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Monthly Market Perspective

June 5, 2015

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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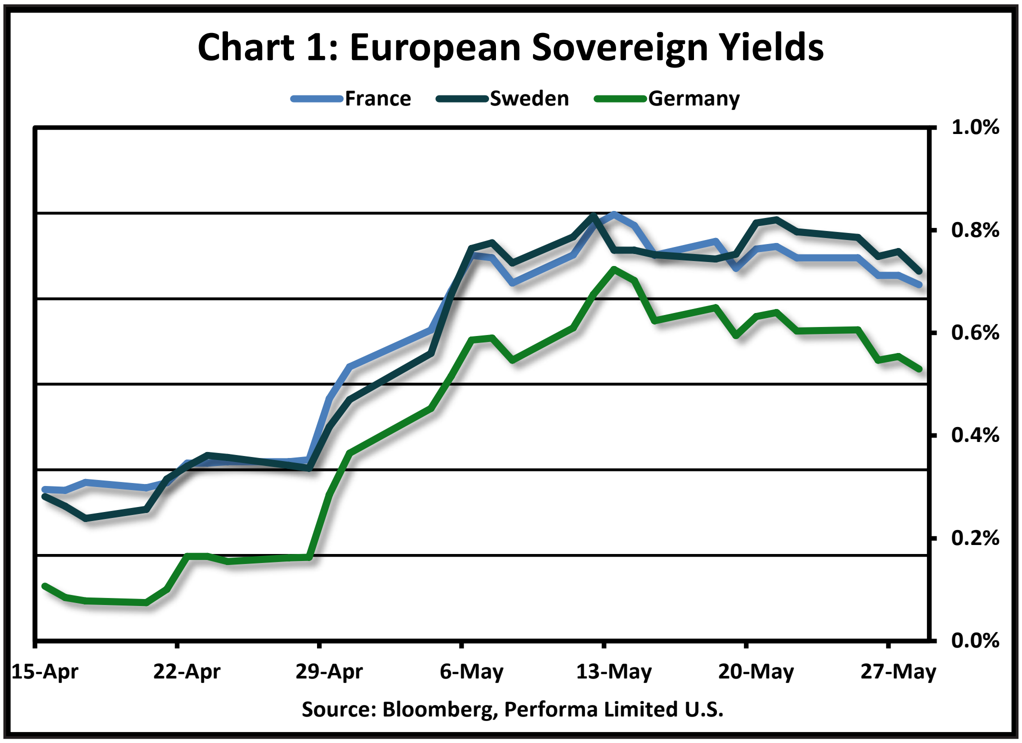
Monthly Spotlight: Mini Pop Goes the Bubble

While it didn't pack as much energy as a supernova, the European sovereign bond market finally exploded in May. Months ago, investors began piling into European bonds in anticipation of the European Central Bank (ECB) launch of a full-scale bond purchase program. To the surprise of many, including ourselves, the buying continued right through the start of the program and European yields hit historic lows by mid-April. Then, suddenly, without a clear catalyst, the buying came to an abrupt halt.

Once the buying stopped, investors reversed course and flooded the market. Yields on the benchmark 10-year German government bond spiked more than 70 basis points in a few short weeks and dragged global yields higher in sympathy. The aggressive bond market selloff serves as the latest reminder of how quickly the door shrinks as the herd rushes for the exit. One-sided trades work - until they don't - and the whiplash is often swift and painful (see Chart 1).

Years of easy money from global central banks has depressed long-term interest rates, inflated asset prices, and perhaps most importantly, displaced traditional investors. With investors crowded out of their usual markets, and the implementation of restrictive financial legislation, liquidity that was once so plentiful within many asset classes has declined considerably. While we try not to sound like a broken record, the lack of liquidity exacerbates market moves in either direction. Bond market volatility over the last few months is a direct result, with the latest bout emanating from the European bond markets during May. We doubt this is the last time we will write about these types of market moves.



The point is not to reminisce about days and years gone by. Wishing for things to return to how they were before the 2008 financial crisis is nothing more than misplaced hope without regard for the perils of that era. Instead, understanding and realizing that central bank policy it is inherently experimental in nature is a more fruitful exercise.

Central bank policy has been compromised in some of the worst economic downturns of the past century: the housing bubble and ensuing 2008 financial crisis, the Great Inflation of the 1960's and early 1970's, and most famously, the Great Depression. We highlight these examples not to place blame on policymakers, but to point out that policies always have unintended consequences. The unknown, unknowns, as the military likes to say, is what worries everyone.

In each of the examples listed above intelligent, well-intended policymakers contributed to massive wealth destruction, considerable job losses, and ample financial hardship. Policymakers are no different today than they were 100-years ago. Sure, they have supremely powerful mega-computers, more sophisticated economic models, and increased statistical prowess, not to mention hindsight from prior mistakes. But at the end of the day, they are still humans doing their best with the limited information they have.

