Investing in Range-Bound Markets

Weak economic data in January stoked recessionary fears, and it quickly eliminated concerns that the U.S. Federal Reserve (Fed) would quickly follow up its December rate hike with another increase in March. As a result, interest rate futures were soon implying a zero percent chance of a rate hike over the remainder of 2016. However, by mid-March, the same futures contracts were suggesting a 43% chance of a rate increase by June and 75% odds of a rate increase before year-end. What changed? The sharp shift in expectations was fueled by some stabilization in economic data and mounting evidence of a rapidly tightening U.S. labor market. A stock market rally also ensued on the back of better economic readings. Arguably, some of the equity market's newfound strength was based on the perception that the economy is likely strong enough to avoid recession but not so strong as to elicit aggressive tightening from the Fed. However, as discussed later in this commentary, if the labor market data continues to improve, potential additional rate increases could act as a headwind to further market gains.

As detailed in the economics section of this outlook, recent signs of stabilization in economic data have eased recession fears. With the Fed seen as likely to remain on hold at least until mid-year, a broad-based market rally has developed in February, which as of this writing remains intact. Encouragingly, commodities, emerging markets, small-caps, and economically sensitive businesses, in general, have led the rally off the February 11 lows. We will watch to see if these trends prove sustainable and for additional evidence that the volatile trading range experienced in recent quarters is giving way to a resumption of the bull market that began in 2009. For now, our view remains that the crosscurrents discussed in our 2016 outlook will keep global equity markets largely range-bound, which is not to stray outside of a particular range of market prices, for much of the year.

Finally, the European Central Bank (ECB) announced a new set of highly accommodative policies that are likely to provide some support for economic growth in Europe over the remainder of the year. In addition to cutting its lending rates to below zero, the central bank significantly increased the size of its monthly asset purchases and expanded the type of assets it will be purchasing to include investment grade corporate bonds issued by non-banks. The aggressive policy tool has, thus far, worked exactly as intended. It has reduced the spreads, between European Treasury securities and European corporate credit. In fact, the policy seems to have had far reaching implications, with pan-European high yield corporate credit stress significantly easing and European sovereign bonds rallying. Without question, the unintended long-term consequences of the ECB's extraordinary remedy of negative interest rates and large-scale asset purchases are a concern. However, despite these long-run concerns, the easing of credit stress, should it prove sustained, could have very positive implications for Europe's growth outlook for the rest of 2016.

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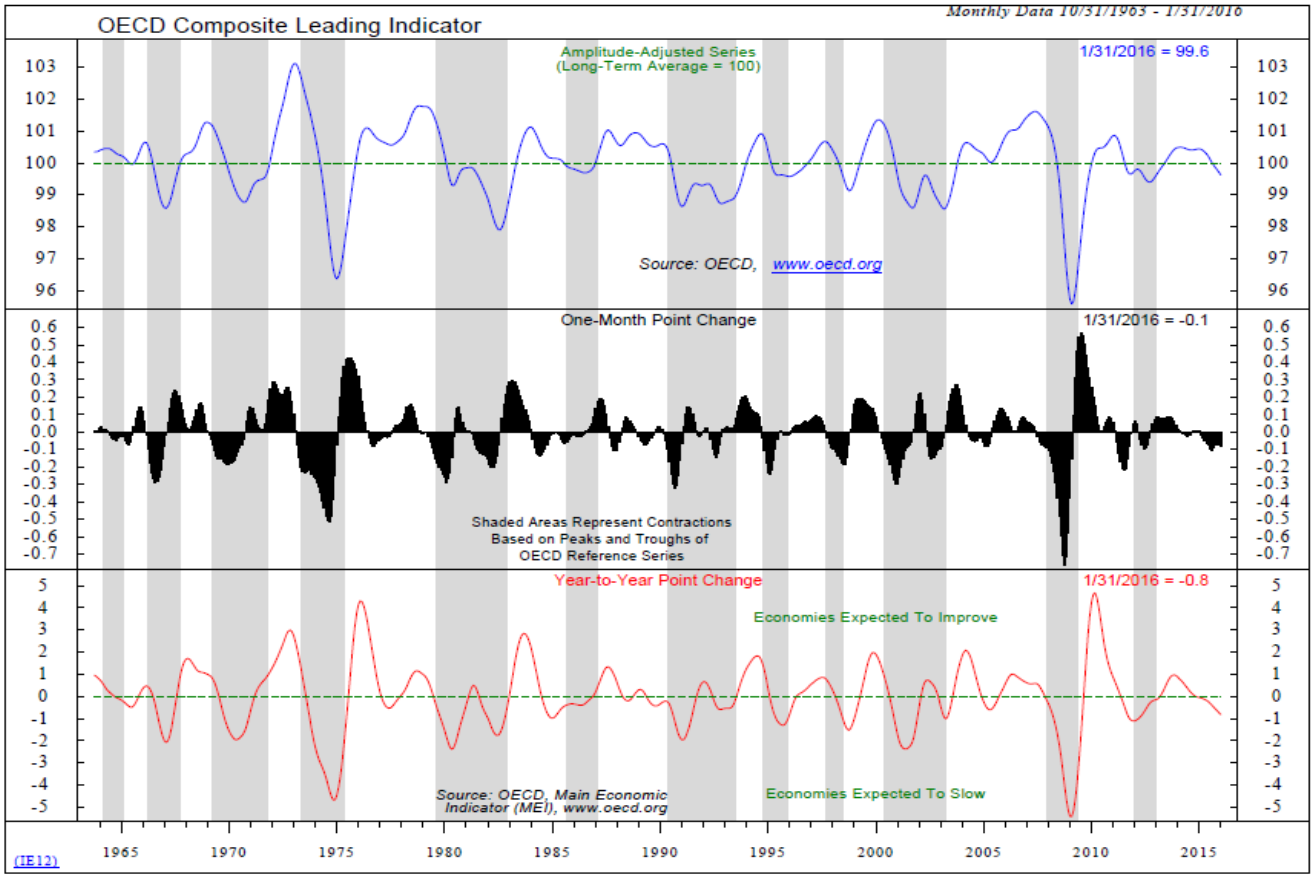
Global Economy

