



Happy New Year to Volatility, Turmoil and Opportunities January 2016

Dear Client:

Investor anxiety continued to rise throughout most of 2015, as concerns about deflation, declining global growth led downward by China and commodity exporting economies like Brazil, who like oil producers suffered as commodities were in free fall. The strengthening US dollar and monetary policy divergence as the Fed started raising interest rates while other major economies were either cutting or talking about reducing interest rates further drove volatility to levels not seen in years. And we saw perhaps the first signs of distress in the high-yield bond market. *However, in Chinese the word for chaos also means opportunity.*



Fourth Quarter Review

The last half of 2015 was extra volatile for all markets with plummeting oil prices the key contributor to markets wide swings. The clear and expected result of Saudi Arabia's determination to keep oil flowing to maintain a supply glut in an effort to bankrupt U.S shale energy companies and pinch Canadian tar sands companies too. Remember tar sands oil is a heavy black oil (also called Canadian bitumen) that is refined from clay and sand and is such a very expensive process that \$50 a barrel oil is about breakeven... *so imagine what oil below \$40 means for producers up north? Or worse during the week of January 11 Canadian bitumen (which by the way is the oil that would have flowed through the Keystone XL Pipeline) crashed to \$8.35 per barrel from its \$80 per barrel price in 2014. After, plummeting 42.6% in 2014, crude oil fell another 45.3% in 2015, including a 24.3% decline last quarter. Further Bloomberg reports in January that some refineries in North Dakota were actually charging producers -\$0.50 per barrel to refine domestic low grade crude oil. While this is not the predominant crude oil used in North America, I do think this is another data point about the growing impact of the decision by OPEC and Saudi Arabia. The oil price collapse impacted global equity markets, particularly the energy sector and high yield bonds. In addition to the drop in oil prices, uncertainty around the Federal Reserve's (Fed's) monetary policy and investor concerns about slowing global grow weighed on all markets for the balance of 2015. The alternating between appetite for risk and risk aversion against the backdrop of investor uncertainty led to a highly selective and tactical investing period in equity and bond markets during the fourth quarter and full-year 2015. **This pattern is likely to continue in 2016 as the bull market that began in 2009 must inevitably slow and revert to mean returns.***



U.S. Equity Market

Unlike the third quarter where volatility led to meaningful declines, the U.S. equities posted gains in the fourth quarter. The U.S. equity market in the fourth quarter was helped by a shift in investor sentiment following the steep pullback experienced in the third quarter of 2015; strong merger and acquisition activity (M&A); more stability in China; and the Fed's belief that the U.S. economy was strong enough to support an increase in short-term

interest rates. *There is shift in our belief that US economy's full employment is likely to accelerate growth in 2016.*



Large-capitalization stocks fared better than mid- and small-cap stocks. Style-wise, growth-oriented stocks outpaced their value-oriented counterparts across all market capitalizations. Of the 10 economic sectors within the S&P 500 Index (which provides a proxy for the equity market), Materials, Health Care and Information Technology posted the biggest gains. Energy, Utilities and Consumer Discretionary posted the smallest gains. For 2015, the Russell 3000 and S&P 500 Indexes eked out gains of 0.5% and 1.4%, respectively.

Similarly, overseas markets posted gains in the fourth quarter. Non-U.S. developed equity markets, as measured by the MSCI EAFE Index (net of taxes), rose 4.7% for the period, while emerging equity markets, as measured by the MSCI Emerging Markets Index (net of taxes), rose 0.7%. For 2015, the MSCI EAFE Index (net of taxes) and the MSCI Emerging Markets Index (net of taxes) declined 0.8% and 14.9%, respectively. In recent months, investor activity can be characterized as being very selective and tactical in nature. Gone for now are the days when "emerging markets" as an asset class are all seen through the same lens. Consequently, whether it's the BRICS, i.e. Brazil, Russia, India, China, and South Africa; CIVET, Columbia, Indonesia, Vietnam, Egypt, and Turkey; or MINT Mexico, Indonesia, Nigeria, and Turkey as well as Taiwan, Philippines, Hong Kong, their country specific dynamics including strength of currency, national debt, oil importer or exporter will necessitate that each are being evaluated more independently than as just a group cohort. The economic slowdown in China is real however one can always argue how authentic are any of the numbers that its government reports. What is always undeniable is the amount of commodities that China purchases and here we do have good visibility that a decline in their consumption/imports has contributed to the slide in global commodity prices, increased market volatility and investor uncertainty, China for political survival is always intent upon firmly restraining its economic slowdown. It has placed a lower limit of 6.5% on growth, which means that additional stimulus packages and other maneuvers, both fiscal and monetary, maybe forthcoming. 2016 should see global policy settings and other actions by developed



nations having widely varying impacts on all of these “emerging market and frontier market countries such that the gap between winners and losers could be stark.

