Monthly Market Perspective

March 9, 2015

Performa is an independent, employee-owned investment management firm, founded in 1992. We combine over 20 years of experience in the captive industry with the institutional expertise of our investment team to provide our clients with tailored investment solutions.

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Negative Yields, No Thanks!

The European Central Bank (ECB) started its new bond purchase program in March, buying private and sovereign debt to the tune of €60 billion a month. As with similar programs, many investors who bought Eurozone sovereign bonds in anticipation of the announcement, have continued buying. All the demand has sent yields to historic lows and, in some cases, into negative territory. In today's policy distorted bond market, there are investors willing to pay Germany and some other countries for the privilege of lending them money. Unless one believes that deflation is knocking at the door, this scenario is a raw deal, indeed.

This is not the first time global bond investors have been enamored with negative yields. At the height of the 2008 financial crisis, many flocked to the safety of U.S. Treasuries bills, and as a result, yields dipped below zero temporarily. Fear, panic, and a lack of liquidity all justified this particular move, but today's landscape looks particularly different and better! So why negative yields now?

Decidedly Better

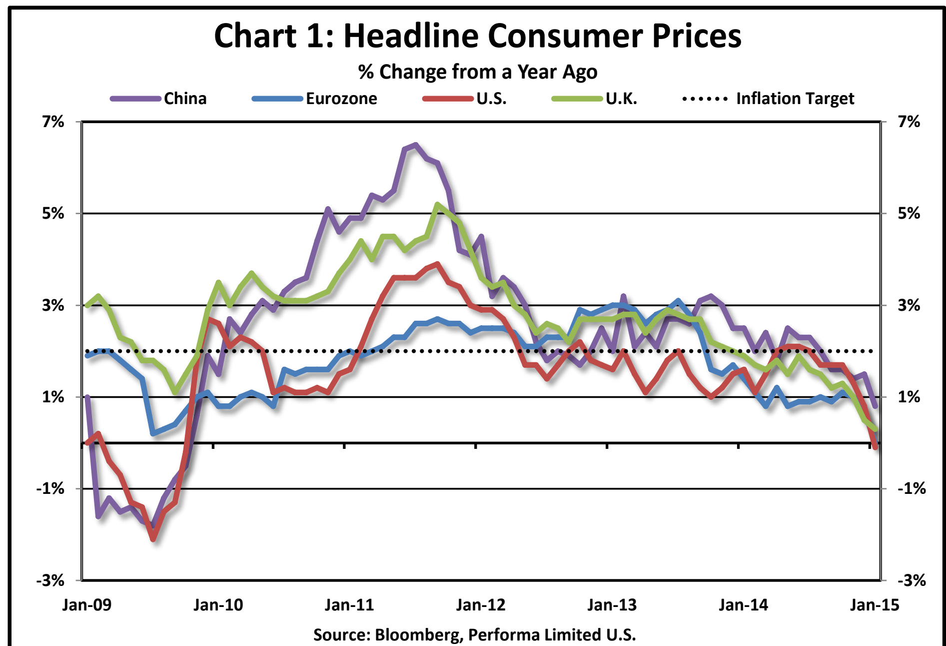
The world is not in crisis mode, so is the culprit really a deflationary environment with accelerating downward price pressures within the Eurozone, or are investors just in love with free Euros? In addressing the latter, traders love to front-run anticipated central bank bond buying programs, as this has proved to be a winning strategy. However, instead of taking profits after the ECB's announcement, investors changed tact and continued to buy!

This atypical response points to deeper concerns – namely, deflation. It is one thing to attempt to make a profit by buying the rumor and selling the fact, but it is entirely different to keep holding bonds that, at some point, have little to no long-term return value.

It is true that headline consumer prices have fallen below the targets set by a myriad of global central bankers (see Chart 1). However, the recent decline in price levels has been largely due to plummeting oil prices, an effect that should prove temporary.

Less Probable

Our view is that the full-blown deflationary spiral in Europe is actually a lower probability today than it had been previously. Economic data over the last 3-4 months do not show a European consumer that is obsessed with hording cash or waiting for prices to fall further before buying. While it might be too early to say "all clear," stabilized consumer prices will help central bankers sleep more easily, and leaves us looking at budding signs of rising prices, and dare we say it, an upward movement in inflation.



The lack of price pressures during this decade gave central bankers the power and the cushion to keep interest rates lower for a longer period. While downside risks still exist in Europe, the U.S. is much further along in its economic recovery. Signs of stronger wage growth are mounting domestically. Recently, announcements of systematic baseline pay increases for hourly workers at Walmart and other companies point to a labor market that is healing nicely. Income boosts will filter through the economy and provide the backdrop and confidence for the Fed to raise short-term interest rates as early as this summer. As for the negative yields, avoidance is the best course of action, as they typically do not stay negative for long.