Global economic data was alarmingly weak early in the year, but it has recently shown fledgling signs of stabilization. Notably, as shown in Figure 1, the Organisation for Economic Co-operation and Development (OECD) Composite Leading Indicator for OECD countries plus six key nonmember economies, which can be considered a proxy for future global growth, fell 0.1 points in January to its lowest level since September 2009. This index has a manufacturing emphasis and has been below its long-term average for more than 12 months. The share of individual countries in the composite that are above their long-term average recently fell to 47%, which is the lowest level since September 2013. This trend is also concerning.

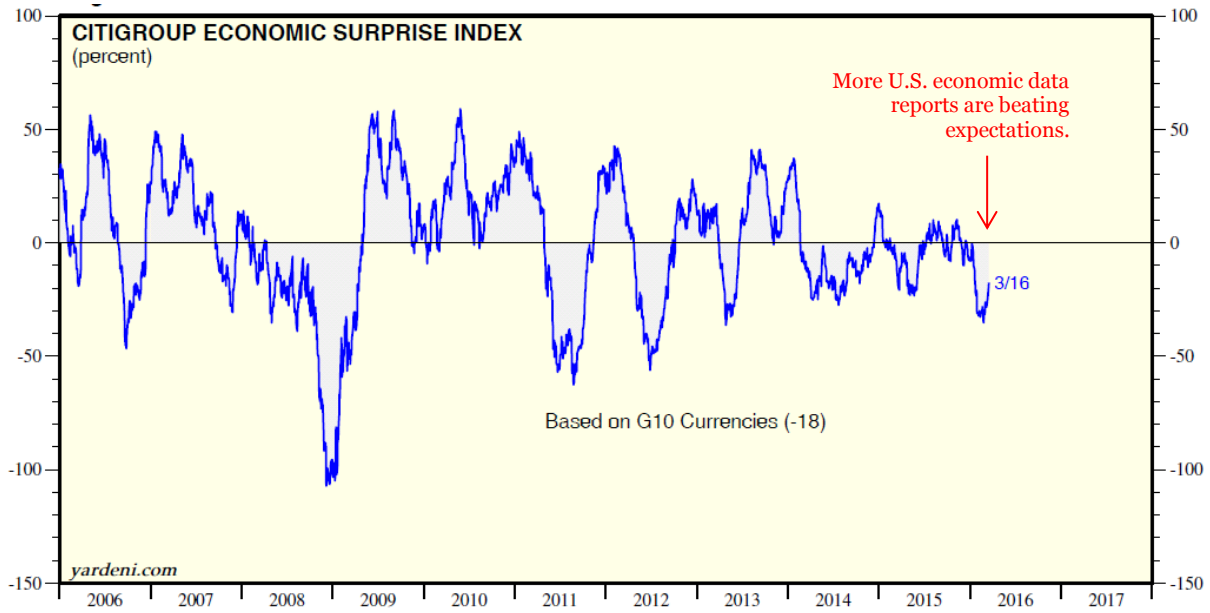
Figure 1. OECD Composite Leading Indicator – Global leading indicator trending lower



Source: OECD.org

The good news, in our view, is that the U.S. economy seems to have shrugged off slowing global growth and dodged recessionary conditions. We expect domestic gross domestic product (GDP) to experience at least moderate growth over the remainder of the year. One way of viewing the stabilization in U.S. economic data is the Citigroup Economic Surprise Index, shown in Figure 2. This index bottomed in January and recently approached the threshold that indicates a majority of economic reports are beating expectations.

