HOW LOW CAN YOU GO?

Market Review **March 2016**

Back in January, investors grew more worried that global growth was slowing and that the global economy's two main engines, the United States and China, were inching toward recession. China continues to struggle through a period of economic reform, February was another nervous ride for investors. Meanwhile, economic indicators are mixed for the United States. Both economies seem to be shrugging off pessimistic investors. The same cannot be said for Europe and Japan. Both of which are perched on the verge of deflation again.

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Around the world, central banks continue to attempt to stimulate their economies and several of them are using negative interest rates to do so. Interest rates are an important tool for central banks. When they set high interest rates, investors are able to invest in relatively low risk bonds and achieve attractive returns, which draws money away from higher-risk investments like stocks and corporate bonds. In doing so, high interest rates can control inflation and slow down an over-exuberant economy. Low interest rates work in the opposite direction. When interest rates are low, investors are unable to earn enough from low-risk assets, which incentivizes them to look to riskier investments. By encouraging greater investment in the private sector, low interest rates can stimulate a sluggish economy and lift inflation to a healthy rate.

Switzerland, Sweden, Denmark, and the European Central Bank are already employing negative interest rates, and the Bank of Japan will now set a similar policy. Negative interest rates were purely theoretical until last year. Economists speculated that they could be used, but the assumption was that they would be very short-lived. Negative interest rates function as an extreme version of low interest rates, where investors pay the government for the privilege of loaning it money. This sounds absurd but, when investors are deeply worried that the private sector is in decline, it is not unreasonable to pay for an asset that is expected to function as a safe haven. However, it should serve as a strong push for investment in the private sector. In economies like those in Europe and Japan, which are leaning toward deflation, negative rates are increasingly common.

Through most of January, global stocks were highly correlated with oil. Correlation is a measure of how two assets move in relation to each other. It is measured on a scale of -1.0 to 1.0, where -1.0 means that the assets move opposite each other, 0.0 means that they move independently of each other, and 1.0 means that the move together. The strong positive correlation between oil and stocks meant that whenever the price of oil declined, stock prices fell too. This correlation was strongest in China and the US, with 10-day correlation values routinely exceeding 0.90 for both the S&P 500 and Shanghai Stock Exchange (SSE). In China, this correlation declined to near zero by the end of January and, while it regained some strength mid-month, it did not manage to reassert its hold in February. In the US, the breakdown of the correlation occurred more slowly and it is now much weaker than it was last month.

Meanwhile, oil prices fell below $28 per barrel again in February before climbing back to $33 per barrel by month end. Investors glimpsed a glimmer of hope when some of the largest oil producing nations started discussing production cuts or freezes. There is no agreement yet, but rebalancing the supply of oil to match demand would help to support prices and encourage recovery. While prices are low, various corporations and countries continue to build up their oil reserves as hedges against future price fluctuations. Investors worry that those inventories could be used to drive the price of oil down once it starts to recover, but those effects would be temporary.

Market Movers

February was an excellent illustration of the benefits of diversification. The United States saw stocks gain while bonds declined and, internationally, bonds gained while stocks declined. This mix of returns is much different than what we have seen in recent months, and years. The Core Allocation portfolios were more resilient relative to global stocks over the past month, year-to-date, and over the last year. However, diversified global strategies have not provided as much downside protection as hoped relative to global stocks over the last year. This was due to weakness in commodities and bonds. Regardless, over full market cycles, maintaining a diversified mix of assets for the foundation of your portfolio has offered attractive returns and important risk management.

Asset Categories	*Feb 2016*	*YTD*
US STOCKS	0.67%	-6.07%
FOREIGN STOCKS	-1.37%	-7.32%
US BONDS	-0.11%	0.43%
FOREIGN BONDS	1.57%	0.84%
HARD ASSETS	2.66%	-1.46%
HYBRIDS	0.21%	-2.89%

US STOCKS endured more volatility in February, but managed to recover and ended the month in positive territory. Large Caps (IVV) were relatively flat, while Mid Caps (VO) and Small Caps (VB) posted gains of approximately 1%. While data from the United States is still mixed, the US economy remains healthier than most other developed markets.

The FOREIGN STOCKS category struggled under the weight of Developed Large Caps (VEA) loss of nearly 3% as Europe and Japan continue to struggle with slow growth. Emerging Markets (VWO) suffered a nominal loss, but did well in light of China's struggles. We are maintaining our allocation for Foreign Stock for now, but it may increase as these countries start to recover.

Investors remain concerned that the US BOND market has too much exposure to the energy sector. With depressed oil prices, investors anticipate a wave of defaults among US High Yields (SJNK) and some spillover into US Bank Loans (BKLN). US Treasuries (SHY) and US Corporate Bonds (VCSH) stayed relatively flat as investors maintained their lower-risk holdings, but investors seeking higher yields looked outside the US.

FOREIGN BONDS benefitted from the lackluster results among US Bonds. As investors looked for higher yielding investments, Emerging Treasuries (PCY) and Emerging High Yields (HYEM) proved attractive. We recently reallocated our Foreign Bond exposure into Emerging Markets, which added value in February.

HARD ASSETS, performed strongly in February. Master Limited Partnerships (AMJ) coped with the volatile price of oil to post a nominal loss, while Global Real Estate (RWO) was flat for the month. Meanwhile, Precious Metals (GLTR) gained more than 8% and drove most of the performance for Hard Assets in February.

HYBRIDS had a lackluster month, but still added value to our portfolios. In a month when US Bonds struggled, Hybrids posted a nominal gain. Hybrids continue to be a valuable component of our portfolios. They provide attractive income and lower volatility than stocks, while allowing investors to participate in stock market gains.