ASHDON
Investment Management

In the beginning of the year, the FOMC executed on a much anticipated interest rate increase or "lift-off" as many market pundits called the exit of Zero Interest Rate Policy (ZIRP). This decision, which was believed to be the first of four to six differing increases throughout the rest of 2016, was initiated in tandem with an already well underway implosion of the oversupplied commodities sectors and some commodity-dependent economies (please see our market views for background). The combination of expected multiple interest rate increases, deteriorating fundamentals in industrial sector China and the stresses building in China-bound exporting/commodity-dependent sectors, sent the USD on a sky-rocket higher. Asset markets re-priced viciously, and we saw for the first time since the Global Financial Crisis the financial markets actually driving the real economy into recessionary conditions. The FED backed-off on further increasing rates during Q1 2016, and to date hasn't increased rates beyond that initial attempt.

Despite the volatility in markets earlier in the year, the S&P 500 Index hit a new all-time high during the quarter, returning +4.4% for the 3-month period and +6.8% YTD. Credit markets, which were rattled by significant spread widening in January-February and feeling a flight-to-safety after the BREXIT vote in June, continued on a path of record-breaking issuance. The Barclays Aggregate Bond Index returned +0.5% for the quarter and +5.8 YTD.

Against this quarter's strength in markets, most are focused on why seemingly strong economic data (jobs and core inflation) aren't resulting in further FOMC action. We would argue the market is actually doing the work for them. One way to see this is to look at the difference between interest rates on long-term and short-term bonds. When long-term rates are higher than short term rates, we say that the yield curve is steep and the economy is more likely to grow in the future. In the opposite case, the economy is more likely to weaken. After a very long period, long term rates have begun to move higher while short term rates have stayed nearly the same. At the same time, we are beginning to see signs that inflation is slowly creeping higher in the US. The market appears to be tightening in spite of the FOMC's inaction.

Higher rates can be a headwind to the economy. At this moment, we also see the potential for a strengthening economy. When the yield curve is steep, banks can borrow short-term at a low rate and lend long-term at a high rate increasing their profitability. And when banks are profitable, they lend more. This has been fuel that stimulates the economy and creates a positive, supportive inflationary experience in the past. Our view is that while economic data paint a picture of increasing strength, the underlying global economic imbalances remain unchanged, such as the deflationary forces of global total debt levels and oversupplied conditions in most industries. Our concern is that the market is pushing rates higher into a period of emerging weakness – and that may intensify the weakness.

It is impossible to predict how things will play out. Our portfolios are allocated to balance the risk in accordance with their probability. We are maintaining exposure to stocks, but also maintain our "dry powder" to be deployed when/if opportunity presents. We have begun to add modestly to specific positions in some portfolios, but we remain cautious.

Thank you for your trust and confidence.

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