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Monthly Market Perspective

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Performa is an independent, employee-owned investment management firm, founded in 1992. We combine more than 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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Monthly Spotlight: Who Cares? It Is Just a Little Inflation

While most people in the developed world spend little time dissecting the inflation story, those in finance have a more acute focus. Consumers certainly can point out what costs more today than in the past, but in many cases, they may substitute chicken breasts for steaks and leave it at that.

Market participants, on the other hand, closely follow the tea leaves of price changes to extrapolate the value of a U.S. dollar (or Euro) down the road. High inflation takes a hefty bite out of investment returns and individuals' purchasing power, while deflation can choke economic growth as wages fall and consumer spending retrenches.

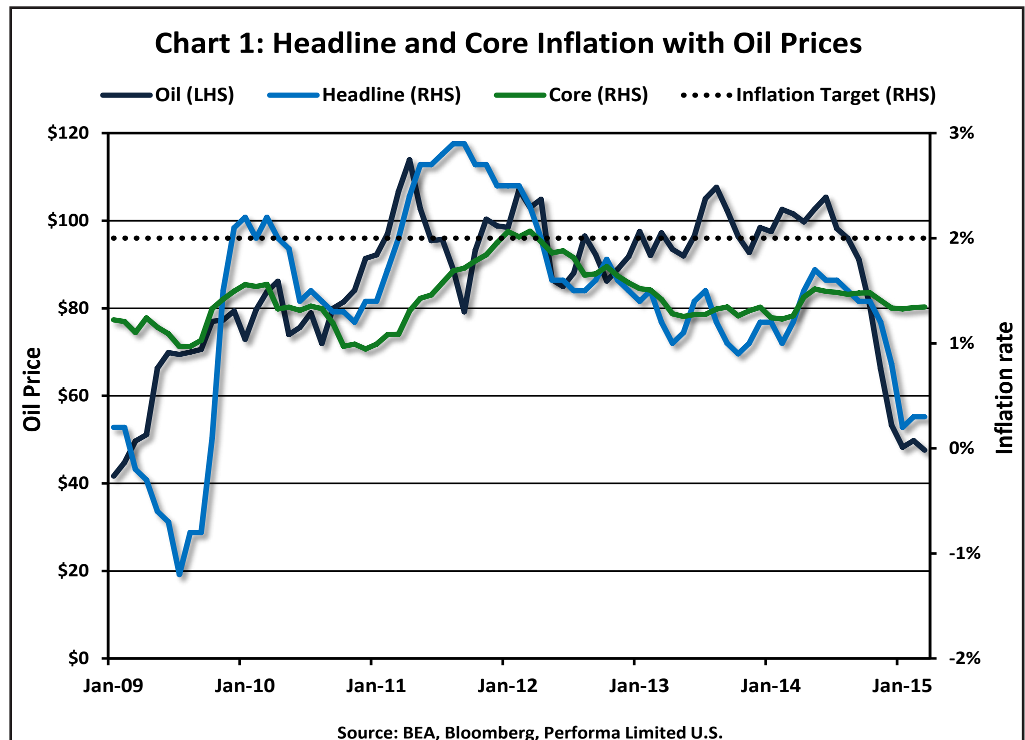
Mindful of the past, modern day central bankers typically set monetary policy with a 2% inflation target in mind. Ultimately, inflation is a vital factor in the decision making process for investors, consumers, and policy makers alike.

Since the Crisis

Low interest rates with muted inflation have prevailed since the 2008 financial crisis. Zero interest rate policies and other unconventional moves by governments and bankers have done little to push inflation above their 2% targets (see Chart 1 on page two).

Since most policy moves over the past six years have not accomplished their goal – higher economic growth and higher prices – most central banks, including the U.S. Federal Reserve, have kept short-term interest rates lower for longer than anyone imagined.

Winds of Change



Continued improvement in the U.S. labor market has been a bright spot. Unemployment has dropped from over 10% in 2009 to 5.5% – normally a sign of a healthy economy and broader inflationary pressures. However, many economists, bankers, and others have discounted the recent improvement in the labor market. Their rationale is that shrinking labor supply actually overstates the fall in unemployment because many people have given up on their job searches. This group of people, supposedly, will resume their search if salaries rise, which will dampen future wage inflation.

So how much lower can the unemployment rate go before we see rising wages? Where did all of those workers go, and when are they going to resume their job searches? While economists have struggled with explanations and answers, we believe that the anecdotal evidence is mounting and deserves attention.

Many states in the U.S. increased minimum wages starting in 2015. Coincidentally, a few large retail and restaurant chains announced significant lower-level wage hikes (much higher than minimum wage) earlier this year. Some companies were quick to conform and others will have to follow suit to remain competitive. We view both outcomes as a new, higher floor for national wages at the lower rung. Coupled with labor shortages in various sectors, these wage increases help to gather momentum for inflation. While rising pay is not the sole factor behind inflation, it certainly aids higher consumption and fuels broader price increases.