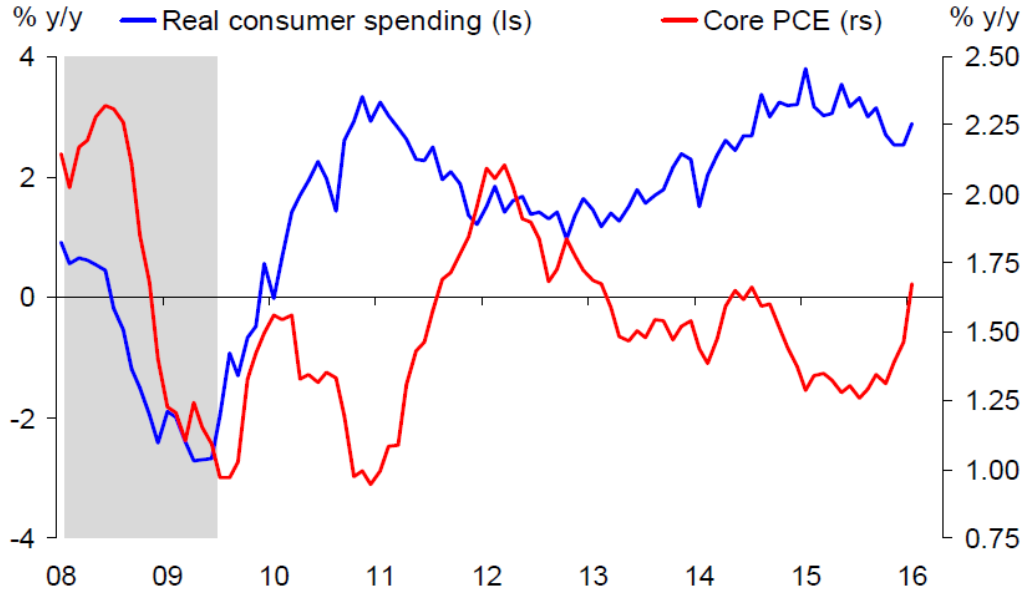
Figure 2. Citigroup Economic Surprise Index – Showing improvement



Source: Citigroup, Yardeni.com; as of 3/16/2016

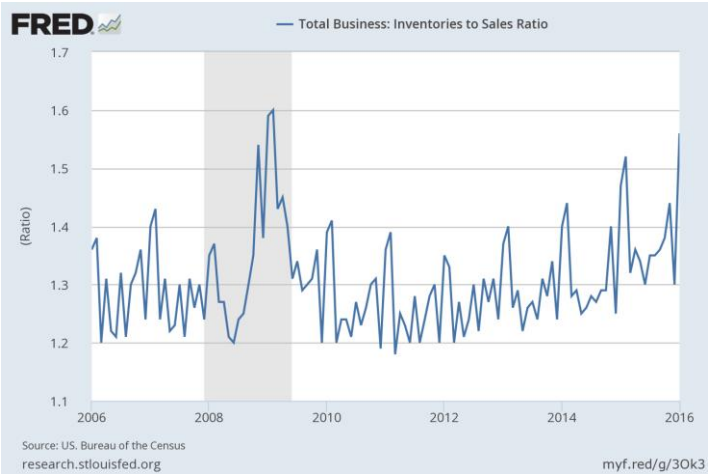
Of particular importance, the ISM Manufacturing Index for February improved for the second straight month and order backlogs, while still signaling sluggish growth, rose to the highest level in nine months. Meanwhile, consumer spending, shown in Figure 3, accounts for 70% of domestic GDP and has been supported by positive trends in housing prices, employment, income, and generally strong household balance sheets.

Figure 3. Consumer Spending – Remaining steady



Source: DB Global Markets Research

Figure 4. Inventories showing marked increase

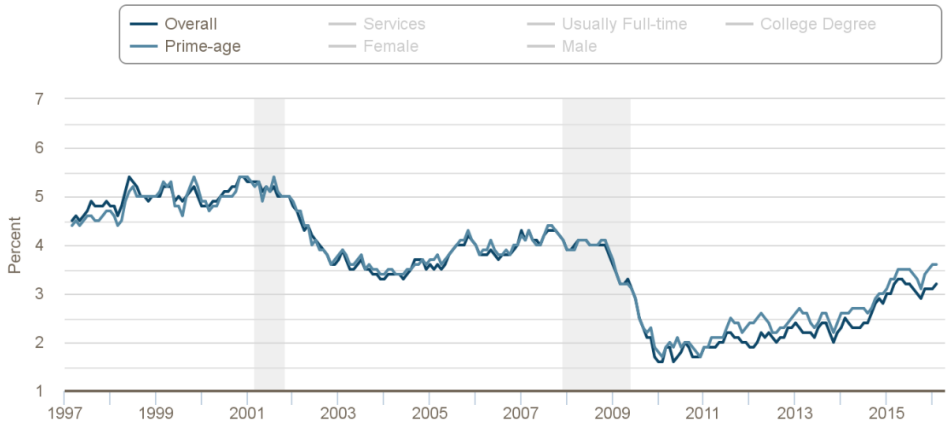


One potential area of concern is the continued ballooning of wholesale inventories. As shown in Figure 4, the ratio of business inventories-to-sales reached a post-recession high in January. Without a significant increase in demand, inventories will need to be pared back in the coming months. This move could weigh on output and production. Furthermore, businesses with excessive inventory at risk of obsolescence may be forced to reduce prices, which could weigh on profit margins and reignite deflationary concerns. The latest retail sales data has shown two straight months of declines. These declines are likely impacted by financial market volatility at the beginning of the year that weighed on consumer sentiment, but they still suggest that heavy discounting in the retailing sector may be forthcoming.

The continued steady gains in the U.S. labor market have offset most of these concerns. The unemployment rate in the first quarter declined to its lowest level since February 2008, and initial jobless claims remain extremely low by historical standards. The job openings rate indicates that demand for labor is the highest since 2001 and far from signaling any imminent decline in hiring. The relatively strong job market is a hopeful indication that consumer spending will remain supportive of domestic economic growth for the rest of the year.