U.S. Fixed Income

In contrast to equity markets, the U.S. fixed income market, as measured by the Barclays U.S. Aggregate Bond Index, declined 0.6% during in the fourth quarter. For the year, the Barclays U.S. Aggregate Bond Index rose 0.6%. Despite the Fed’s decision to increase short-term interest rates during December 2015, the 10-year U.S Treasury yield, a foundation for global finance, ended 2015 at 2.27%—10 basis points higher than where it ended 2014. The Fed’s rate policy has tended to have a more subdued effect on long-term bond yields, which are more influenced by global economics and the inflation outlook. A sluggish global growth outlook and limited signs of reported inflation, as well as relatively attractive yields among government bond markets in the developed world, have continued to draw buyers into U.S. Treasury debt. Despite the Fed’s increase in the target short-term interest rate from historically low levels, overall global monetary policies remain accommodative. Many are beginning to argue that disinflation i.e. the falling of and not the rise of inflation, or deflation as seen by falling consumer prices may in fact be on the horizon. Either of which would bring into question the Fed’s expressed move to now raise rates. Of course the most notable action in fixed income was the turmoil in the high yield market most notably the case of the Third Avenue Focused Credit Fund. Third Avenue management created in 1974 by value investor icon Marty Whitman had to halt investor redemptions to its mutual fund which at one time had assets of over \$1B due to the massive sell off in junk bonds. The fund held large positions in debt of domestic energy companies as well as materials and industrial companies all of which saw big declines in their projected business cash flows as a result of declining commodity prices. This sent a shiver through the junk bond market.

While investors’ focused in 2015 on the exact timing of the Fed’s first interest rate hike, China’s slowdown and currency policy, will or won’t Europe or Japan be in recession and how long or deep with the slide be for emerging economies. Expect these same major themes and investor concerns that caused bouts of pervasive pessimism, widespread market selloffs and heightened volatility in 2015 will continue in 2016. Shifts are taking place. Look as the first 3 weeks of trading are all about’ concerns that China’s economic slowdown (*has created a market shift*) that will spill over into the economies of other emerging and developed markets.

Looking Ahead

I continue to actively pursue opportunities to grow clients’ capital while seeking ways to manage risk, *particularly in a year where downside risk is growing*. Maintain discipline with your **Asset Allocation** well-diversified portfolios, a clearly defined and repeatable investment process, active portfolio and risk management, and monitoring your investment manager(s) are keys to successfully navigate through challenging market environments to successfully



achieve investment goals. I am seeing 2016 as a year filled with a lot more divergence across economies, central bank policy, currencies, and growth rates. This growing and unpredictable volatility rise will long term translate into opportunities in securities and asset classes that are oversold and unloved since chaos and panic by some lead to discounted purchases by others. In my view, this has created an environment where a selective and tactical approach for investing in **emerging markets, some international equities, distressed equity, assets, and debt** appear to show opportunities where levels of potential long term returns compare favorably to current risks. Further, some suspect that Third Avenue was the canary in the high yield market coal mine and thus investors will rightly be very sensitive to the action in *high yield debt*. Opportunities there and across credit/fixed income are likely to arise during this year. Recently the Wall Street journal wrote a report from law firm Haynes & Boone indicates that more than 30 small oil companies that collectively owe \$13billion have already filed for bankruptcy protection during this downturn...more to come so hang on.

With a new year upon us and ample volatility let us discuss your risk tolerance and asset allocation in the context of the long term targets goals and objectives of your portfolio. I wish you health and happiness in the New Year. As always, if you have any concerns, questions, or general thoughts about your portfolio or any other matter, please never hesitate to contact me.

Appreciatively,

Walid L. Petiri

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Sources: Barclays Capital, MSCI Barra, Russell Investments, Standard & Poor's, Reuters, Federal Reserve Board