Home prices are also rising. Yes, home prices are well off the bottom, but it is the cost of renting that might cause sticker shock. We have written about changing demographics and lower home ownership rates in the past, and rising rents are the result. High rental costs push people to become roommates, co-inhabit, or marry. Higher household formations usually lead to babies, tempering the declining birthrate, a trend that has been in place since 2009. It is not hard to see the positive implications for consumption due to this demographic stabilization and its future inflationary effect. As usual, it is all about the kids!

Lastly, let us pause to point out the elephant in the room – six years of highly inflationary monetary policy. The dynamics of these policies will play out in the long-run, with potentially severe consequences for inflation if misshandled by policy makers. In the more immediate future, if our view of the job market and rising wages proves correct and the base effects of last year's oil price declines wear off, the Fed will increase short-term interest rates – potentially catching some market participants off guard.

The Macro View

Economic growth in the U.S. slowed to a crawl in the first quarter of 2015. Exports struggled, hurt by a strong U.S. dollar, business investment sunk on the heels of falling oil prices, while consumption was tempered by harsh winter weather. The markets will look to the April employment report (released on May 8th) for confirmation that the labor market remains on solid footing and a second quarter economic rebound lies ahead.

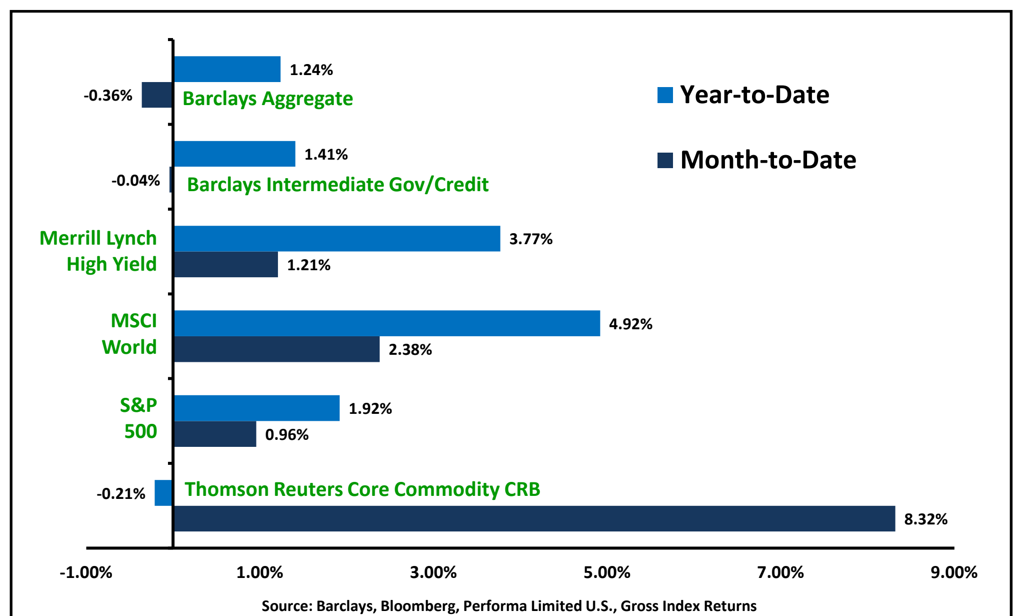
First quarter economic growth in the United Kingdom also missed market expectations. While modestly disappointing, the 0.3% growth rate marked the ninth consecutive quarter of economic expansion. Our outlook for the second quarter remains positive as improving labor market dynamics and trending consumption should support economic activity. Meanwhile, the Eurozone economy continues to show signs of life as fears of deflation dissipate. Trends in Germany, far and away the biggest economy in the Eurozone, remain positive and leave us constructive on the region as a whole.

Economic signals out of China suggest a further slowdown in economic activity, making their 7.0% growth target look more like an ambition rather than a floor. Officials have taken initial steps to support growth, and we expect further action if data continues to disappoint.

Accommodative and glacial are two choice words to describe global monetary policy. The easy money game is in full swing internationally. The yield on 10-year German bonds almost turned negative as investors scrambled to front run the ECB. Meanwhile, the Federal Reserve is working hard to reshape market expectations. Their goal is to convince participants that every Fed meeting is live, i.e. if the data is strong enough a rate hike can happen at any meeting.

Asset Class Overview

After assuming a rather cautious tone in March, investor sentiment shifted in April as risk assets outperformed. The MSCI World Index outpaced domestic equities in April, more than doubling S&P 500 returns for the year. Meanwhile, the Thomson Reuters Core Commodity CRB Index mounted an impressive rally during the month, returning more than 8.0%, as oil rebounded approaching $60 a barrel. Despite experiencing decent inflows throughout the month, investment grade fixed income markets experienced negative returns. The Barclays Capital Aggregate Index, a measure of the broad investment grade bond market, returned negative 0.36% for the month, as year-to-date returns slipped. That said April wasn't all bad news for the bond market; the High Yield sector had another solid month as year-to-date returns are quickly approaching 4.0%.



