While U.S. economic growth continues to be persistently slow, including two quarters of negative economic growth during the recent post-financial crisis period, we have managed to avoid a full-fledged economic recession. In contrast, Europe has slipped into recession three times since 2009 and Japan has had negative economic growth in 11 out of 24 quarters since 2009.

A WILD RIDE

From January 2nd through February 10th, the S&P 500 dropped a dramatic 10.5%, and then reversed sharply, rising nearly 13%, to end the quarter with a net gain. China, Japan, and the European markets followed a similar trajectory, falling sharply and reversing, but **did not fully recover by the end of the quarter.**

FIRST QUARTER 2016 RETURNS

In the U.S., first quarter returns ranged from +3.8% for the S&P MidCap Index to -2.4% for the NASDAQ Composite, with the S&P 500 Index generating a total return of +1.4%. The MSCI All-Country World Index (MSCI ACWI) returns, for dollar-based investors, were +0.5% before foreign dividend taxes, and -0.1% net of these foreign taxes.

Bond returns, as measured by the Barclays Government/Credit Intermediate Bond Index, outpaced stock returns, with a 2.5% return for the quarter. This brought the index's twelve month return into positive territory with a 2.1% return. U.S. stocks were remarkably divergent on a sector by sector basis, with the two most bond-like sectors, Telecommunications and Utilities, returning 16.6% and 15.6% respectively, while Health Care stocks lost 5.5% and Financials dropped 5.1%.

The volatility of the last few months can be traced to four major issues which are all interconnected: 1) sluggish worldwide economic growth 2) a change in the composition of China's economic growth 3) the fall in global energy prices, and 4) the differing pace of the U.S. economic recovery, as compared to the rest of the world.

The post-financial crisis expansionary monetary policies of the U.S. Federal Reserve, the European Central Bank and the Bank of Japan averted prolonged recessions in the developed market economies. These policies also raised international liquidity levels, drove down worldwide interest rates, and stimulated developing market economies.

This set up a potential conflict between developed market economic policies and emerging market economies, so that when the U.S. Federal Reserve announced its plans to begin tapering, or winding down, its quantitative easing, the ensuing jump in U.S. interest rates led to tighter financial conditions in emerging markets.

This tightening of financial conditions in emerging markets was exacerbated by decreasing demand for commodity imports by China. Since 2012, as China's government attempted to increase the percentage of consumption spending — relative to investment spending — within its economy, China's demand for commodities such as oil, copper, and cement decreased. China ranks as the world's second largest importer, so this decline in China's commodity demand led to falling worldwide commodity prices, including particularly sharp declines in the price of oil.

> In a very slow economic environment, where interest rates are already near zero, the decline in headline inflation — as a result of falling oil prices — actually RAISES inflation-adjusted (real) interest rates.

SIGNALS AND NOISE

Falling oil prices have historically signaled declining worldwide demand for oil, but may also be driven by a significant increase in supply. In this post-financial crisis, extremely slow growth, near zero-interest-rate environment, investors are challenged to disentangle what part of the decline in oil prices is due to falling demand, and what part to increased supply. A second challenge, which became apparent over the last six months, is determining whether falling oil prices are a net benefit or a net negative for oil importing countries.

Historically, falling oil prices have been viewed as a positive for consumers: the price of gas declines, budget-constrained consumers are able to use the savings for other consumption, and businesses using oil as an input see lower costs.

This results in a tightening of financial conditions, making investment less attractive, and further slowing economic growth. Under these conditions, the effect of the drop in inflation on real interest rates, as a result of falling oil prices, overwhelms the positive effect on consumption.

This restraining effect on economic growth began to appear in the second half of 2015, as economic indicators were showing widespread signs of weakness, and financial conditions were tightening, even as the European Central Bank and the Bank of Japan extended their stimulative policies.

In the context of a U.S. economy which is stronger, as compared to the rest of the developed countries, the U.S. Federal Reserve has been signaling for over two years that it would begin to decrease monetary stimulus. The Fed had foregone raising the Federal Funds rate in September, when worldwide financial markets were falling sharply on concerns about Chinese growth and fears that the Chinese de-linking of the renminbi from the U.S. dollar would ignite a round of destructive competitive exchange rate devaluations.

After U.S. stock markets rallied during the Fourth Quarter, the Fed apparently assessed conditions as stable enough to begin its long-signaled move toward policy normalization, and in mid-December, it raised its target for the Federal Funds rate by 0.25%. However, in the words of poet Robert Burns, "The best laid plans o' mice an' men gang aft aglay [go often askew]." Over the next month, the US dollar rose against major currencies, financial conditions in the EuroZone tightened, equity markets fell, stock market volatility increased, and oil prices continued to slide. The recently released minutes of the March Fed meeting indicate that these were not the expected results, and Fed Chair Yellen began to signal that a March or April increase in the target Fed Funds rate was very unlikely. After the Fed reiterated that its "data-dependent" policy decisions would indeed be data-dependent, i.e., that the Fed would not continue to tighten in the face of worldwide declining economic activity, the market began to improve.

VALUATION

Current valuations for U.S., European, and Japanese stocks are neither excessive nor extremely attractive. U.S. economic growth continues to be solid, even if slow. Job creation has been strong, inflation is well-contained, and our positive view on the U.S. economy should support current stock valuations, allowing for growth in line with earnings.

OUTLOOK

During the first quarter, we maintained maximum equity exposure for clients where we have the ability to allocate between stocks and bonds. With monetary policy continuing to be broadly expansionary, U.S. and developed market economic growth solid if slow, and valuations reasonable, we believe the balance of risk and reward favors stocks. We do, however, favor stocks with strong balance sheets and attractive end markets. The welcome recent depreciation of the trade-weighted value of the dollar will put U.S. exports in a more competitive position, which should support exports and U.S. corporate earnings.

There is a significant concern regarding the June 23rd United Kingdom vote on whether the U.K. should leave the European Union. Financial markets are pricing in significant risk and uncertainty about the vote, which would likely reduce British economic growth over the short and long terms. The ongoing U.S. election cycle certainly could disrupt the markets, but there have already been too many surprises to tempt us to base a market call on the election, rather than economic and market fundamentals.

Our forecast for emerging markets is slightly more positive than last quarter. China's slowing growth rate seems to have stabilized, which should reduce commodity-related stresses for emerging markets. The recent stabilization in oil prices should lower anticipated financial stresses for oil-exporting countries.

We acknowledge that further temporary drops in the equity markets may be ahead, but we believe that one year from now, investors who calmly assess the supportive economic background in relationship to the potential risks will come out ahead of those dwelling on the threat of multiple potential risks.