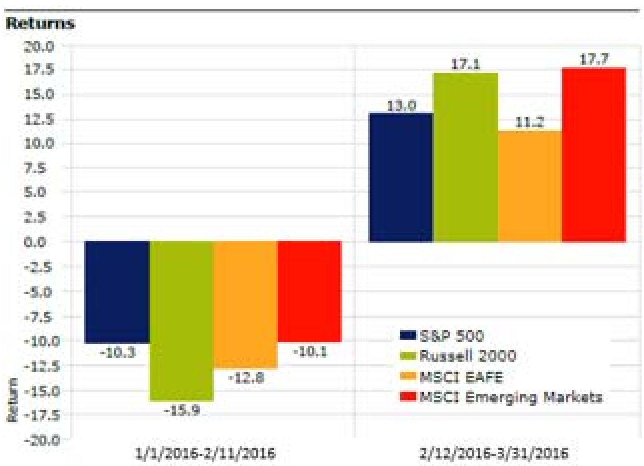
PATHSTONE
FEDERAL STREET

Economic & Market Commentary
Q1-2016

While equity markets were relatively flat and bond returns positive, the market environment was anything but stable during the first quarter of the year. The global equity market, as measured by the MSCI All-Country World Index, declined by almost 12% through February 11th and recovered in the latter half to post a 0.2% gain for the quarter. Investment grade bonds, as measured by the Barclays Aggregate Index and Barclays 5 Year Municipal Index, appreciated nicely throughout the quarter returning +3.0% and +1.2% respectively, while high- yield bonds followed the same flip-flop performance pattern as equities, ending the quarter with a 3.3% gain.

The equity and high-yield market decline in the first six weeks of 2016 was mainly attributable to fears of global recession, exacerbated by the uncertainty surrounding the U.S. Federal Reserve's future interest rate moves. Despite the equity markets' recovery in the latter half of the quarter, the economic backdrop changed very little. In fact, the U.S. Treasury market was clearly and consistently acknowledging the continued slowdown in global economic growth, and Treasury rates declined from the start of the year. The Federal Reserve, likewise, acknowledged the weakness in the global economy by choosing to ratchet back their original, more aggressive plans to raise interest rates.



Source: Morningstar Direct

The most notable event during the quarter was the reversal in investor sentiment in early February, where value seekers suddenly gained the confidence they needed to start buying again. On February 11th, OPEC hinted of curtailing the supply of oil which then catapulted the prices of oil, energy stocks, and any other related stocks shortly after oil had hit a 13-year low in January. On that same day, after the shares of JP Morgan had fallen almost 17% since the start of the year, CEO Jamie Dimon's $25 million purchase of stock was the sigh of relief investors needed. The financial sector subsequently experienced a 15% recovery. Even before the early February market reversal, value was finally starting to be appreciated by the market as investors were more anxious to sell their over-priced growth stocks than their value stocks. Performance chasers, particularly those who jumped into the market's biggest movers of last year, were severely punished. Biotech stocks, for example, have fallen 25% so far this year after increasing 227% cumulatively in the last four calendar years, and the U.S. dollar did not continue to appreciate as so many had predicted, and lost 4.0% on a trade-weighted basis.

If not already evident, one of the most important lessons we investors were reminded of this quarter is the punishing power of swift market movements where yesterday's unloved stock can suddenly become the next market leader and vice versa, as we saw with the biotech sector. As we look ahead, there continues to be bifurcation in terms of valuation and investor sentiment. For example, economically defensive stocks are trading at large premiums to economically sensitive stocks, and small cap stocks are now trailing large cap stocks by over 19% since early 2014. While history has shown just how quickly these trends can reverse when expectations shift, this extended period of performance dispersion has tested even the most disciplined and patient investors. So while we do not expect the recent six-week stellar market trajectory to continue, we are encouraged that the market's recognition of value, although slow in coming, is trending in the right direction. And with that trend, we expect that the investors who adhered to their time-tested approaches to buying under-appreciated stocks, will once again be rewarded for their efforts.