2016 Market Outlook

January 19, 2016

A Year In Review - 2015

2015 was all about the second set. General complacency and relatively low volatility made the first seven months of 2015 rather uneventful – that all changed in August. A surprise Chinese currency devaluation sent shock waves throughout global financial markets. Commodities, equities, high yield debt, and anything related to emerging markets all succumbed to heavy selling pressure. Government bond yields across the developed world benefited from the ensuing flight-to-quality, as global growth fears dominated investor sentiment.

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The market volatility tested the resolve of the Federal Reserve who ignored its data dependent nature and decided to play global risk manager, voting to delay liftoff at their September meeting, leaving interest rates unchanged at zero. Markets eventually rebounded as promises of additional central bank stimulus and the Fed's pause temporarily quelled fears. The unease resumed in late December as commodities (highlighted by oil) resumed their decline and further fallout within Emerging Markets were coupled with the Federal Reserve delivering the rate hike they should have provided in the early fall.

For the year, the bellwether U.S. equity markets manage to eke out modest gains, while foreign markets were not so fortunate. 2015 was another lackluster year for the broad investment grade bond market, which managed only modest gains. While the high yield bond market suffered from its high exposure to the poorly performing oil and gas production sector, it underperformed both investment grade bonds and equity markets – an unusual occurrence indeed. High yield Exchange Trade Funds (ETFs) significantly underperformed High yield Indices due to heavy investor selling and an overweight to the energy sector.

Below we discuss a few of the key themes that contributed to the late 2015 fireworks and provide a look ahead to 2016.

Asset Class Performance (Source: Barclays, Bloomberg, Performa Limited U.S., Gross Index Returns)

Index	Month-to-Date	Year-to-Date
Barclays Aggregate	-0.32%	0.55%
Barclays Intermediate Gov/Credit	-0.33%	1.07%
Merrill Lynch High Yield Cash Pay	-2.55%	-4.55%
MSCI World	-1.72%	-0.25%
S&P 500	-1.59%	1.38%
Thomson Reuters Core Commodity CRB	-3.50%	-23.40%

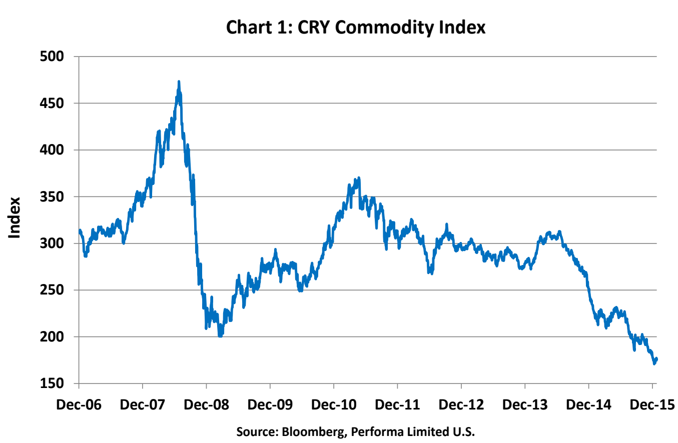
The Year The Fed Finally Moved

After seven years of maintaining a zero interest rate policy, the Federal Reserve finally increased short-term interest rates in December. What finally brought the Fed out of its slumber? The cumulative progress made in labor markets since the end of the 2008 financial crisis; reasonable confidence that inflation will move back towards their 2% target; and, calmer financial markets were the stated reasons.

After the decision to increase rates, investors immediately began looking for clues on the pace of ensuing rate hikes over the next few years. In its latest forecast (published in December 2015), the Fed is expecting four rate hikes in 2016. The market has only priced in two. This deviation between the Fed and bond traders warrants significant attention in the New Year.

Commodity Rout

Recovering from the 2014 damage, commodities staged a modest comeback during the first half of 2015. Triggered by the Chinese Yuan devaluation in August, the healing quickly vanished and there seemed to be no sustainable floor under commodity prices for the remainder of the year. The fear of contagion from a Chinese growth slowdown sent the CRY Index, a broadly diversified commodity index, below levels not reached since the peak of the financial crisis (see Chart 1).



