WEEKLY MARKET REVIEW

FEBRUARY 9, 2016

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CLS INVESTMENTS

Market Performance

Stock Market	LAST WEEK	QTD	YTD '16
Total U.S. Market[1]	-3.22%	-8.68%	-8.68%
Domestic Large Cap Equity[2]	-3.04%	-7.85%	-7.85%
Domestic Small Cap Equity[3]	-4.78%	-13.15%	-13.15%
International Equity[4]	-1.13%	-7.86%	-7.86%
Developed International Equity[5]	-1.52%	-8.64%	-8.64%
Emerging Market Equity[6]	-0.34%	-6.81%	-6.81%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '16**
U.S. Bonds[7]	+0.24%	+1.62%	+1.62%
Cash Equivalent[8]	+0.01%	+0.01%	+0.01%

[1]Russell 3000 [2]S&P 500 Index [3]Russell 2000 Index [4]MSCI ACWI ex-U.S. Index [5]MSCI EAFE Index [6]iShares MSCI Emerging Markets Index [7]Barclays Capital U.S. Aggregate Bond Index [8]Barclays Capital 1-3 Month U.S. Treasury Bill Index

Week in Review

Volatility remained prevalent in the equity markets last week, as did the increased correlation between the price of oil and stocks. Oil was down more than 8% for the week, dragging stock prices lower with it. Large-cap U.S. stocks fell more than 3%. International stocks held up better but were still negative. Developed international stocks were down 1.5%, with emerging market stocks performing best, down only 0.4%. Bonds were positive during the week, with the Aggregate Bond Index up 0.2%.

The big story from the week's economic data came in Friday's payroll report. The U.S. economy added 151,000 new jobs in December, substantially below expectations. November's strong jobs number was also revised lower. Though the unemployment rate fell to 4.9%, the focus seemed to be on the hourly earnings data that came in higher than expected.

How Do You Like Me Now?

In May 2013, the then-Chairman of the Federal Reserve (Fed) Ben Bernanke announced the intent to begin withdrawing an extraordinary policy tool known as quantitative easing (the purchase of Treasury bonds by the Fed for the purpose of suppressing interest rates). The market's subsequent negative reaction, and the extreme selloff in fixed-income assets became known as the "Taper Tantrum." Since then, portfolio managers at CLS have had countless conversations with advisors concerned about rising rates. Market pundits called for the dawn of a new bond bear market. Investors wanted to sell out of their bond allocations completely.

Fast forward nearly three years to a length of time that is actually appropriate for a review of performance, rather than the typical focus on monthly or quarterly returns. How did bonds do versus equities? How was investor performance for those who ignored the noise and stayed the course versus those who got caught up in the hype?

As it turns out, the bond market did not implode as many were predicting, and it has actually outperformed the stock market! Had investors with moderate risk tolerances and approximate risk budgets of 60 strayed from their plans and moved their bond allocations to cash, they would have earned a cumulative return of about 3.5%. On the other hand, an investor who was able to control his or her emotions and stay true to his or her investment plan would have earned a cumulative return of nearly 7%. This amounts to an outperformance of nearly 3.5%, and it was done with less risk.

So, what is the moral of this story? Bonds remain an invaluable tool for investors to diversify their portfolios. Stay balanced!

Market Returns Since the "Taper Tantrum" (5/22/13 - 2/5/16)

	Cumulative Return	Standard Deviation
100% Stock Portfolio	5.07%	9.62%
60% Stocks / 40% Cash Portfolio	3.50%	5.77%
60% Stocks / 40% Bonds Portfolio	6.98%	5.61%

Cumulative return is the total return (not annualized) during the period. Standard deviation measures the volatility during the period; Cumulative return illustrates the return while standard deviation illustrates risk.

Source: Morningstar

Where Can Yields Go From Here?

Last December, the Fed initiated a rate hike for the first time in nine years. Despite this move, Treasury yields are the lowest they've been in 12 months, and are considered low relative to historical levels. A question on the mind of many investors is "where will yields go from here?"

At this time, both the market and Fed predict the benchmark interest rate will be higher by 2017. There is, however, a large gap in expectations of how much higher it will be. As of their last policy meeting, Federal Open Market Committee (FOMC) members published a median estimate of four rate hikes for 2016. On the other hand, the market indicates investors believe there will be only one hike based on the current pricing of Fed Fund Futures. At CLS, we believe the number of rate hikes will likely be somewhere between what the market and the Fed are expecting.

Regardless of how many times the Fed increases rates this year, there are a few reasons to believe interest rates (especially on the long end of the curve) will be capped. Heightened volatility in the stock market causes a flight to quality as investors seek the relative safety of Treasuries. Other central banks around the globe continue to ease, with more and more adopting negative interest rate policies. Expectations for growth and inflation remain low. And finally, the Treasury announced a reduction in the issuance of longer-term notes and bonds in favor of Treasury bills with a maturity of one year or less. This reduction in supply on the long end of the curve can serve to boost prices and therefore lower yields.

Josh Jenkins, CFA
Portfolio Manager

Joshua Jenkins joined CLS in March 2013, and serves as a Portfolio Manager. He is the lead manager of an income-focused separately-managed account strategy and also functions as the lead analyst for the CLS Growth and Income Fund, CLS Flexible Income Fund, and the Milestone Treasury Obligations Fund. In these roles, Mr. Jenkins utilizes fundamental and technical analysis to assist portfolio managers in asset allocation decisions. In addition, due to his extensive knowledge of exchange traded products, he drives CLS's implementation process and is integral in selecting the appropriate ETPs to gain desired exposure within CLS portfolios.

Prior to joining CLS, Mr. Jenkins worked as an analyst on the private equity desk at Auriga USA, LLC, a small broker-dealer headquartered in New York City.

What's on Sale in Fixed Income?

In our January Monthly Market Review, Chief Investment Officer Rusty Vanneman, CFA, discussed our current outlook and portfolio positioning. In this discussion he made a simple statement, "CLS likes to buy stuff on sale." Value investing, unlike so many other "investment strategies" and fads, has stood the test of time. So the question is: Where does CLS see value in fixed income? Or, to put it like Rusty did, what part of the bond market is on sale?

By now the average investor is well aware of the far-reaching impacts of low oil prices on other asset classes. A great example of this is the high-yield bond market. As prices on bonds issued by energy companies fell rapidly, the negative sentiment was transmitted to the broad high-yield market. The result of this contagion effect is that the high-yield market appears priced as if a recession is imminent, which we do not believe is the case.

Inflation-linked bonds are another area that looks very cheap. In fact, since they were first issued by the Treasury in 1997, 10-year TIPS have only been cheaper than they are right now 6% of the time. The current price on TIPS implies inflation will only average 1.38% over the next 10 years, something that has not happened during the last 40 years.

Finally, heightened market volatility, concerns regarding the Chinese economy, and fears of tightening monetary policy in the U.S. have weighed on emerging market stocks and bonds alike. Dollar-denominated debt raised by emerging market issuers has only been cheaper 7% of the time over the last 10 years.

Each of the above fixed-income segments looks attractively priced relative to both the bond market as a whole and to its own price history. If the bond market had a bargain bin, you would find these assets there. That makes them attractive to us. CLS portfolios either currently hold large positions in these segments or are looking to increase exposure in the near term.

"CLS likes to buy stuff on sale." ... What part of the bond market is on sale?

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