CAPITAL ADVISORS

**Market Comment**
January 13, 2016

# Here's What We're Thinking…

- Recent action in the financial markets has darkened our outlook somewhat.
- We have taken steps in both *Managed Equity* strategies to reflect a more conservative outlook.
- The *Tactical Dynamic Allocation* strategy has been mostly out of the equity markets since last summer, and it remains conservatively positioned with 80% of the model portfolio in fixed income and cash reserves.
- The *Tactical Diversifying*[1] strategies remain fully invested in risk markets by design, but both strategies have been under-weighted in two of the most troubled sectors – natural resources and emerging markets – for several quarters, and will remain so through the end of March, at a minimum.
- Our fixed income strategies have *not* been hurt by the recent sell-off in sub-investment grade bonds (i.e. high yield "junk" bonds) because we sold out of this sector more than a year ago.
- We hope to take advantage of developing opportunities in high yield bonds whenever the sector demonstrates signs of stability, but we are not in a hurry.

When it became clear late last year that the Federal Open Market Committee (the Fed) intended to raise interest rates at its December 16 meeting we wondered if the first rate hike in nearly a decade might be a *positive* catalyst for the financial markets. At the time it seemed possible that global asset markets might accept a well-telegraphed rate hike from the Fed without distress. Had this happened, it seems plausible that investors might have become *more* confident about the future.

That's not what happened. Instead, global stock markets just experienced the worst first-week start to a new calendar year on record. Two things went off-script relative to the more optimistic scenario we previously felt was possible.

First, the Fed's commentary surrounding its initial interest rate hike has been out of sync with expectations. Many analysts, including us, believed the Fed would bend over backwards to shape expectations toward a *very* gradual pace of interest rate normalization. Instead, the Fed accompanied its initial rate hike with an updated "dot plot" that reflected a median forecast among Fed governors for four rate increases in 2016. This would bring the target Fed Funds rate to 1.25%-1.50% by year-end according to the dot plot.



[1] The "Tactical Diversifying" strategies are *Tactical Global Growth* and *Tactical Global Income*

Based upon recent prices in the futures market, the consensus expectation among investors calls for just two rate hikes in 2016, which would keep the fed funds rate below 1.0% through year-end.[2] In contrast, Janet Yellen and other Fed governors have reiterated the four-hike scenario in multiple interviews and speeches in recent weeks, reflecting a tin ear for the message coming out of the futures market.

This may be distressing for some investors because the Fed's plans seem inconsistent with the substantial tightening of credit market conditions that has already occurred through natural market forces. Specifically, the U.S. dollar is up over 20% against our major trading partners over the past 12 months, while credit spreads have spiked to more than 700 basis points for sub-investment grade benchmarks.[3]

The second variable that has gone off-script from a more bullish outlook is China. The Chinese stock market declined nearly 15% in the first six days of the year, while the Chinese currency made a step-move lower against the dollar. These market signals justify concern that the necessary transition of the Chinese economy from capital investment and industrialization towards consumption and services may not be going as smoothly as previously believed, with negative implications for global GDP growth and commodity prices.

In addition to a stubborn Fed and fear of a "hard landing" in China, markets are dealing with several geopolitical anxieties, including the migrant crisis in Europe, the severing of diplomatic ties between Saudi Arabia and Iran, and elevated awareness of terrorism in the aftermath of recent high-profile incidents.

Our base-case assumption is for the stock market to stabilize before a bear market decline of 20% or more, but we cannot ignore a growing list of signals that suggest a more negative outlook may be justified. Corporate profit growth has turned negative; The ISM Manufacturing Index[4] has been below 50 for two consecutive months; High-yield credit spreads have blown out for the energy sector, while spreads have risen more than 240 basis points outside of energy; Global equity markets recently lurched lower in unison; And commodity prices are extraordinarily weak, particularly oil. These are the kinds of signals that have historically preceded recessions (though not always!).

We have taken the following steps to reduce risk in our two *Managed Equity* strategies:

1) Target weightings for several positions on the Buy List for both strategies were reduced in recent months, so that new money added to these strategies made smaller commitments to certain stocks trading close to our target price, and/or facing heightened uncertainty in the near-term.
2) In the *Managed Equity Growth* strategy, seven stocks have been sold and one was reduced since September 30, 2015, while just one position was added and two saw an increased weighting over the same period.



[2] Source: CME Group http://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html
[3] Source: Bloomberg
[4] The ISM Manufacturing Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders and supplier deliveries in the domestic economy.

3) Most clients should have between 15%-20% of their *Managed Equity Growth* allocation in cash following these moves (differences arise from client-directed deposits/withdrawals).
4) Sales and reductions have modestly exceeded new purchases in the *Managed Equity Dividend* strategy since September 30.
5) Most portfolios should have a cash reserve of 4%-7% in their *Managed Equity Dividend* sleeve.
6) We have reduced the risk profile of the energy exposure in both strategies, although we remain optimistic for an eventual recovery in the sector.

Beyond the two *Managed Equity* strategies, we are comfortable with the current risk profile of our other portfolio strategies. As indicated in the opening bullet points, these strategies have been at the conservative end of their respective ranges since last summer.

Concurrent with recent efforts to reduce risk in client portfolios, we are also evaluating opportunities to go in the other direction whenever market conditions stabilize. Recent volatility is creating attractive opportunities that could be exciting to pursue when the time is right.

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