That said, doing one's best is quite different from actually having the answer. Central bankers don't have a magic model, or some profound insight that is incomprehensible to other less sophisticated humans. Policies put in place over the last 7 years will have unintended consequences down the road. The most recent flare-up in European bond markets only serves as the latest reminder of the fragility of today's overdosed financial markets.

The Macro View

For the second year in a row the U.S. economy is off to a slow start, contracting 0.7% in the first quarter of 2015, revised down from the initially reported 0.2% expansion. The downward revision was not a surprise, as the U.S. trade deficit (driven by the U.S. Dollar's surge) swelled to its widest level since 2008 which detracted the most from economic growth in 30 years. Looking forward, the employment report on June 5th will help shape expectations for a second quarter rebound if it reveals a quicker pace of hiring.

In the United Kingdom, the second release of first quarter economic growth confirmed only modest expansion. While economic activity in the first quarter underwhelmed, further improvement in Britain's labor market and rising purchasing power should support consumption going forward. Meanwhile, in the Eurozone, negotiations between Greece and its creditors dominated news flows. Away from the Greek headlines, economic activity continues to be supported by domestic demand, while deflation fears have been quelled by recent, improving, inflation data.

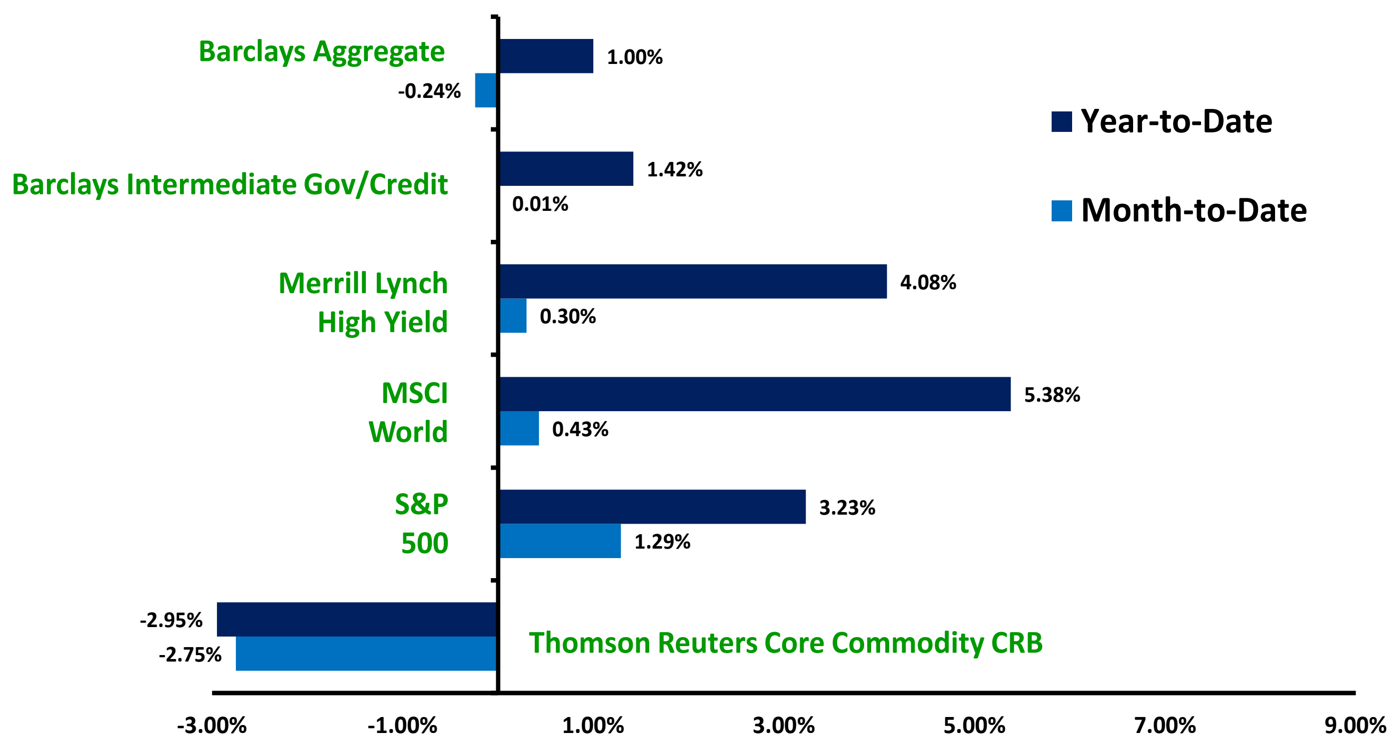
China remains a source of uncertainty in the global economy. Economic data continues to miss market expectations, increasing speculation that officials will have to do more to stimulate the slowing Chinese economy.

Global Monetary Policy

Disappointing U.S. economic data has dramatically reduced the probability that the Federal Reserve will increase interest rates at the June meeting, delaying liftoff until the second half of 2015. Despite recent chatter, we expect Draghi to reiterate that the ECB remains fully committed to their bond purchase program that is scheduled to last, at least, until September 2016. The BOE left policy unchanged and remains committed to accommodative policy, doing little to shift market expectations.