Wage data support the idea that the Fed may still surprise us by becoming more aggressive in its tightening. For example, the percentage of new hires that were previously not considered in the labor force has recently spiked to a multi-year high. The ability of the long-term unemployed to find new jobs is indicative of tightening labor market conditions.

Figure 5. Atlanta Fed Hourly Wage Tracker, three-month moving average of median wage growth



Meanwhile, as shown in Figure 5, the Atlanta Fed's measure of median hourly wage growth for workers in their prime working age (25-54 years) recently surged to the best year-over-year (YoY) growth since 2008. These figures are also indicative of a tightening labor market that could lead to a surprisingly fast pickup in inflationary pressures.

Source: Federal Reserve Bank of Atlanta

Our view remains that the U.S. economy is likely to continue growing while offsetting many of the global headwinds with:

- Strength in housing.
- Consumer spending.
- Stabilization in manufacturing.

The relative strength of the U.S. economy is vital to our outlook that equity markets will avoid a severe bear market in 2016.

Equity Markets

Following a very choppy 2015, equities began the New Year with a renewed bout of volatility. Extreme crosscurrents created an unstable market environment in the first quarter, as investor concerns oscillated between fears of further rate hikes from the Fed on the one hand and a global recession on the other. Slipping measures of global growth, alarm over a slowdown in China, and plunging oil prices led to a period of falling equity markets and rising credit market stress in January. The Dow Jones Industrial Average got off to its worst two-week start to a year in its history. Equity declines were widespread. Many global indices fell more than 20% below cycle highs and into bear market territory. The damage in the S&P 500 was far less pronounced, with the bellwether index enduring a peak-to-trough decline of a little less than 15% from its all-time high reached last May.

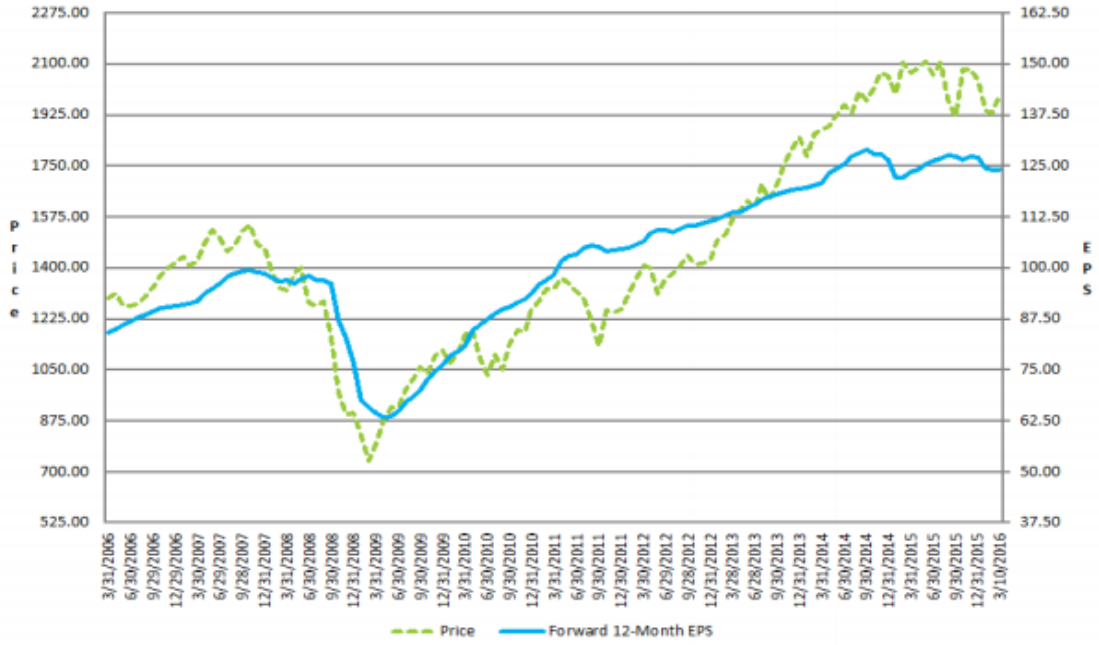
January's market turbulence exacerbated widespread fears that the global economy may be slipping into a recession. However, we believe these fears may be overblown. Our analysis of the historical record suggests that the equity markets have largely priced in the slowdown in global growth, and indications of a recession in the U.S are limited.

Earnings and Valuation Headwind

Our "weight of the evidence" approach suggests that downside risk beyond what was experienced earlier this year is probably limited. This assessment is due to stabilizing U.S. growth, aggressively accommodative global central bank policy, a cautious U.S. Fed, and the diminishing impact of a strong U.S. dollar. At the same time, headwinds persist that are likely to cap any market advance in the near-term. Most notably, corporate earnings remain mired in a prolonged slump. According to FactSet, analyst consensus estimates now call for an 8.3% YoY decline in first quarter S&P 500 earnings, which would be the first time earnings have declined for four consecutive quarters since the 2008-2009 recession ended. Moreover, earnings growth expectations have fallen for all ten economic sectors since the beginning of the year. On a positive note, the U.S. dollar appears to have settled into a range over the past 12 months. As its strength relative to other currencies wanes, so should its negative impact on earnings going forward.

