CIO REPORTS

# The Weekly Letter

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→ **Stability in the Four Cs:** Stability in the four Cs—consumers, commodities, credit and China—has contributed to the meaningful retracement of risk assets of late. Consumers are still powering the economy, with consumer credit card charges up 5% from a year ago and consumer-intensive stock sectors outperforming. Commodities are finding a floor, as the Bloomberg Commodity Index (as of March 11) has risen 8.1% since February 11, when OPEC members signaled they may be ready to cooperate on reducing crude output. Credit is also being forgiven, as the first week of March recorded $5.8 billion inflows to High Yield bond funds, the largest on record in absolute terms.

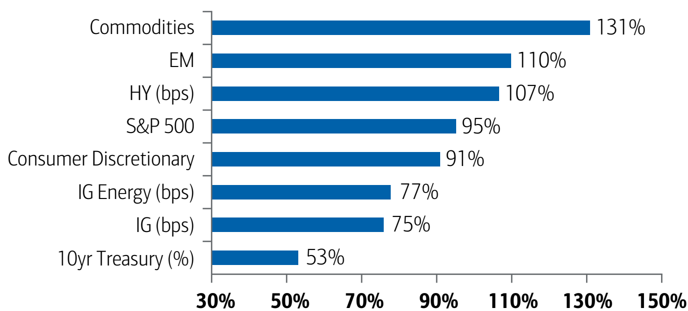
→ **Markets in Review:** Last week equities rose, with the S&P 500 Index up 1.2%, while international equities, as represented by the MSCI EAFE Index, rallied 1.0%. Bonds fell on the week, with the 10-year Treasury yield at 1.98%, versus 1.87% in the prior week. Commodities overall, as measured by the Bloomberg Commodity Index, rose 2.0% last week, as WTI crude increased 7.2%, to $38.5 per barrel, while gold declined 0.7%, to $1,250.7 per ounce.

→ **Looking Ahead:** In the U.S., the Federal Reserve is expected not to raise interest rates this month, while the University of Michigan Sentiment Index is expected to increase. In the eurozone, CPI is expected to increase month-over-month.

## Stability in the Four Cs

Since mid-February, the financial markets appear to have stabilized. In fact, they have experienced recoveries (from February 11 to March 11): The S&P 500 Index has risen 11%, energy prices have risen 47%, and Investment Grade (IG) and High Yield (HY) bond spreads have tightened 36 and 205 basis points (bps), respectively. We have even seen the largest inflows to EM debt since May 2015 (albeit modest inflows, and no sign of inflows to EM equities). Exhibit 1 shows how risk assets have meaningfully retraced this year's lows/wides since February 11.

**Exhibit 1: Meaningful Retracement of Risk Assets**




Source: Bloomberg and Chief Investment Office. Data as of March 11.
Note: Retracement levels are derived using Fibonacci methodology. Commodities as measured by the Bloomberg Commodity Total Return Index.

After the tumult in January, some investors are asking whether this is the calm before the next storm or the start of smoother sailing. We believe the latter, mainly because the great sell-off of 2016 was largely an over-reaction to a mix of fear and uncertainty and heavy risk positioning, and now investors have lighter positions and more of the uncertainty has been priced in. We like Treasury Inflation-Protected Securities (TIPS), because they are priced for a slower pace of inflation than we expect and the Federal Reserve (Fed) is seeking.

### So, what's changed?

In last week's Weekly Letter, **Sunshine Through the Clouds**, we highlighted several downward revisions to our expectations for 2016 U.S. economic growth, Fed interest rate hikes, Treasuries, and equity markets. None of that can justify calmer markets. What is new is a reduction in the markets' uncertainty over a U.S. recession, instability in China, and further declines in energy prices. All three risks look a little more balanced and much more priced in:

**A Fed error or a U.S. recession is less likely:** A key change has been the Fed acknowledgment that the four rate hikes it projected for 2016 at the end of last year are less likely now. Since the comments from Fed Chair Janet Yellen on February 10 and 11, the market has tapped the breaks on its fear of a Fed error by tightening too much. Now, we expect only two

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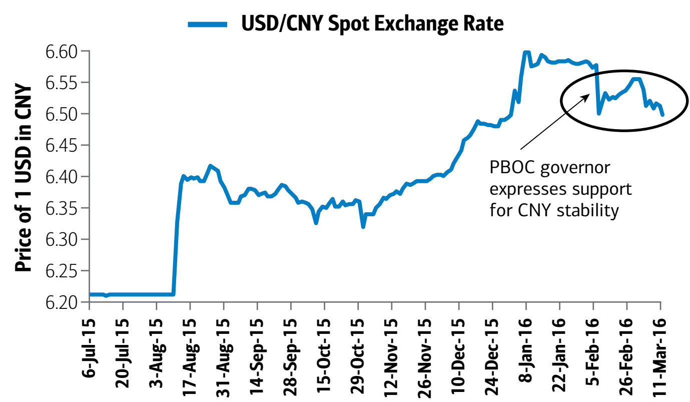
Fed hikes this year, in June and December, and the market has priced back in one hike by year-end. In addition, the economic data remain positive: solid durable goods, continued jobs growth, strong personal consumption, rising real wages, rising inflation, and a hint of a pick-up in manufacturing.

