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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.

IN THIS ISSUE

We Are Going To Err On The Side Of Higher Inflation

In our 2016 Outlook, we discussed how inflation would dethrone the unemployment rate as the most significant economic indicator for U.S. monetary policy. Then, in February, we argued that unconventional policies (both fiscal and monetary) have helped create a shallow but prolonged recovery. Well, last week Federal Reserve Chair Janet Yellen addressed both topics in a highly anticipated speech at the Economic Club of New York.

She communicated a clear message: Fed policy is attempting to err on the side of higher inflation and, in doing so, will likely prolong the life of the current credit cycle. The entire speech was designed to bring market participant and Fed views closer together, while simultaneously attempting to jawbone inflation expectations higher – or at least anchor them at current levels. The speech was a turnabout from recent Fed speak and decidedly more dovish considering that the Fed began hiking rates just three months ago.

Throughout her speech, Chair Yellen highlighted the downside (and to a lesser degree, the upside) risks to her economic outlook. She also downplayed the recent improvement in inflation data, indicating the Fed does not expect inflation to achieve its 2% target until 2017 or 2018. In effect, barring a large negative growth shock, the U.S. economy should continue its gradual improvement and monetary policy will contain a bias towards allowing inflation to overshoot the Fed's 2% target.

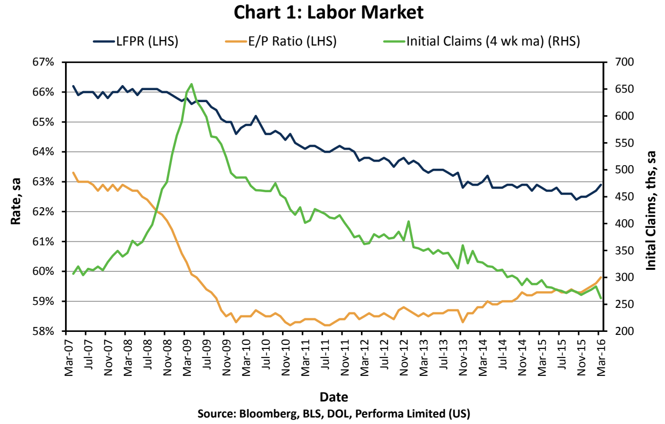
So what transpired since the December FOMC meeting to turn Chair Yellen decidedly more dovish?

In general, Yellen is reacting to the poor start of the year from both a market as well as an international economic growth perspective. The early first quarter swoon in oil and other risk asset prices, plus lower growth numbers from a transitioning Chinese economy, caused the Fed to question their policy stance, rightly or not. The Fed has adopted the role of global risk manager and is taking its new self-imposed responsibilities quite seriously.

Just how much are international developments playing into the Fed's thinking? Let's take a look at some facts that pertain to the Fed's dual mandate of full employment and 2% inflation.

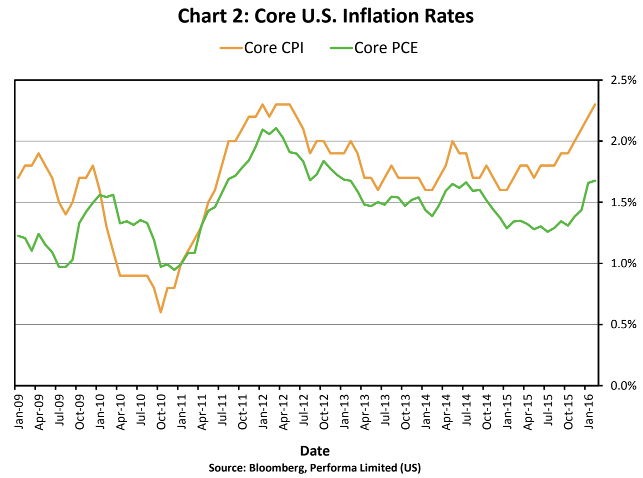
The U.S. Labor Market

Since December, the U.S. labor market has continued to improve as evidenced by impressive job creation (225k per month average since December), historically low levels of initial jobless claims, and increases in both the labor force participation rate (LFPR) and employment to population ratio (E/P Ratio), see Chart 1. In short, the labor market has made solid gains since December – that is undeniable.



U.S. Inflation

The consumer price index (CPI) and the personal consumption expenditure (PCE), the two most widely followed measures of U.S. inflation, have both improved in recent months, with core rates (which strip out the volatile food and energy components) posting multiyear highs in February, see Chart 2.