Meanwhile, pessimism regarding the near-term outlook for earnings does not appear to be fully reflected in the valuation, which determines current worth of U.S. stocks. The 12-month forward price-to-earnings (P/E) ratio of the S&P 500 is 16.1—well above the 10-year average of 14.2. As shown in Figure 6, the price of U.S. stocks has diverged significantly from forward earnings estimates in recent quarters. A wide variety of market valuation tools are sending a similar message. The valuation of U.S. stocks is stretched, which signals that the market may be overvalued relative to earnings as we head into the second quarter. As a result, even if near-term earnings surprise to the upside, the market is likely to remain range-bound until the global economy really finds its legs and earnings estimates inflect decisively higher.

Figure 6. S&P 500 Change in Forward 12-Month EPS vs. Change in Price: 10 Years



Source: FactSet

A final factor that may have contributed to some of the volatility experienced early in the year is the U.S. election cycle. The average Presidential election tends to produce a volatile first half of the year, with below average returns followed by a stronger second half. Investors, at least historically, have apparently tended to prefer some policy certainty and grow more comfortable with the elections potential outcomes as the election nears. The U.S. election cycle provides additional support to our view that stocks are likely to remain volatile and range-bound in the coming months, but they are likely to end the year at somewhat higher levels in the long run.

Fixed Income Markets

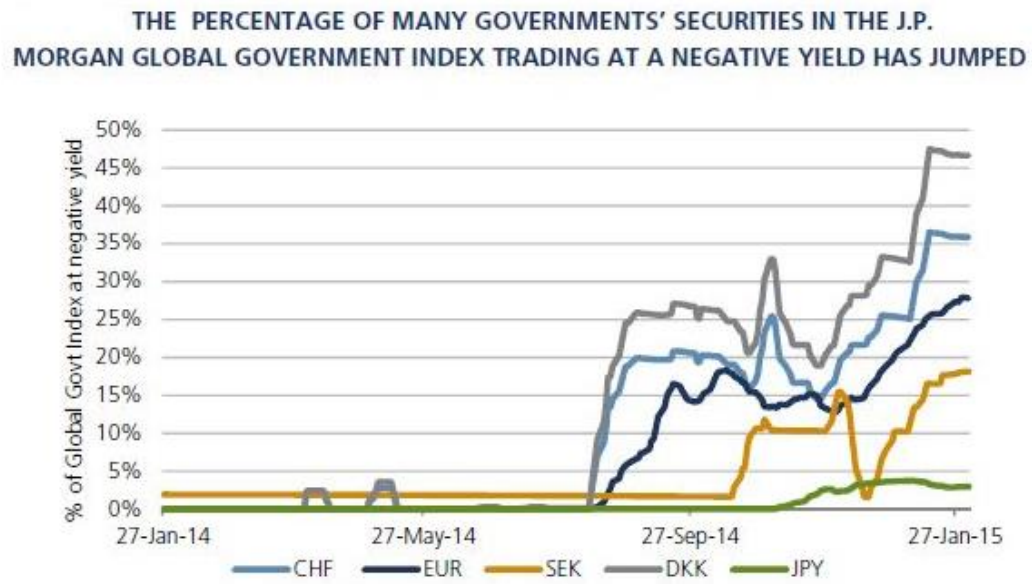
The markets defied central banks in the opening months of the year, bidding up prices for government bonds worldwide. Weaker corporate results, lower commodity prices, and uncertainty around global growth drove investors away from riskier assets. The U.S. 10-Year Treasury yield, which moves inversely with bond prices, traded under 1.65% as market participants discarded fears of additional Fed rate hikes in the face of weakening financial conditions. However, continued positive economic readings in the U.S. and additional monetary easing abroad lessened concerns of a recession toward the end of the quarter. The 10-year Treasury rate moved modestly higher in March, but remains below the 2.24% level where it started the year. As result, performance for the first quarter was mildly positive for the conservative bond sectors. More aggressive bonds, including below-investment-grade, have not yet recovered from their lows. However, they are outperforming investment grade bonds on a year-to-date basis.

Interest rates may continue to fluctuate as investor attention turns from safety and liquidity to monetary policy. After increasing short term rates by a quarter percent in December, the Fed indicated four more rate hikes were possible in 2016. However, the market consensus was that the pace of rate increases would be more gradual, with only one to two rate increases likely over the course of the year. This expectation was confirmed on March 17, when the Fed reduced their forecasted rate hikes for the rest of the year and decided not to change rates. In our opinion, while short term rates may move higher, long term rates will likely remain range-bound. We continue to expect short term bond yields to rise more than long term bond yields, resulting in a flatter yield curve in 2016.

International monetary policy also supports our expectation of an upper bound to longer term. Over the first quarter, both the Bank of Japan and the ECB instituted negative interest rates for the banks they oversee. Both

these central banks also engage in quantitative easing, meaning they purchase bonds in the open market. As bond yields move in the opposite direction to the price of bonds, central banks can buy enough bonds to drive up the price so high that the yields on these bonds turn negative. Then, the bonds are so expensive they result in a negative return to investors. This, along with the flight toward government bonds mentioned earlier, has pushed most short to intermediate government bonds in Europe and Japan into negative yield territory, as shown in Figure 7. These negative international bond yields have caused a substantial increase in demand for U.S. Treasury bonds from international buyers. Demand for Treasury bonds from institutions is likely to continue, which will help keep rates low.