The Macro View

The U.S. economy continues to expand at a moderate pace. Activity looks to have fared much better this winter compared to the dramatic weather induced slowdown we experienced in 2014. With springtime just around the corner, labor market momentum continues, while price pressures remain relatively subdued. That said, we are starting to see some signs that wage pressures are building, an outcome that has been missing during the current recovery.

European economic data continues to post modest upside surprises. Germany, the economic engine of the Eurozone, grew faster than expectations in the 4th quarter, helping boost overall Eurozone activity. Consumption supported growth, as consumers enjoyed stabilizing labor markets and a boost to real disposable income from lower gas prices. In Britain, the pace of economic expansion declined in the 4th quarter, as construction and manufacturing activity slowed. We remain encouraged by further improvements in the U.K. labor market and solid gains in average weekly household earnings.

Performa Preliminary Intermediate Fixed Income Composite Performance *

	Feb	YTD
Performa Gross	-0.36%	0.81%
Performa Net *	-0.38%	0.76%
BarCap US Int. Gov't/Credit	-0.70%	0.95%

Market Returns

Equities	Feb	YTD
S&P 500	5.74%	2.57%
FTSE World	5.65%	3.90%
Fixed Income		
BarCap Treasury	-1.51%	1.00%
ML High Yield Cash	2.39%	3.09%
BarCap Aggregate	-0.94%	1.14%

* The investment management fee for the Performa Intermediate Fixed Income Composite is 0.30% per annum. Please see the last page for important performance disclosures.

GLOBAL MONETARY POLICY

After announcing its bond purchase program in January, the ECB started buying sovereign bonds on March 9th. The program, at a minimum, will last until September 2016 and will remain in place until officials see inflation on a sustained path back toward 2%. As expected, the Bank of England left policy unchanged in February, continuing with its easy money bias. The FOMC did not have a meeting in February, but Fed Chair Yellen gave her semi-annual testimony. While her remarks left much room for interpretation, she continues to set the table for the eventual liftoff from the zero interest rate policy.

FIXED INCOME MARKETS

After a tremendous rally in January, the bond markets gave most of it back last month creating trading opportunities around macro events such as the Greek elections and U.S. payroll reports, but nothing for investors to hang their hats on over the long-term. The Barclays Capital Aggregate Index, a measure of the broad investment-grade bond market, fell almost 1% in February, with year-to-date returns still positive at +1.14%.

Credit

Solid economic data; a constructive finish to first quarter earnings' season; and, a slower than expected new issuance calendar highlighted an improving environment for corporate bonds for the first time in several months. Corporate bonds narrowed their spread to U.S. Treasuries by 13 basis points in February and now yield +1.20% to the benchmark. This spread provided almost 1% of excess returns last month alone, pushing the 2015 total back into positive territory – just over +0.50%.

- Fundamental themes for companies remain solidly in place at the end of the 1st quarter earnings season. According to the JP Morgan JULI index, overall market credit metrics continue gradually deteriorating despite modest revenue and earnings growth.
- Low interest rates continue to inspire companies to increase their debt loads and send proceeds back to shareholders. If opting for higher dividends or share buybacks, many companies are looking at a friendly merger & acquisitions landscape. Top line growth looks significantly stronger after stripping out the effect of weaker commodity and currency prices. We continue to believe that the steady decline in metrics is concerning overall, but markets will remain focused on more macro factors for the near future.
- New bond issues totaled $115 billion for the month. While the total was a good $20 billion higher year/year, it was below market participant estimates. We expect March to be extremely active as merger and acquisition related deals, that many expected last month, finally emerge.

- We remain overweight credit as a substitute for Treasuries and U.S. Agencies in this low yield environment. We continue to reduce overall duration of the corporate portfolio targeting floating rate paper while opportunistically adding longer bullet maturities in order to maintain yield.

Structured Products

The Structured Products sector, like others, had negative returns for February but outperformed duration matched U.S. Treasuries both for the month and since the New Year. While investors were conscious of the Treasury market selloff and its potential implications, they were willing to cautiously increase their holdings. The market consensus anticipates the U.S. Fed holding out for a while longer than previously thought before raising rates and therefore, the entry point is not only better in the sector, but it apparently offers value for longer bonds. While we disagree with the consensus, it certainly helps our current positions.

ABS - The Asset Backed Security market continued to play the role of the tortoise… slow and steady. Supply and demand dynamics were balanced in February and the theme remains constant: shorter maturity, high quality bonds provide a nice alternative to cash and longer maturities, and sub-sectors that are more esoteric fill a hole for the yield challenged buyer. We continue to like the sector and in particular favor the lower volatility former.

CMBS - Commercial Real Estate securities performed nicely against U.S. Treasuries as well. Here, new issuance supply was relatively heavy. Investors continue to differentiate between different types and quality of collateral pools and this has led to price tiering amongst new deals. We are seeing a migration away from older collateral into the new, longer maturity bonds. While this normally is activity seen throughout the hedge fund crowd (fast money), we are seeing typical buy and hold buyers tagging along. While some in the market believe this puts bonds in stronger and deeper pockets, we take the other view that it signals an overextended reach for yield and a red flag. We continue to favor slightly shorter maturity and the highest quality bonds in the sector, and will avoid credit sensitive areas until valuations are driven by fundamentals and not excessive yield desires.