The Markets

Credit

A solid tone to initial earnings reports, combined with higher overall rates, and a lack of supply early in the month created a solid back drop for the corporate credit market. The spread between credit and U.S. Treasuries tightened in April, as corporate bond yields are now 1.22% higher than their benchmark. For the month credit produced 0.17% of excess return over duration matched Treasuries, bringing the year-to-date total excess return to 0.35%.

- The primary market was characteristically muted early in the month with companies announcing first quarter earnings. As we entered the last week in April, rates moved significantly higher inspiring corporations and bankers to come to market more aggressively. Primary issuance beat market expectations again, with almost $110 billion of new supply in April ($500 billion for the year).
- As of month end, a majority of the S&P 500 has reported with about 150 names left to report in May. General themes remain in place as top line numbers continue to disappoint while equity friendly behavior benefits the bottom line. The mergers and acquisition rumor mill remains active as companies exit earnings season.
- 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 product market had a nice month in April, finishing with positive absolute returns as well as a solid excess return versus their duration matched U.S. Treasury hedges, according to the Barclays Capital Aggregate Index. Trade flows were choppy, but overall investors were comfortable with the supply and used the sector to add incremental portfolio yield in an uncertain macro environment.

ABS - Supply in the Asset Backed Security market was robust throughout the month. Investors were undeterred by the heavy supply, as demand for cash substitutes was unwavering. Demand was so robust that for the first time in a long while we saw credit spreads turn negative to their pricing curves! The student loan sub-sector is a source of modest concern, as Moody's put certain bonds on downgrade watch. The sub-sector suffered meaningful price declines and is not a space we typically invest in.

CMBS - Despite a slightly negative total return, the Commercial Mortgage Backed Securities sector outperformed Treasuries for the month. Liquidity was difficult to attain at times and trading was somewhat opaque in the secondary market. We did not look to add materially in April, but continue to hold strong collateral stories where the bonds offer positive risk adjusted returns relative to other sectors.

MBS - Mortgage Backed Securities, particularly those backed by U.S. Agencies, had a solid month in April. The backup in interest rates not only indicated a potential slowdown for borrower prepayments, but also provided a more positive yield profile that attracted several types of investors to the market. The sector still has a negative relative return versus U.S. Treasuries year-to-date and the month-to-month volatility keeps us largely on the sidelines as we see better value in other sectors of the structured products market.

High Yield

After modest losses in March, the High Yield market rebounded nicely in April, supported by gains in the energy sector. For the month the Merrill Lynch U.S. High Yield Cash Pay Index returned a healthy 1.21% in April (3.77% year-to-date) easily outpacing domestic equity markets.

For the month, Performa High Yield investors experienced a positive 1.11% return, lagging the benchmark by 10 basis points. The underperformance was attributable to a large cash position in a rising market and an underweight to the energy sector. Offsetting some of the negative factors was security selection in the metals and mining, retail, and finance sectors. We continue to look for opportunities to redeploy cash, specifically in undervalued energy names and misunderstood credits in other sectors.

Equities

The bulls were running when April began and stocks extended their gains until the bears took over late it the month. Despite the month-end selloff, most major indices managed to post positive gains in April. For the month the S&P 500 returned 0.96% (1.92% year-to-date) recouping some of the losses experienced in March.

While the investment landscape has not changed dramatically, equity investors now seem more wary than in previous months. Last week's GDP report may be a cause for concern as U.S. economic growth virtually came to standstill in the first quarter. Additionally, first quarter corporate earnings are now being reported. A clear picture is forming whereby earnings growth is approximately 4.5%, but revenue is declining. So corporate profitability and negative revenue growth may portend a more challenging equity environment. Admittedly, some of the factors weighing on growth will prove temporary, but with the Fed waiting in the wings to raise interest rates, and an aging bull market, investors are more cautious.

International markets have been on a tear, clearing outperforming U.S. equity markets. Led by China and the European countries, equity returns have been quite substantial. While the fundamentals in China are strong, a questions remains whether GDP growth can stabilize at the 7% level or will continue to slow. European growth is minimal, but valuation levels had been so low that capital flowed into the markets to take advantage of compelling levels. After such a big run in China and Europe, we are watching both markets closely and monitoring their respective economic outlooks for signals for future equity market direction. Don't get us wrong, there are stocks to buy with attractive valuations and industries that still can flourish, but a measured and diversified approach is required.

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Our capabilities include asset allocation and active fixed income management through diversified mutual funds or separate account portfolios. With offices in the world's largest captive domiciles, including Bermuda, Vermont and South Carolina, we are focused on delivering customized solutions to meet the unique investment objectives and liquidity requirements of our investors.

We are 100% employee-owned and currently manage $2.7 billion in assets worldwide. Our Investment Philosophy is value driven and long-term in nature. Whether approaching asset allocation, fixed income or equities, our ability to be nimble, contrarian and decisive sets us apart from our peers and promotes capital preservation.

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