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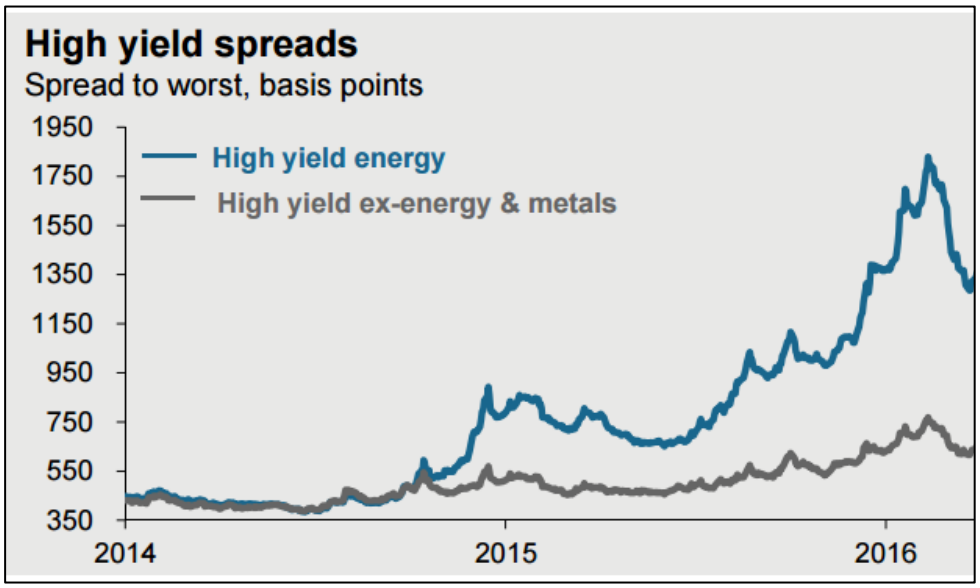
Recap of Q 1 2016 Markets and Economy

The markets had a difficult start to the year as volatility in oil prices spilled over into the stock and bond markets, continued concerns about China's outlook and the trajectory of the global economy weighed on sentiment at the start of 2016. This ramped up fears of both a global and domestic recession that pushed stocks substantially lower and into correction territory.

The tone then reversed sharply mid-quarter amid the steady U.S. economy and easier global monetary policy, including the Federal Reserve softening its rate-hiking stance pushing stocks back up to end about flat for the quarter. Gold prices benefited from the early on risk-off environment and commodities recovered from weakness at the beginning of the quarter to also finish roughly flat.

The Federal Reserve held short-term interest rates steady in the range of 0.25%-0.50% in March, and has lowered its projections for federal funds rate increases in 2016 from four to two, citing uncertainty about the neutral level of rates, as well as concerns about tightening domestic financial conditions and rising international vulnerabilities. Negative interest rate policies by the ECB and Bank of Japan has foreign money piling into U.S. bonds, driving the prices up and depressing yields on long duration US government bonds. Returns were solid in Q1, with longer-duration and higher-risk credit products outperforming. Emerging market currencies and local currency bonds also rebounded.

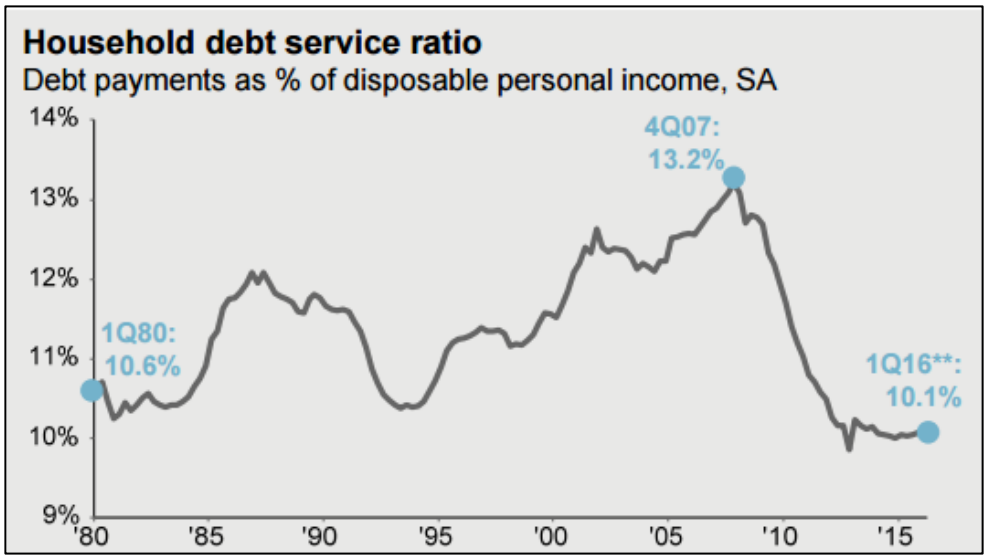
Volatile oil prices have also led to wider high yield credit spreads. As shown in the following chart, despite some spillover to the broader market, most of the move in high yield spreads is concentrated in the energy-related issues. Default rates have risen, and will likely continue to rise, but this is also primarily concentrated in the energy sector.



