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WEEKLY INVESTMENT COMMENTARY

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Finding Bargains After the Selloff

Stocks Bounce Back

Equities sold off aggressively for most of last week before rebounding strongly at week's end. The Nasdaq Composite Index led the major asset classes, rising 2.29% to end the week at 4,591, while the S&P 500 Index advanced 1.38% to 1,906 and the Dow Jones Industrial Average was up 0.66% to 16,093. In fixed income, the yield on the benchmark 10-year U.S. Treasury inched up from 2.03% to 2.05% as its price fell.

As last week's gyrations show, financial markets remain volatile. The good news is that, absent evidence of a more pronounced global economic slowdown, the recent selling looks overdone. And that could mean some bargains are emerging, though most developed equity markets are still far from cheap. We would highlight Japanese equities as one market offering relative value, as well as financial stocks in the U.S.

Supply Glut Means Oil Price Likely to Struggle

Prior to the rally on Thursday and Friday, Japanese, U.K. and French stocks all had entered a bear market and most volatility measures had spiked to multi-month highs. Credit markets also remained under pressure. High yield "spreads," the difference between the yield of a high yield bond and that of a comparable-maturity U.S. Treasury, widened on expectations for rising defaults in the energy sector. Meanwhile, the weakness in high yield is also infecting investment-grade credit. With investor risk aversion rising, flows were heavy into safe-haven Treasuries and fund managers were hoarding cash. The Global Fund Manager Survey showed cash levels at 5.4%, the third highest level since 2009.

The selling earlier in the week was driven by the same litany of factors that has been troubling investors for months: plunging oil, falling U.S. earnings estimates, concerns over China and slowing global growth. Indeed, the International Monetary Fund lowered its 2016 forecast for global economic growth from 3.6% to 3.4%.

As for oil, investors continue to be influenced, arguably too much, by the drop in prices. The per-barrel price of crude oil sank into the mid-$20s last week before rebounding sharply on Thursday and Friday. Prices came under pressure early in the week as Iran looked to increase production by 500,000 barrels per day (bpd). This comes at a time when U.S. production has remained remarkably resilient. Despite a collapse in the rig count, U.S. production has actually been nudging higher, hitting 9.23 million bpd last week. While the selling earlier in the week was excessive, oil is likely to struggle to find a long-term bottom until supply begins to abate.

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Old Habits Die Hard

By the end of the week, weary investors had returned to an old habit: looking to central banks for solace. While the Federal Reserve is unlikely to kick-start another round of quantitative easing (QE), other central banks can step up. After disappointing investors in December, European Central Bank (ECB) President Mario Draghi suggested that the ECB may expand its current QE program as early as March.

The Bank of England also suggested a more benign path for monetary policy. Governor Mark Carney indicated that the U.K. central bank is in no rush to begin raising rates. And while the Fed is unlikely to introduce new QE, the odds of a U.S. rate hike in March have been dwindling. All of this suggests 2016 will be yet another year in which monetary conditions remain extremely accommodative.

The dovish shift in monetary policy is having a predictable ***impact on bond yields.*** Yields on 10-year Treasuries dipped back below 2% before rebounding at week's end. That may sound low, but those yields still appear compelling relative to those elsewhere. For example, five-year German Bund yields have fallen to a record low of -0.24%, while 10-year Bund yields are now below 0.50%.

Bargain Shopping

In our opinion, much of the recent selling has been overdone and, as such, has created some bargains. Take fears over a Chinese economic slowdown, which were the initial catalyst for this year's selloff, as an example. Recent data are showing the economy is not headed toward a hard landing. Reports on retail sales, industrial production and fixed asset investments were roughly in line with expectations, although fourth-quarter gross domestic product decelerated to a 25-year low. But fears over a more pronounced slowdown in China have added to the pressure in other Asian markets. Japanese equities, for example, officially entered a bear market early in the week before bouncing back and notching a nearly 6% advance by week's end. Despite the recent volatility, ***we remain constructive*** on Japanese equities, particularly as the latest selloff has returned some value to that market.

Closer to home, one of the few bright spots last week was the U.S. financial sector. Although earnings overall have been lackluster, financial companies, notably Morgan Stanley, JPMorgan and Bank of America, are producing better-than-expected results. With financial stocks getting hit hard over the past several weeks, we see this as another place for investors looking to bottom fish to consider.

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