Asset Class Overview

Risk assets enjoyed another month of positive performance, as equities and high yield posted solid gains. Domestic equity markets played some catchup during May, as returns outpaced global equities for the month. That said, for 2015, domestic returns still lag global returns by more than 2%. Investment grade fixed income markets sold-off sharply in early May (see Monthly Spotlight section above). The Barclays Aggregate Index, a measure of the broad investment grade bond market, returned negative 0.24% for the month, as year-to-date returns now stand at positive 1%. After an impressive April, commodity prices took it on the chin in May, giving back some the outsized gains from the prior month.



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

The Markets

Credit

The Barclays Corporate Credit Index was weaker in May and yields were 5 basis points higher, to 1.27% over government bonds. Excess returns dropped 0.30% during the month and eroded most of the 2015 gains.

- May set a new record for monthly supply with over $150 billion in new issuance, beating January's $130 billion. Increasing interest rate volatility and the summer doldrums inspired potential issuers (and bankers) to move.
- Credit metrics are showing debt issuance fatigue. Top line revenue growth declined marginally in the first quarter (largely attributable to companies in the commodity space) while earnings followed a similar trend. The continual selling of bonds (instead of using large cash stockpiles) to fund share buy-backs and dividends favor equity investors.
- We continue to believe high grade corporate bonds provide a significant, intermediate term opportunity for excess return relative to Treasuries. As overall rates move higher, we expect new issuance to slow relative to the last few years. Secondarily, higher overall rates will likely inspire yield sensitive participants to remain active in the market. While the late cycle earnings data and leverage behavior concerns us, the current fundamental stability can persist and even improve given the economic backdrop.

Structured Products

The Structured Product market had a solid month in May outperforming both their duration matched Treasury hedges and the overall Barclays Aggregate Index. Supply remained steady and investors continued to stay involved finding various pockets of value in the sector.

ABS - The Asset Backed Securities sector was able to produce positive total and excess returns over Treasuries for the month. Primary supply was heavy to start the month, but slowed considerably into Memorial Day. The strength in the market belied a softness creeping into the ABS sector. Bucking the recent trend, dealers added a considerable amount of bonds to their inventory even while yield spreads on shorter bonds began to move higher. We view this as a small buying opportunity for one year and less maturities.

CMBS - The Commercial Real Estate market was quiet, but managed positive absolute and relative returns for May. The market should pick up steam in June, however, many analysts have significantly lowered their projected new bond issuance. This brings stability to secondary prices and leads us to believe that the CMBS market should continue to deliver solid relative value compared to other risk adjusted sectors, specifically in floating rate coupon bonds.

MBS - The Residential Mortgage market slightly underperformed on a total return basis, but were able to outpace equivalent Treasury returns. As expected with rising interest rates, new mortgage supply tilted towards purchase loans as opposed to refinancing. The Fed continues to be the major buyer, but banks have recently stepped up as well. Investors and REITS have moved to directional trading based interest rate moves. We are neutral on the sector as we find better value and lower volatility elsewhere.

High Yield

Despite rising interest rates (lower bond prices) the High Yield market posted positive returns for the month of May. Similar to pervious months where the High Yield sector produced positive returns while the broader bond market suffered losses, the negative impact of falling bond prices was more than offset by positive return from income.

The Merrill Lynch U.S. High Yield Cash Pay Index returned 0.30% for the month, and has now returned 4.08% year-to-date. We continue to favor single B's, which outperformed during May, as they provide a yield advantage over double B's, while having less interest rate risk. In addition to a core allocation to B's we are maintaining a cash position to take advantage of volatility and more attractive valuations.

Equities

Looking at recently reported economic statistics, it's clear that the global economy remains stuck in a slow growth phase. While slow economic growth would normally create headwinds for equity markets, continued stimulus from global central banks has worked to propel equity prices higher. Given current (stretched) valuations, meandering economic growth, and the prospect of a Fed interest rate hike, domestic equity investors appear more hesitant.

In one of the more intriguing developments, merger and acquisition (M&A) activity reached record levels this year, and the trend looks likely to continue. In the semiconductor industry in particular, activity has been robust, with Intel buying Altera and Avago buying Broadcom, for an industry record $37 billion. Intense industry competition, market share wars, and the allure of mobile phone technologies have been the trigger for these deals. On the heels of such heavy deal activity, many are beginning to wonder whether it signals an equity market top.

Going forward, we expect market volatility to persist as investors digest shifting market dynamics. Thus, instead of chasing momentum in overvalued stocks, we are carefully picking and choosing our spots to invest in names that trade cheap to the broader market, yet still offer considerable upside appreciation potential. Currently, our equity strategies seek to provide more downside protection while being less volatile than the overall equity market.

Despite the 6-year market run-up, we continue to identify companies' whose stocks look attractive on many valuation measures. Corporate America came through first quarter earnings season unscathed, but both revenue and earnings growth have slowed considerably. We will be watching closely for signs as to how companies will fare through the remainder of 2015.

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ABOUT PERFORMA

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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 $2.8 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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