Source: J.P. Morgan Global Economic Research, J.P. Morgan Asset Management

The U.S. consumer continues to look healthy, with low energy prices, low unemployment, higher wages, and reduced debt loads.

Housing has been a strong point rising 2.2% year-over-year but has recently shown signs of leveling off a bit as existing home sales fell 7.1% in February according to the National Association of Realtors.



Source: J.P. Morgan Global Economic Research, J.P. Morgan Asset Management

Although the job openings number fell in February, it remains extremely high at 5.4 million open jobs. Some of these jobs are likely to be filled by people entering the labor force; the unemployment rate rose in March to 5.0% largely due to the recovery drawing people back into the labor force, says Dr. David Kelly, CFA, JP Morgan. Wages look like they are moving higher, too; average hourly earnings rose 2.3% year over year in the latest government report.

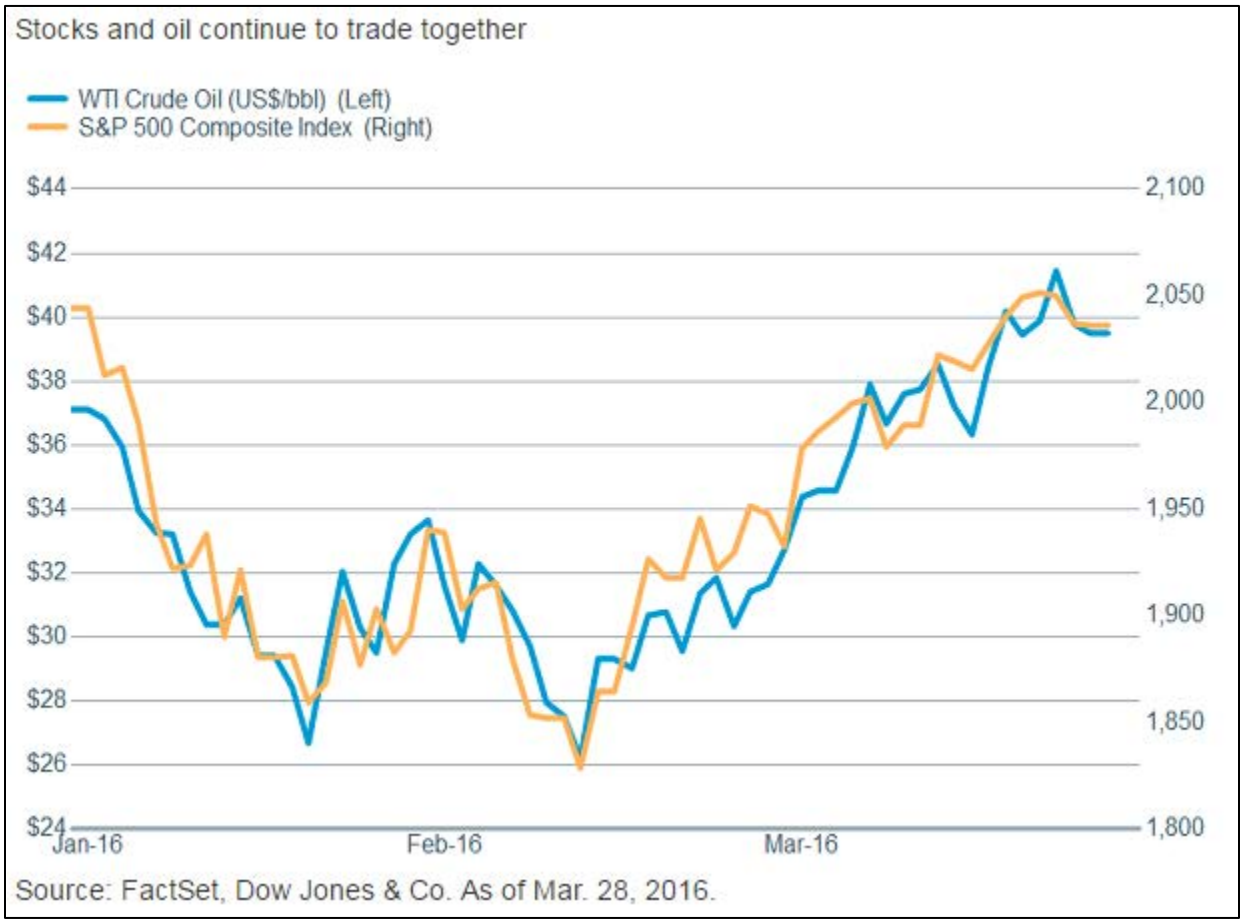
In an effort to encourage stronger growth, the European Central Bank and the Bank of Japan are implementing negative interest rates. The goal of negative interest rate policy (NIRP) is to encourage bank lending to businesses and consumers by charging banks a fee, rather than paying them interest, to hold money safely at the central bank. The theory is that commercial banks would prefer to boost their lending to households and businesses rather than incur the cost of parking reserves at their central bank. This in turn should stimulate overall economic activity. These policies have contributed to a dramatic increase in the number of government bonds that are yielding less than 1%. (JP Morgan – Market Insights) The ECB also increased its bond buying program from €60 billion to €80billion in March to inject liquidity into the banking system. The Fed is gradually tightening while other central banks are easing. This has pushed the dollar higher (until very recently), and that in turn has put a strain on the Chinese yuan and on other emerging-market currencies.