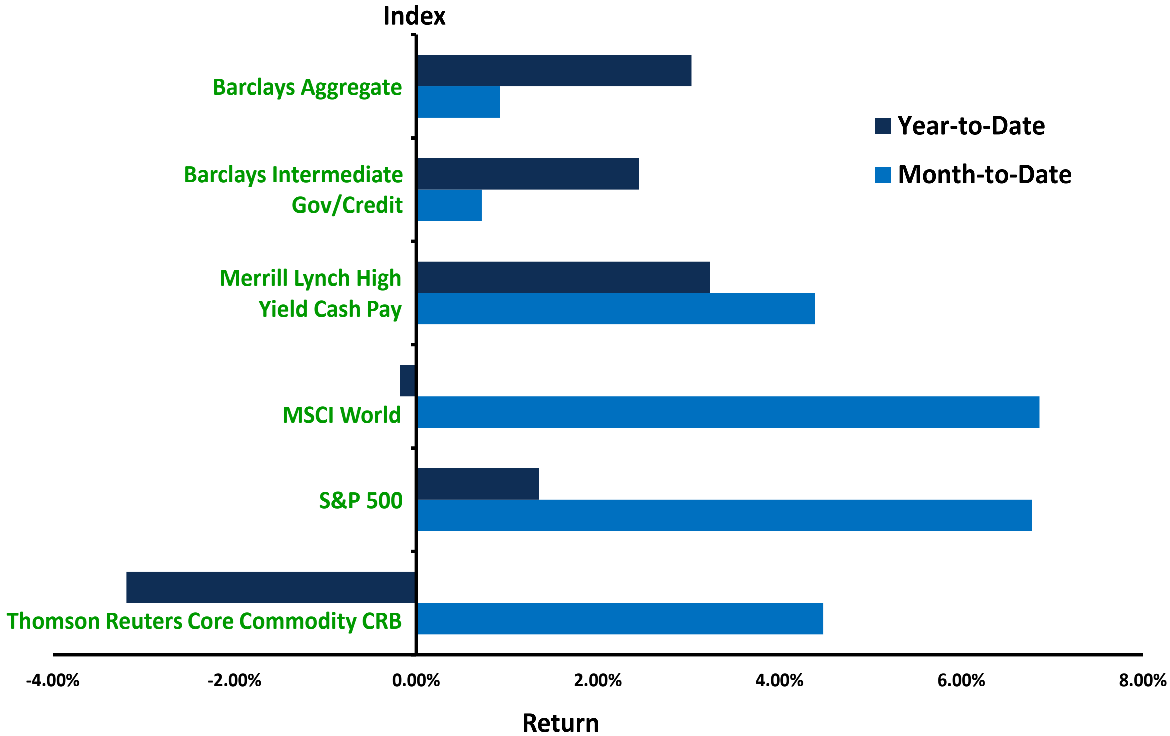
In addition, the Cleveland Fed tracks two modified versions of CPI that are less sensitive to extreme data points, both measures are north of 2.5% and have been trending higher for months. Of course, the recent uptick in inflation measures could prove to be a head fake as Chair Yellen fears, but the trend seems to be higher at this juncture.

To be sure, the China situation warrants careful consideration, but to use international economic developments to heavily discount improvements made domestically suggests that not only is the Fed comfortable with monetary policy being behind the curve, it ***WANTS*** to be behind the curve. And guess what? She got the exact market reaction she was looking for. The U.S. dollar weakened, risk assets rallied, volatility fell, and perhaps most importantly, inflation expectations increased as breakeven rates rose.

The transition period to higher rates has only just begun and will likely last a lot longer than even the Fed initially thought. Keenly aware of the bad monetary policy that turned a recession into the Great Depression, Yellen is doing her best to extend the current business cycle while letting inflation measures guide policy. We note that waiting too long to tighten policy can cause a glut of economic problems. The most obvious is inflation, but perhaps more important are the growing financial market imbalances that have historically resulted in extreme corrections.

Asset Class Overview

Uneventful would be an absolutely horrendous adjective to use to describe what transpired in financial markets during the first quarter of 2016, but you'd never know it looking at year-to-date performance. Financial asset prices mounted an impressive March rally to close out the first quarter aided by easy global monetary policy, rising oil prices, and diminished contagion fears stemming from China. The MSCI World Index, a measure of developed world equity markets, returned a sturdy 6.86% for the month, erasing almost all of the year-to-date losses. Meanwhile, the U.S. equity markets managed to turn positive for the year after returning 6.78% during March (1.35% year-to-date). Fixed income markets enjoyed another month of positive performance, with the high yield bond market leading the way. The high yield market returned a handsome 4.39% last month, according to the Merrill Lynch U.S. Cash Pay High Yield Index, as year-to-date returns increased to 3.23%. The Barclays Aggregate Index, a measure of the broad investment grade bond universe, returned a more modest 0.92% in March (3.03% year-to-date).



Source: Barclays, Bloomberg, Performa Limited U.S., Gross Index Returns

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ABOUT PERFORMA

Combining our extensive knowledge of the insurance industry with the institutional expertise of our investment team, Performa has been managing assets on behalf of captive and other insurance clients for over 20 years.

Our capabilities include asset allocation, active fixed income and equity 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 nearly $3 billion in assets worldwide representing more than 50 clients. 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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