Previously insatiable Chinese demand for steel and other products that rely on raw commodities (such as oil and metals) slowed significantly causing gridlock in commodity markets. Emerging market currencies declined in sympathy and some economies fell back into recession, as much of their national economic base relies on revenue from commodity production. Even developed countries (like Canada) were not immune, as mining and oil companies were forced to slash jobs and capital investment plans. The lack of clarity on the demand side and a clear overhang of supply portends the continued downdraft seen in early 2016.

2016 Themes

U.S. Economics - Steady As She Goes

We expect moderate growth in 2016, supported, yet again, by consumer spending from lower gasoline prices, improving labor market dynamics, and higher pay. Risk of the economy overheating is fairly limited given persistent global headwinds and ongoing uncertainty in the commodity space. While the U.S. manufacturing sector is still in the dulldrums, the service sector (80% of domestic earnings) should continue its expansion through 2016 as a tightening labor market results in growing demand.

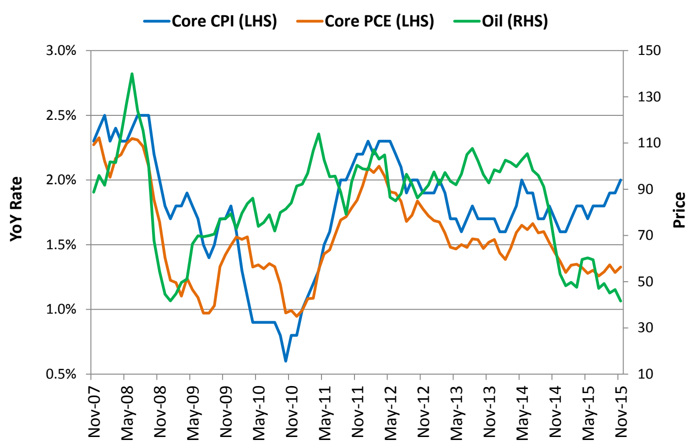
In 2015, the U.S. consumer enjoyed another year of healthy job growth, rising earnings, and low gas prices. Sentiment measures remained elevated, but consumers have not fully turned on the spending spigot as they chose to save a bit more than usual.

However, higher savings rates today support consumption down the road. In addition, the decision to save some of the windfall from lower gas prices is a prudent one and might indicate a shift in consumer psyche as a result of lessons learn during the 2008 financial crisis [Click Here for more detail in our December Monthly Market Perspective]. While broader measures of retail sales may be considered lackluster, that was certainly not the case for new car purchases. Auto sales beat expectations by a wide margin and early data from the holiday shopping season suggest a solid season as we head into the New Year.

Orange Is The New Black - Inflation Now Trumps The Unemployment Rate

For years U.S. monetary policy was closely tied to the healing of the labor market, making the monthly unemployment rate the most followed economic indicator. Now that the Fed has entered a new rate hiking era, inflation will take over as the most significant economic indicator in 2016. Should inflation surprise to the upside, the Fed will likely hike more aggressively than markets currently anticipate. In the other direction, if inflation remains stubbornly below the Fed's 2% target, it will likely produce fewer rate hikes in 2016 (consistent with market forecasts mentioned earlier).

Chart 2: Inflation and Oil Prices



Source: Bloomberg, Performa Limited U.S.

Inflation should trend higher during 2016. The lagged effect of increased minimum wages from both the public and private sector should produce some visible signs this year. Rental rates continue to rise in most areas and food prices remain high. Additionally, the extremely strong U.S. Dollar is likely close to its local high, which will help commodities stabilize. Once bottoming out, commodity price rebounds will positively impact inflation dynamics. Lastly, previously contained health care costs resulting from the initial Affordable Care Act push are quickly dissipating, pointing to yet another potential increase within inflation statistics as the year progresses.