Figure 7.

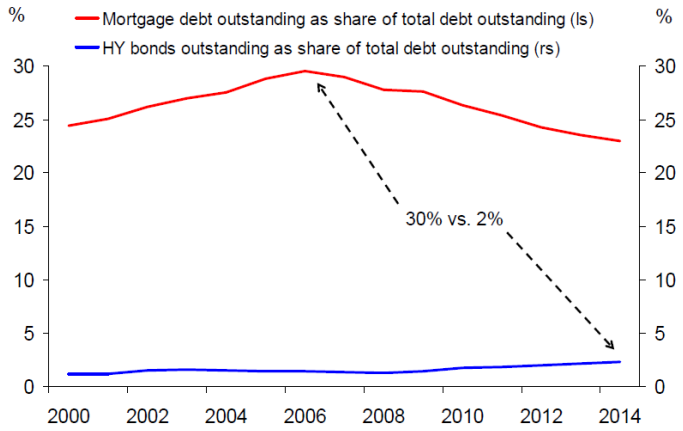


Source: PIMCO, JPMorgan Index data, January 2014 to present

Treasury bonds are sensitive to interest rates, and there is still a chance that most rates may increase if the Fed raises the short-term Federal Funds rate. But for the reasons listed above, our view is that the returns of intermediate to longer duration Treasuries may be flat to mildly positive for 2016 even if overall yields trend higher. Shorter term bond issues come with higher volatility risk, but they are also less sensitive to rate moves, which may limit their downside risk.

One potential risk to a Treasury-only portfolio is inflation. Inflation has been at very low levels for a number of years, and the market has not priced in a big inflation risk premium. While we do not expect a substantial spike in inflation, the low price effects of a strong dollar and declining energy costs are starting to dissipate. As input prices stabilize, or move modestly higher, and as wage pressures increase, inflation may move toward 2% or even higher. Such a rise would result in most Treasury bonds returning a rate below the inflation rate.

Figure 8. High Yield vs. Mortgage Debt Outstanding

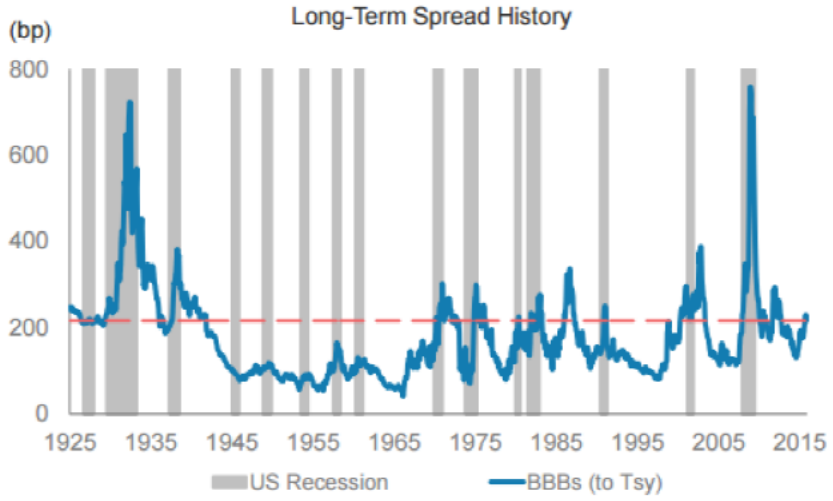


Source: DB Global Markets Research

One source of equity market volatility early in the year was severe stress in the high yield bond market. It contributed to the general fear of recession that enveloped markets in January. While concerning, the stress in high yield to this point has been largely confined to the energy and mining sectors and has not broadened out in a manner that would indicate the U.S. economy was about to slip into recession. It is also important to note that, as shown in Figure 8, the high yield bond market represents about 2% of total debt outstanding. This figure is a small fraction of the size of the mortgage market in 2006. As a result, we believe comparisons of the recent stress in high yields bonds to signs of stress in the housing market in 2006 are misguided.

Credit spreads in investment grade and high yield spiked at the beginning of 2016, but have since retreated to levels close to where they started the year. We are constructive on investment grade bonds since their yield is sufficient to cover inflation and company fundamentals remain strong, buoyed by a stronger U.S. consumer, continued improvements in housing, and solid job growth. The demand for investment grade corporate bonds may also increase as investors diversify out of Treasuries. Coupled with continued economic expansion in the U.S., this backdrop may cause investment grade spreads to decrease from their current levels, shown in Figure 9, and may improve the performance of investment grade bonds even if Treasury rates were to increase modestly.

Figure 9.