One key factor we need to see is stabilization in Emerging Markets currencies. EM currencies have seen a meaningful depreciation versus the U.S. dollar over the past couple of years. The positive news is that a variety of EM currencies are now cheap relative to their respective 10-year averages, suggesting that a lot of the adjustment has been made for a variety of countries. In addition, the Fed's dovish March meeting seems to have taken some pressure off of the dollar's appreciation and helped commodity prices stabilize. This suggests that the worst EM currency moves may be behind us.

Some improvement in commodity prices and Chinese growth can help increase EM growth expectations more sustainably. We have seen early signs that this has begun, but challenges remain for certain countries. (JP Morgan – Market Insights)

Commodities staged a nice turnaround, aided by a flattish to slightly weaker U.S. dollar. The correlation between oil and markets has increased. The higher correlation to oil has led to sell-offs in the broad equity market, likely leading to attractive valuations in sectors outside of energy. (JP Morgan – Market Insights)

As long as the oil/stocks correlation remains elevated, continued improvement in the stock market may hinge on the path of oil prices. With oil inventories at historic highs and the ability of oil rigs which have been shuttered to restart in relatively short order, it's tough to paint a picture of oil moving substantially higher from here over the course of the year," Schwab strategists said.



Outlook 2016

"We remain neutral on equities — meaning investors should remain at their long-term equity allocations — and believe 2016 is shaping up to be much like the first quarter, volatile at times but generally trending higher," Liz Ann Sonders stated.

For 2016, earnings are expected to grow by 2.9% (or 5.9% if the energy sector is excluded). Since earnings estimates usually come down as the year progresses, we could see another lackluster year for earnings. But with the weaker dollar, it is possible that earnings may surprise on the upside this year, according to analysts at Fidelity.

Historically, stock performed much better when the Fed moves slowly, as will likely be the case this cycle. We continue to believe U.S. stocks are in a secular bull market; but in a more mature phase which will be dotted with volatility and pullbacks, say analysts at Fidelity. A contributor to the volatility will be the ramped up rhetoric from both sides of the aisle as we move closer to the November Presidential election.

The U.S. economy looks to still be in the mid-phase of the business cycle, but signs suggest the late phase may be coming. That phase can often be characterized as an overheating stage for the economy, in which rising inflation tends to crimp profit margins and lead to tight monetary policy. Most analysts agree that a recession in the US is not likely.

For fixed income, the muted economic picture justifies continued low and range bound rates, with the resulting impact of the aggressive postures of the ECB and Bank of Japan likely to be felt globally. The Fed's shallower path for rate hikes may have capped the rally in the dollar, creating new opportunities for value added strategies in the emerging market local bond and currency markets.

Oil futures are at levels that could lead to an outright decline in non-OPEC (primarily U.S.) production in 2016, since drilling new wells may not be cost effective for oil producers if prices stay low. Reduced investment in future production could, therefore, bring greater supply-demand balance, and higher prices, as the year progresses. There have been several "talks" among OPEC members about coming to an agreement to freeze oil production as a way to combat low oil prices as well. With core inflation already firm, any stabilization in oil prices could push headline inflation higher over the course of 2016 according to Fidelity.

The yields on money market mutual funds had flat-lined for years. But with the Fed's December 2015 increase in interest rates, it may make sense to revisit your money market fund choices, to make sure you are taking advantage of what yields may be available.

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Sources: *JP Morgan: Market Insights & Michael Bell, Vanguard, Joe Davis, Vanguard's global chief economist, Charles Schwab: Liz Ann Sonders, Thinkadvisor.com, Fidelity View Points, Prudential Quarterly Outlook*