**Fewer shock devaluations in China:** We also are starting to see a little hope from China. On February 12, we heard promises from Zhou Xiaochuan, the governor of the People's Bank of China (PBOC), of fewer unpredictable yuan devaluations that compound financial market turmoil (see Exhibit 2), a reminder that China can restrict capital outflows and recognition that growth in Chinese gross domestic product will be "muddling through" at 6.6% in 2016, according to BofA Merrill Lynch (BofAML) Global Research.

**Exhibit 2: PBOC Expresses Support for Yuan Stability**




Source: Bloomberg and Chief Investment Office. Data as of March 11.

**A limit to further declines in energy prices:** On February 11, *The Wall Street Journal* reported that OPEC members may be ready to cooperate on reducing crude output. Recent developments imply that we are nearing a floor on oil prices, with oil returning to around $40 per barrel, U.S. data showing a tapering in production as spot prices are near cash costs, and the approach of the U.S. driving season. However, we acknowledge that it is still too early to call an end to a continued war for crude oil market share within OPEC. For the near term, BofAML Global Research recently revised down its average 2016 forecast for Brent to $46 per barrel (from $50) and WTI to $45 per barrel (from $48), while, over the next five years, global oil demand is estimated to increase by 1.2 million barrels per day per year, at $55-$75 per barrel, for Brent and by 1.7 million barrels per day per year, at $30 per barrel, for WTI.

## Watching the four Cs, redux

Reducing uncertainty gives us stability in the four Cs—China, commodities, credit and consumers. In the January 19 Weekly Letter, **Watching the Four Cs**, we argued that financial market stability would only reappear when we saw stability in all four areas. Consumption is still powering the economy, growing at 3% in real terms. BofAML Global Research data show consumer credit card charges are up 5% from a year ago and consumer-intensive stock sectors are outperforming. Commodities are finding a floor, as the Bloomberg Commodity Index (as of March 11) has risen 8.1% since February 11. Credit is also being forgiven, as the first week of March recorded $5.8 billion inflows to HY bond funds, the largest on record in absolute terms. Furthermore, HY spreads have tightened 205bps between February 11 and March 11.

**Portfolio Strategy:** We believe an attractive way to play the modest rise in inflation that we expect is through TIPS. That market is currently priced for U.S. 10-year breakeven inflation of about 1.5%. The Fed is targeting 2.0% inflation, which is close to our forecast. Because of the tax treatment of TIPS, we recommend holding them through funds or in tax-deferred accounts.

We reiterate our positive stance on IG corporate bonds. They should remain supported by stronger inflows from abroad, driven by the relative yield pick-up, attractive valuations following the market turmoil and, most importantly, improving fundamentals. However, we remain cautious on HY corporate debt, despite the recent spread tightening and stabilization in energy prices. Our HY credit strategist sees default rates ticking higher this year and estimates spreads could widen beyond 1,000bps some time in 2017.

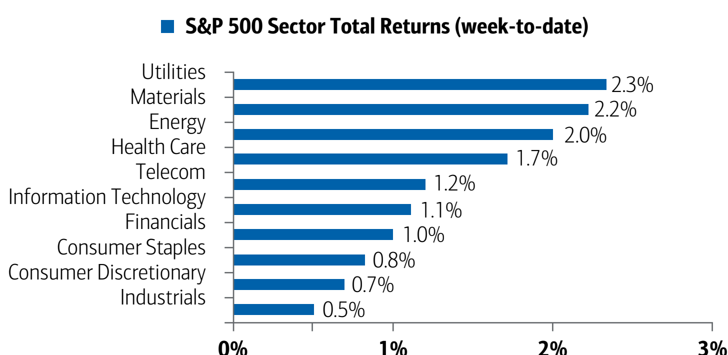
Within equities, we remain constructive on U.S. stocks, Japanese stocks, and currency-hedged European stocks. Broadly, we continue to favor high-quality companies with stable earnings, cash flows and the potential for dividend growth. Our view that market volatility will increase across many asset classes from the lows we have experienced over the past few years, detailed in the February Monthly Letter, **Asset Allocation in a Flatter World**, calls for a broader approach to diversification. Where suitable, select hedge fund strategies may help mitigate traditional equity and fixed income risk found in balanced portfolios.