The Hunger Games, Central Bank Style - Divergence To Convergence in Monetary Policy

Divergent monetary policy, an important theme in 2015, will remain so during 2016. With the European Central Bank, the Bank of Japan, and the Public Bank of China all looking to stimulate sluggish economies, the Federal Reserve is finally beginning to remove accommodation with the Bank of England on a similar, but staggered path. This divergence is warranted as the U.S. economy has been the clear global frontrunner and emergency levels of accommodation should have ended well before last month.

Throughout 2016, foreign central banks will continue employing easy money gimmicks (such as negative interest rates and bond buying programs) to further simulate bank lending and consumption. While the jury may still be out on the effectiveness of such policies, we believe that the marginal benefits ended a few years ago. In fact, in our view, central bankers' continued use of untested policies not only counterintuitively harms economic growth, but also restricts/crowds out potentially more effective government spending stimulus as centralbankers enable lawmakers to sit on the sidelines.

Given the current state of affairs in global monetary policy, it's hard to fully picture the landscape in a year or two. At some point today's global policy divergence will become policy convergence. Central Banks will end their futile folly, in turn making room for increased infrastructure and other government spending to speed the economic healing process or, in some countries, provide enough breathing room for economies to heal naturally and return to using more conventional monetary policy tools. Whether this is a 2016 or 2107 event remains to be seen, but the gap between American and core European interest rates and preference for assets not denominated in Dollars will surely converge.

Global Growth Fears

China remained a wildcard and the source of significant financial market volatility during 2015. Economic growth slowed to below 7% as the country took steps to transition to a service economy. Throughout the year, growing bankruptcies and countless empty cities with vacant high-rises were concerning to say the least. For years, the growth of the Chinese economy was predicated on gobs of infrastructure and building investments and huge population migrations into cities. As that chapter comes to a close, we expect further volatility stemming from the region in 2016. Much of the stress from China continues to affect Emerging Market economies and currencies as described above. Where China's impact is felt directly within developed markets is the Central Bank of China's need to sell their vast holdings of U.S. Treasury bonds when they decide to defend their falling currency. This effectively caps how far U.S. rates can fall in a flight-to-quality scenario.

Crowded Trades

Momentum is a powerful force that can swiftly make the improbable probable. When it's on your side there is no better feeling and when it's working against you the pressure can feel insurmountable. Momentum's impact on financial markets is undeniable.

Probably one of the most remarkable characteristics of financial markets is their uncanny ability to sniff out and punish crowded trades. When all resemblance of balance is lost and sentiment is completely one-sided, markets will quietly begin to turn, and suddenly without notice, momentum will shift leaving some to wonder how a winning trade is now underwater.

Today, markets continue to expect muted rates of inflation for years to come in part due to lower for longer commodity prices. While we agree that the outlook for global inflation remains subdued and it will be hard for U.S. inflation rates to decouple, one should not become complacent. The herd is clearly looking for further downside in commodity sector and muted rates of headline inflation throughout 2016. With sentiment so one-sided, there exist some overlooked opportunities that could benefit with a relatively small upside surprise in prices.

In the New Year investors will begin to focus on markets that dramatically underperformed in 2015. To date, commodity sensitive markets such as high yield, emerging markets, and currencies were completely abandoned by market participants. The tendency has been to extrapolate from a struggling commodities sector, assuming an almost straight line to zero, to the broader market. The result has been fast and indiscriminate selling. While it is still too early to sound the all clear on the commodity rout, it is prudent to begin digging through the rubble.

CONTRIBUTORS

Editor: **Scott Mildrum, MS, Economic & Macro Strategist**

Contributors: **David Kilborn, CFA, CIO and Scott Mildrum, MS**

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CONTACT US

Relationship Management
Hugh Barit
Chairman & CEO
(441) 295-6754
hbarit@performa.bm
25 Church Street, 2nd Floor
Hamilton HM12, Bermuda

Portfolio Management
David T. Kilborn, CFA
CIO & President
(843) 297-4130
dkilborn@performausa.com
14 North Adgers Wharf
Charleston, SC 29401

Relationship Management
John James
Captive and Consultant Relations Mngr.
(802) 540-1752
jjames@performausa.com
3 Main Street Suite 215
Burlington, VT 05401