New Albany
Investment Management

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Market Insight:
1st Quarter Review

Changing Market Dynamics Imply New Investment Landscape:
For the first time in many years, correlation of prices across global markets and even specific asset sectors dropped dramatically during the first quarter, perhaps indicating a changing investment landscape. Since the recovery began in 2009, it was typical to see positive price correlation across major global markets in both stocks and bonds. This means prices rose or fell in tandem in major markets according to various fiscal and monetary events that rotated across the global stage. But this quarter was remarkably different, where correlations have not only declined but in some cases have even turned negative, perhaps signaling a more significant change in the dynamics of the global economy and a need for a more dynamic investment strategy.

The charts below show 1st Quarter returns for key Global Stock & Bond Sectors, and Morning Star's Generic Investment Allocations:

Stocks	NYSE	S&P	Technology	Small Cap	Europe	China	Emerging	Japan
Return	7.8%	10.6%	8.2%	12.4%	2.7%	-1.5%	-0.8%	16%

Bonds	US Corporate	Foreign Corporate	US High Yield	Foreign High Yield
Return	-0.2%	-0.2%	2.9%	-1.4%

MS Allocation (Stks/Bonds)	Conservative (18%/82%)	Moderate (57%/43%)	Moderate/Aggressive (77%/23%)
Return	1.4%	5.1%	6.8%

Key Implications/Signals: Future expectations of the economy, fiscal and monetary policy, and corporate earnings are what drive prices. The market often 'leads' the data, pricing in what is expected to materialize 6mo to 12mo forward. Thus, a careful study of changes across and between asset sectors can sometimes provide a good picture of the future and where both risk and opportunity lies. The returns stated above offer some very interesting signals. Here is my interpretation:

1) Outperformance of Stocks verses Bonds: By far the most dramatic change from previous quarters is the significant outperformance of stocks verses bonds in the US and Asia. This performance is very bullish as it signals expectations of strengthening economy, but with that, potentially rising rates. Japan is just beginning to embark on stimulating growth, so the risk of rising rates in Japan is minimal. However, the US Bond market is a different story and has far greater risk. The Fed is *buying $85billion in long maturity bonds each month* in an effort to keep borrowing rates down and prop up all financial assets. Removal or even indication of the Fed thinking about removing the stimulus would cause bond prices to get pummeled.

2) Outperformance of US Small Cap vs Large Cap Stocks: In previous quarters, Large Cap/Defensive sectors have been the leader in the market as investors were fearful of another financial melt-down. Small cap stocks are generally riskier investments and require a healthy economic environment to thrive. Thus outperformance signals investors have more confidence in stability of fiscal policy and growth in the economy.

3) Underperformance of China and Emerging Markets: Previously, these two markets thrived and kept pace or outperformed the developed markets because their economies were the main engine for global growth. The tables have turned, or at least the perception of future growth has declined significantly. In deed, China is still growing but is curtailing growth to reduce the credit bubble and keep inflation in check. Emerging economies are facing a potential huge decline in manufacturing/exports, as the US begins to utilize nature gas for production at home. According to energy giant, BP, "*the US will become almost self-sufficient for its energy needs by 2030*" Still with decent growth*, "major emerging economies such as China and India will become increasingly reliant on energy imports. These shifts will have major impacts on trade balances.*" This is a potential game changer and very bullish for US growth and US stocks.

4) Outperformance of Japan: A new era in Japan? After 15yrs of declining wages and stocks, hopes are high for the Bank of Japan to undergo a sea change from overly conservative to very stimulative monetary policy. This change is significant. If markets have confidence that aggressive policy will be maintained, it may become self-fulfilling, causing the yen to weaken and benefit Japanese stocks over the intermediate term.

In Summary: Over the last 5 years, there has been little difference in aggregate return between a Conservative allocation (mostly bonds) and an Aggressive allocation (mostly stocks). The table below compares 5yr returns of a portfolio invested 100% in corporate bonds verses stocks and shows it has not paid to take more risk via owning stocks.

Index	US Corporate Bond	NYSE Composite	S&P 500
5yr Return	5.6%	0.4%	4.9%

Two key factors have driven these results: the Fed pushing rates lower (Bond prices higher) and Investors' low risk tolerance (fear) of stocks. **But if the new signals, indicated by the 1st Quarter results are correct, a new market landscape may be indeed underway.**

Portfolio Strategy: Over the 1st Quarter, changes in allocations were: Decreased fixed rate bonds; increase floating rate bonds; increase US Mid and small Cap stocks.

As always, please contact me with any questions or concerns.

Kind Regards,
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