# Markets in Review

## Trailing Economic Releases

- Initial jobless claims declined to 259,000 for the week ended March 5, from 277,000 (revised from 278,000). This was much better than expectations of 275,000 and pushed the four-week moving average lower, to 267,500, from 270,000.
- Import prices fell 0.3% month-over-month in February, modestly better than expectations of -0.7%, while the January data were revised to -1.0%, from -1.1%.
- Eurozone fourth-quarter gross domestic product (GDP) growth came in at 0.3% quarter-over-quarter, in line with expectations, and 1.6% year-over-year, modestly higher than expectations of 1.5%.

## S&P 500 Sector Returns (as of last Friday's market close)




## Equities

| | Level | Total Return in USD (%) WTD | MTD | YTD |
|---|---|---|---|---|
| DJIA | 17,213.3 | 1.3 | 4.4 | -0.5 |
| NASDAQ | 4,748.5 | 0.7 | 4.2 | -4.9 |
| S&P 500 | 2,022.2 | 1.2 | 4.8 | -0.6 |
| S&P 400 Mid Cap | 1,407.1 | 0.6 | 5.6 | 1.0 |
| Russell 2000 | 1,087.6 | 0.6 | 5.3 | -4.0 |
| MSCI World | 1,626.2 | 1.2 | 5.2 | -1.8 |
| MSCI EAFE | 1,644.9 | 1.0 | 5.7 | -3.7 |
| MSCI Emerging Mkts | 800.9 | 1.3 | 8.2 | 1.1 |

## Fixed Income

| | Yield (%) | Total Return in USD (%) WTD | MTD | YTD |
|---|---|---|---|---|
| ML US Broad Market | 2.33 | -0.1 | -0.5 | 1.7 |
| ML 10-Year US Treasury | 1.98 | -0.6 | -1.8 | 2.8 |
| ML US Muni Master | 2.13 | 0.1 | -0.3 | 0.9 |
| ML US IG Corp Master | 3.55 | 0.4 | 0.4 | 1.5 |
| ML US HY Corp Master | 8.38 | 1.2 | 3.7 | 2.5 |

## Commodities & Currencies

| | Level | Total Return in USD (%) WTD | MTD | YTD |
|---|---|---|---|---|
| Bloomberg Commodity | 161.2 | 2.0 | 5.3 | 1.8 |
| WTI Crude $/Barrel[1] | 38.5 | 7.2 | 14.1 | 3.9 |
| Gold Spot $/Ounce[1] | 1,250.7 | -0.7 | 1.0 | 17.8 |
| **Level** | **Current** | **Prior Week End** | **Prior Month End** | **2015 Year End** |
| EUR/USD | 1.1 | 1.4 | 2.6 | 2.7 |
| USD/JPY | 113.9 | 0.1 | 1.0 | -5.3 |

Source: Bloomberg.[1] Spot price returns. All data as of last Friday's close.
**Past performance is no guarantee of future results**.

# Looking Ahead

In the U.S., the Federal Reserve is expected not to raise interest rates this month, while the University of Michigan Sentiment Index is expected to increase. In the eurozone, CPI is expected to increase month-over-month.

## Upcoming Economic Releases

- On Wednesday, the Federal Reserve is expected not to raise interest rates this month, as it assesses spillovers from the recent tightening of financial conditions and debates the inflation outlook.
- On Friday, the University of Michigan Sentiment Index is expected to increase to 92.5 in the preliminary report for March, from 91.7 in the final report for February. Although gas prices have risen in March, relatively low gas prices are still giving consumers extra dollars to spend.
- On Thursday, eurozone CPI is expected to increase month-over-month, to 0.1%, in February, from -1.4% in January.

## BofA Merrill Lynch Global Research Key Year-End Forecasts

| S&P 500 Outlook | 2016 E |
|---|---|
| Target | 2,000 |
| EPS | $120.00 |
| **Real Gross Domestic Product** | **2016 E** |
| Global | 3.2% |
| U.S. | 2.0% |
| Euro Area | 1.5% |
| Emerging Markets | 4.2% |
| **U.S. Interest Rates** | **2016 E** |
| Fed Funds | 0.88% |
| 10-Year T-Note | 2.00% |
| **Commodities** | **2016 E** |
| WTI Crude Oil $/Barrel | $45.00 |
| Gold $/Ounce | $1,250 |

All data as of last Friday's close.

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