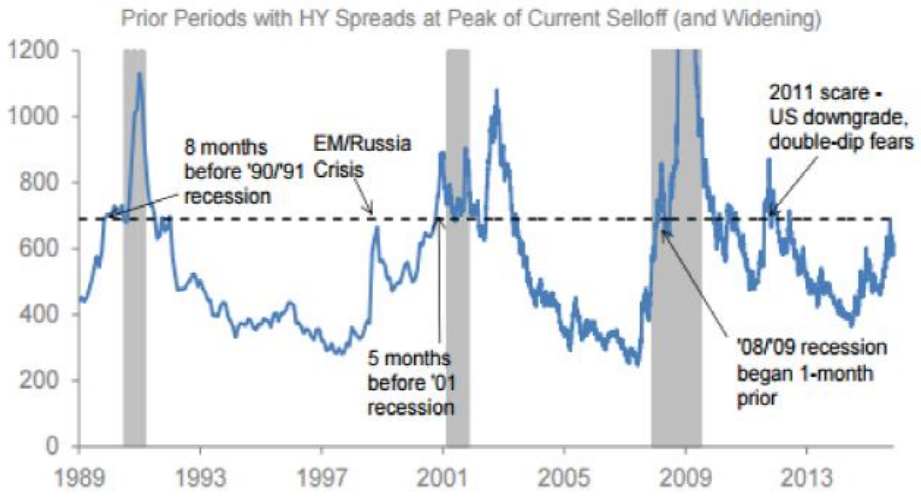


Source, Thornburg Inv. Mgmt., Morgan Stanley research, Yieldbook, Bloomberg, Moody's, NBER

High yield spreads widened more than investment grade corporates at the end of last year, and at this point may represent an attractive investment opportunity. This sector also trades at a wide spread over Treasuries, which may additionally limit the impact of rising rates on a portfolio. However, high yield bonds tend to be more volatile since they are relatively less liquid. As shown in Figure 10, high yield spreads recently reached levels typically seen prior to a recession. However, as we have stated many times, we do not believe a recession is imminent.

As the economy continues to grow and a recession is unlikely, we remain positive on high yield for 2016. This environment is supportive for earnings of high yield issuers. Although, we note that the energy sector, which now represents about 10% of the high yield index, remains a concern.

Figure 10.



Source, Thornburg Inv. Mgmt., Morgan Stanley research, Yieldbook, Bloomberg, Moody's, NBER

The municipal bond market may continue to benefit from stronger demand as yields have been relatively stable, making municipal bonds relatively attractive to Treasuries to investors in higher tax brackets. Fundamentals, such as increased tax collection associated with improving housing and employment, and expected declines in bond issuance (which limits supply) are also positive for municipal bonds. These trends may keep muni yields more stable than Treasuries for the upcoming period.

Risks to Our Outlook

While we have a constructive outlook on the global economy and financial markets, we note important risks that could derail this story. These include weaker growth in China, unexpected inflation, market valuations, and increasing market volatility.

China and Global Growth

Emerging market economies account for roughly 70% of global growth. China is the second largest global economy and the cornerstone of the emerging markets. Accordingly, we will maintain a close eye on China and its role in overall global growth. Policymakers are working to transition China from an investment-driven system to a market-based and consumption-driven economy, an endeavor that we expect to encounter a number of headwinds along the way. Early this year, the International Monetary Fund (IMF) lowered 2016 and 2017 Global GDP Growth estimates. The weaker forecast was based on the following driving factors:

- China's economic transition.
- Lower energy prices.
- The gradually tightening U.S. monetary policy.

More recently, industrial production and retail sales readings out of China may signal further weakness. Retail sales are typically strong in January and February around the Lunar New Year holiday. However, retail sales disappointed with 10.2% growth—a meaningful drop from December's 11.1% figure. It was not a strong showing given China's desire to move to a consumer-based economy. Although China may have the tools to manage through their transition, many asset classes previously bolstered by China's expansion are no longer supported by that demand.

Unexpected Inflation and Its Ramifications

Coming out of the Great Recession, global inflation has been largely subdued. A lack of inflation may be harmful to global economies—it makes raising prices difficult for companies. Without this ability, corporate profits may slow, leading to decreased capital spending and lower wage growth for employees. The Fed, however, raised

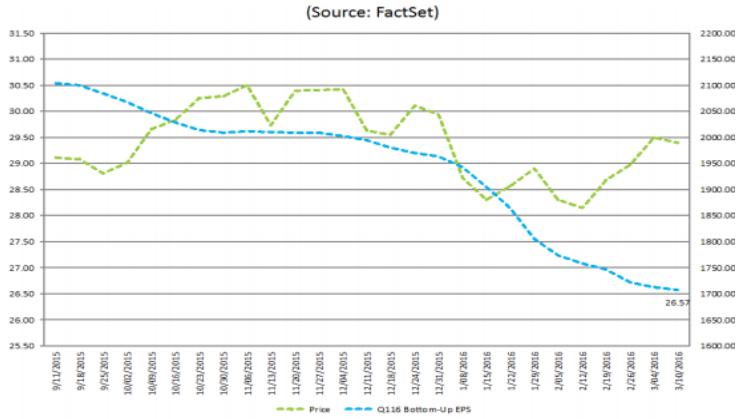
interest rates late last year, citing strength in labor and housing markets. A lack of inflation led them to leave rates unchanged in March. With the recent pickup in commodity prices, more accommodative monetary policies in Europe and Japan, better-than-expected readings in economic data, and the previously discussed pickup in wage growth, inflation could surprise on the upside. For example, during the 12 months through February of this year, core consumer prices (excluding food and energy) rose 2.3%, the largest gain since May 2012. In short, while inflation may be subdued today, a rapid and unexpected increase could prompt the Fed to raise rates faster than investors expect. Such a move would lead to a stronger U.S. dollar and heightened market volatility.

