Market Commentary
Third Quarter 2016

Marret Asset Management

Markets survived September, traditionally the worst month for risk assets, without much drama. The U.S. Federal Reserve went another meeting without raising rates, and OPEC surprisingly appeared to agree on some vague form of production cuts (not a freeze) at its meeting in Algiers. While volatility remained below average, there were a few themes running under the market that suggested caution. U.K. bond yields have risen consistently over the past several weeks and the pound has been under pressure. U.S. bond yields have started to move higher as well, and there have been rumours that the European Central Bank will taper its bond purchase program. All of this has markets thinking that central bank liquidity is starting to reverse and inflation pressures are beginning to build in the U.S.

The U.S. inflation situation is something we are watching closely. Our models suggest the cyclical trend in inflation is changing from disinflation to a modest increase. How the bond market and the Federal Reserve react to rising inflation will likely be very important to how markets perform over the next year. It is important to note that we strongly believe the secular trend in inflation remains downward based on the high level of indebtedness in the world and an aging population. However, the cyclical trend is starting to move higher due to oil prices coming off the bottom, wage pressures from a low unemployment rate and minimum wage increases, and increases in the owners' equivalent rent calculations inherent in CPI.

We see high-yield and equity markets as being somewhat complacent to these risks, and volatility will ensue if/once they begin to focus on the risks. High-yield spreads are actually at average levels when normally at this point in the cycle they would be much tighter, but absolute yields close to 6% are near the bottom of what we feel is the trading range. We continue to believe a recession is not imminent, so we are not looking to be net short. We are being defensive and looking for periods of volatility to add risk, preferably when the market yield gets into the 7.5-8.0% range.

We also believe that the energy sector, which has been a major contributor to returns this year, is no longer undervalued and may soon approach overvaluation. This will balance the market somewhat and make flow more two-way.

Overall we will continue with a defensive positioning in our portfolios until better value presents itself.

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