MBS - The Residential Real Estate market bounced back last month, reversing January's poor relative performance. The U.S. Fed mentioned recently that they may slow down the reinvestment of mortgage proceeds they receive from their vast holdings. This would be a negative for the mortgage market in terms of slowing demand, however, like other Structured Product sectors, buyers seem more enamored with overall dovish sentiment on the path of Fed's interest rate increases.

High Yield

After a slow start to the year the High Yield market had an impressive February as oil prices stabilized and geopolitical concerns abated. The Merrill Lynch Cash Pay High Yield Index returned 2.39%, a particularly impressive outcome given the significant backup in rates that occurred throughout the month. After months of detracting from performance, the energy sub-sector rebounded in February, outperforming the index by more than 3%.

The Performa High Yield Composite returned 2.27%, slightly underperforming the benchmark. A large cash position in a rising market hurt overall performance, while security selection in the metals and mining and finance sectors contributed positively. We continue to take profits in names that have outperformed the broader index and redeploying capital to names where we see better relative value.

EQUITIES

The equity markets turned positive in February. The S&P 500 index registered a monthly gain of 5.75%, the biggest monthly return since October 2011. Against a backdrop of low interest rates, equities remain a favored asset class for many investors. While revenue and earnings growth rates are slowing (see Credit section), the attraction of dividend yields has been a major catalyst for stocks.

After negatively affecting the stock markets in January, oil prices stabilized considerably in February. Lower prices at the gas pump are beginning to trigger an increase in consumer spending and a longer perceived glide path to the Fed's impending change in monetary policy leaves equity investors on the bullish side. Strong January employment numbers were also positive for stocks, although tempered slightly by slower GDP growth estimates from the last quarter of 2014. Any further declines in U.S. economic growth rates in the coming quarters would be a cause for market concern.

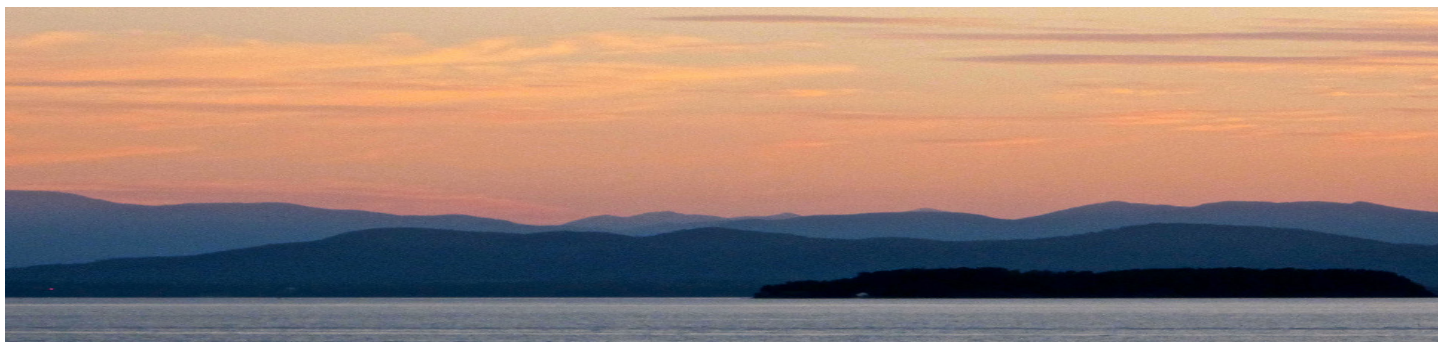
Equities have been one of the strongest performing asset classes this year as all three major U.S. stock indices set record highs in February. Consumer discretionary and technology stocks led the pack; energy shares rebounded nicely; and, utility stocks continued to lag due to their interest rate sensitivity. While equities are still a preferred asset class, the market does appear to have a slightly nervous bullish edge to it.

ASSET ALLOCATION

After a stellar performance in January, fixed income markets reversed course in February and volatility remained elevated. In total, the back up in yields reminded fixed income investors of the pain inflicted by higher rates.

Throughout the month commodity markets stabilized, which filtered through to the equity markets. U.S. markets rebounded nicely in February, reaching new all-time highs supported as mentioned above. However, as noted in our 2015 outlook, European markets have mounted more impressive price gains after the ECB's announcement of a large-scale bond purchase program and Greece's problems received a quick kick down the road.

Capital preservation remains our primary focus as we continue to implement strategies to mitigate client interest rate risk, while leaving enough flexibility to opportunistically add exposure when value presents itself.



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We are 100% employee-owned and currently manage over $2 billion in assets worldwide. Our Investment Philosophy is value driven and long-term in nature. Whether approaching asset allocation or fixed income, our ability to be nimble, contrarian and decisive sets us apart from our peers and promotes capital preservation.

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