Market Valuation

Aggregate earnings and revenues of the S&P 500 have declined for the last three and four quarters, respectively. Major detractors to earnings growth include the continued weakness in the price of crude oil and other commodities prices, as well as a strengthening dollar. According to Factset, analyst earnings estimates are pointing to a fourth consecutive quarter of earnings decline in the second quarter of 2016, which has not occurred since the periods between fourth quarter 2008 and third quarter 2009.

Figure 11 shows that despite the sharp drop in earnings estimates, the S&P 500 has not followed suit. As a result, common valuation ratios of the S&P 500 are above their 5-year and 10-year averages, signaling the market may be overvalued relative to earnings. Although many argue a low interest rate environment and accommodative monetary policy warrant higher-than-normal valuations, it is difficult to envision meaningful equity market gains without an increase in corporate profits.

Figure 11. S&P 500 Change in Q1 2016 Bottom-Up EPS: 26-Weeks



Increasing Market Volatility

So far in 2016, 31 of the first 48 market trading days (65%) saw the Dow Jones Industrial Average finish higher or lower by at least 100 points. As global markets digested diverging monetary policies, a risk of global recession, and continued commodity price weakness, these market fluctuations were a reminder of the importance of risk management amid the sensitive global market backdrop. Mixed news on global growth, higher market valuations, and unexpected inflation could further increase market fluctuations and cause investors to question their long term equity allocations.

Investment Implications

We believe the current secular bull market should continue, albeit with more measured gains. Considering slower global growth projections and current market valuations in general, we would expect long-term returns in stocks and bonds to be below average, accompanied by higher volatility. Globally, central bank stimulus should provide support to financial markets and backstop against any type of major bear market selloff. We expect equities to trade within a range, though we still see more upside potential from current levels. As such, we would not recommend drastic deviations from long-term targeted allocations.

Within stocks, we feel that companies that are able to grow despite an anemic economic backdrop are likely to command a premium. We continue to favor growth over value across the market cap spectrum. However, we have witnessed growth outperform value by the widest margin since 1969, so it is possible that value may grow increasingly attractive on a relative basis. From a global perspective, we still favor domestic equities. However, opportunities in international developed markets have increased with more accommodative central bank policies in Europe and Japan, coupled with more attractive valuations and being in earlier stages of economic recovery. Over the past five years, domestic equities have outperformed international equities by the widest margin since the period from 1996 to 2000. While emerging markets should remain volatile with elevated risk levels, stabilization of energy prices and the U.S. dollar should provide opportunities, given its lengthy period of underperformance.

Within fixed income, we continue to maintain a somewhat defensive position, with duration slightly below the benchmark, and a solid allocation to credit sensitive and high yield bonds. We believe high yield bonds may fare better in periods of increasing GDP growth and modestly rising rates. In higher quality bonds, we favor an allocation toward the long end of the duration spectrum, as longer term rates are likely to be more stable. With the expectation that interest rates may remain lower for a longer period, due to a lack of inflation and only a modest economic growth environment, we have lowered our long-term range of expectations for bond yields. As we bounce off the bottom of this new range, we will likely begin reducing our defensive positioning.

Lastly, to mitigate unforeseen volatility in an increasingly uncertain environment, we believe it prudent to retain an allocation to alternative investments that have low correlations to traditional investments. From a portfolio implementation standpoint, we prefer managers with flexible investment styles that provide discretion and ability to move nimbly within their mandates when faced with the changing circumstances we anticipate going forward.

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Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

Commodities markets have historically been extremely volatile.

Small-cap stocks may be subject to a higher degree of market risk than large-cap stocks, or more established companies' securities. Furthermore, the illiquidity of the small-cap market may adversely affect the value of an investment so that shares, when redeemed, may be worth more or less than their original cost.

A High Yield Fund yield is high due, in part, to the volatility and risk of the high securities market. High yield funds are also known as "junk bonds."

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Glossary

*The **Barclays U.S. Corporate High Yield Index** measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.*

*The **Citigroup Economic Surprise Index** measures the reaction to US economic news by comparing how much actual economic data deviates from the expectations of economists. Expectations are measured through a Bloomberg survey of economists which takes place before the release of the economic data and the median value of the survey results are calculated.*

*The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.*

***Employment Trends Index (ETI)™,** is produced by the Conference board and is a leading composite index for employment which aggregates eight labor market indicators from different sources, each of which has proven accurate in its own area.*

*The **ISM Manufacturing Index** is an index 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. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.*

***MSCI EAFE Index** (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada.*

***MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.*

***MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.*

*The **OECD system of Composite Leading Indicators** (CLIs) is designed to provide early signals of turning points in business cycles - fluctuation in the output gap, i.e. fluctuation of the economic activity around its long term potential level. This approach, focusing on turning points (peaks and troughs), results in CLIs that provide qualitative rather than quantitative information on short-term economic movements.*

***Russell 1000 Index** measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000 Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.*

***Russell 2000 Index** measures the performance of the small-cap segment of the U.S. equity universe and is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.*

***Russell Midcap Index** measures the performance of the mid-cap segment of the U.S. equity universe and is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap represents approximately 31% of the total market capitalization of the Russell 1000 companies.*

*The **S&P 500** is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.*