300 billion ($2.45 billion) annually of exchange-traded equity funds, in addition to the ¥3 trillion in ETFs it has purchased annually since late 2014.[3] In terms of the market reaction, the initial surge in Japanese stocks quickly fizzled and global equity markets declined. The BOJ's new measures were interpreted as uncharacteristically modest, given the size of its asset-purchase program. And they were unexpected as BOJ Governor Kuroda has maintained in recent weeks that the bank's policies are having the desired effect and that underlying inflation remains on an upward trajectory.[4]

The ECB and BOJ's recent additional stimulus is in contrast to the US Federal Reserve's "lift-off" from zero interest rate policy, and highlights the divergent monetary policies of global central banks. We expect this policy divergence not only to continue to impact financial markets and contribute to volatility, but to also create potential investment opportunities, particularly for highly flexible strategies. We also believe that the Fed's cautious approach, coupled with ongoing stimulus measures being implemented by the ECB and JOB, should be supportive of asset prices over an intermediate time horizon.

Recent Developments in the Energy and High Yield Corporate Bond Markets

Both crude oil and natural gas prices have remained under pressure and declined to new lows for the year. Oil prices experienced another pullback in the aftermath of a December 4th OPEC meeting at which the oil-producing countries removed their production ceiling. Natural gas has also come under increased pressure in the meantime due to warmer-than-average weather.[5]

The continued decline in the price of oil has reinforced fears over slow economic growth and deflation, placing pressures on a range of asset classes, particularly those related to energy. For example, energy master limited partnerships (MLPs) continue to experience volatility and have declined to new lows for the year. In addition to ongoing commodity price declines, several factors have contributed to the renewed pullback in MLPs, including increased tax-loss selling as we approach year-end and increased concerns about MLPs' access to capital markets to fund and maintain distributions.[6] Though elevated near-term volatility may persist, we continue to believe that the fundamentals of many well-run MLPs remain intact and current valuations potentially lay the foundation for meaningful capital appreciation over a multi-year time horizon.

The collapse in oil prices is also reviving concerns over energy issuers in the high yield market. The spread between the yield of high yield corporate bonds and that of comparable Treasuries has widened to its highest level in over three years. In addition, investor flows into the asset class have once again turned negative.[7] Exacerbating asset class volatility was the recent announcement of the liquidation of the Third Avenue Focused Credit Fund (TFCIX), a high yield mutual fund. In an unusual move, Third Avenue announced the closure of the fund and suspension of redemptions while the fund managers attempt an orderly liquidation of the holdings. Importantly, TFCIX is not representative of a typical high yield bond fund—Third Avenue's portfolio was far riskier and more concentrated that the average fund. More than 50% of its assets were unrated by credit agencies, while another 28% of the fund held bond issues rated CCC[8]. That's nearly triple the proportion held by its peers, according the S&P Capital IQ.[9] In short, it was a very high risk, high reward strategy that likely shouldn't have been in a mutual fund vehicle.

The Third Avenue Focused Credit Fund announcement has left some to wonder if this is a "canary in the coal mine" type of event. At this point, we tend to agree with the view that the closure was more of a fund-specific issue as opposed to an early warning sign of larger issues to come in the credit markets. Though defaults are likely to rise in the energy sector, credit quality among issues in the rest of the high yield universe appears solid.[10] That being said, we continue to take a somewhat cautious view on credit in general. Within the space, we've maintained exposure to higher-quality bank loans that potentially benefit from and protect against rising short-term rates and unexpected inflation. Given recent spread widening, we now also see relatively attractive value in the high yield corporate bond space. However, we continue to recommend avoiding passive, exchange-traded vehicles given the potential liquidity mismatch with the underlying bonds.

Broader Portfolio Strategy

Notwithstanding the recent bouts of volatility and substantial declines in some risk assets in 2015, equity markets and most other risk asset classes have been strong for the past five years. In regards to the macro backdrop, our base case assumptions include continued slow economic growth, low inflation, low interest rates, and ongoing monetary policy accommodation. In our view, this set of conditions is likely to remain supportive of risk assets and equities over the intermediate term.

Our current portfolio positioning themes include the following:

- *Don't tilt too far away from a thoughtfully-constructed, long-term strategic asset mix. As the table below indicates, we view most asset classes as being close to fairly valued.*
- *Maintain a slight underweight position in fixed income as bond yields are likely to rise longer-term, but remain low by historical standards. Within the fixed income space, municipal bonds continue to offer attractive value.*
- *Maintains a slight overweight positon to equities, emphasizing US large cap/high quality stocks and non-US developed markets stocks, which stand to benefit from continued monetary policy stimulus and attractive relative valuations.*
- *Within the real assets space, maintain exposure to energy master limited partnerships, reflecting our belief that the sell-off far exceeds the change in fundamentals. In our view, current valuations reflect an attractive long-term opportunity.*
- *Maintain strategic allocations to certain diversifying alternative/hedge fund strategies as the opportunity set should continue to improve given global economic/policy divergence and increased market volatility.*

Asset Category Tactical Views	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Fixed Income					
US Government Bonds		■			
Corporate Bonds		■			
Tax-Free Municipal Bonds			■		
High Yield Corporate Bonds			■		
Equities (Public & Private)					
US Large Cap Stocks			■		
US Small Cap Stocks			■		
Non-US Developed Markets Stocks				■	
Emerging Markets Stocks			■		
Private Equity					
US Large Buyout	■				
US Mid-Market Buyout			■		
Real Assets (Public & Private)					
Commodities			■		
Public Real Estate (Core)	■				
Private Real Estate (Opportunistic)			■		
Diversifying Alternatives					
Less-Directional Hedge			■		
Directional Hedge			■		

Note: Based on research and opinion provided by Greycourt & Co. as of September 30, 2015. Tactical views reflect a three-year investment horizon. Suggested asset class weights are influenced by Greycourt's detailed quarterly tactical analysis and are used as a starting point in assessing client portfolio weights against strategic targets which typically reflect a ten-year investing horizon.

Definitions

The Chicago Board Option Exchange's (CBOE) Volatility Index is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

The MSCI All Country World Index (ACWI) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. As of May 27, 2010 the MSCI ACWI consisted of 45 country indices comprising 24 developed and 21 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market country indices included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

General Disclaimer

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[1] *Paul Ashworth, Capital Economics, United States Economics Update, December 16, 2015.*
[2] *Rick Reider, BlackRock Investment Management, Why the Fed's Rate Increase is Good (Not Bad) News, December 19, 2015.*
[3] *Takashi Nakamichi and Megumi Fujikawa, Wall Street Journal, Bank of Japan Takes Fresh Action, December 18, 2015.*
[4] *Ibid.*
[5] *Matthew Rubin, Neuberger Berman, Weekly Market Highlights: FOMC Convenes Amidst Market Volatility, December 14, 2015.*
[6] *Ibid.*
[7] *Russ Koesterich, BlackRock, Liftoff Takes Backseat as Oil Drives Sentiment, December 16, 2015.*
[8] *According to Standard & Poor's, debt rated CCC has a currently identifiable vulnerability to default and is not likely to have the capacity to pay interest and repay principal in the event of adverse business, financial, or economic conditions.*
[9] *Amy Feldman, Barron's, Third Avenue Focused Credit Closes, December 12, 2015.*
[10] *K.C. Nelson, Driehaus Capital Management, Our Thoughts on the Third Avenue Focused Credit Fund Closure, December 11, 2015.*

