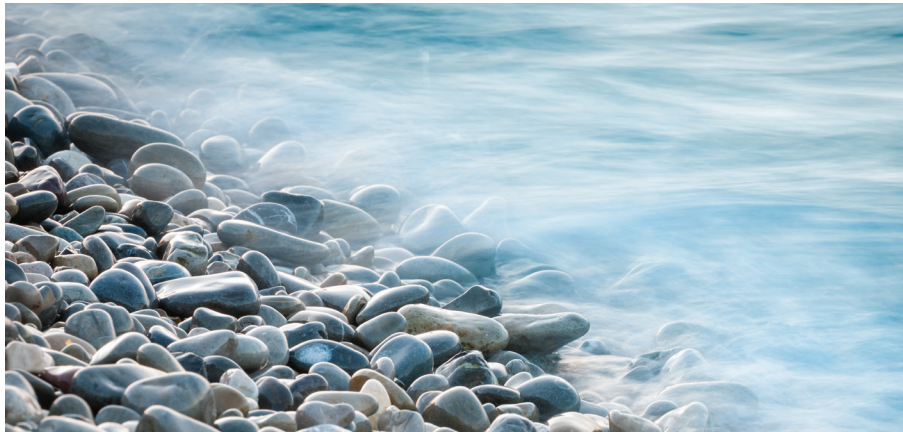


Perspectives

Keeping you informed and engaged about macroeconomic trends and market events



Falling Down a Rabbit Hole

“The rabbit-hole went straight on like a tunnel for some way, and then dipped suddenly down, so suddenly that Alice had not a moment to think about stopping herself before she found herself falling down what seemed to be a very deep well.... Well!” thought Alice to herself “After such a fall as this, I shall think nothing of tumbling down-stairs!... Down, down, down. Would the fall never come to an end?”

—Lewis Carroll, Alice in Wonderland

MARKET ACTION HAS BEEN CURIOSER AND CURIOSER, as 2016 jumped off to the most volatile start since 2009 only to quickly retrace most losses by the end of the quarter. Like a scene from the fantasy world of Alice in Wonderland, down the rabbit hole we went as a selloff in China’s stock market left global investors fearful its economy was contracting at too rapid a clip and global contagion would ensue. Energy prices followed Chinese stocks down, with WTI crude falling another 28% in the first three weeks of the year. Weak oil exacerbated pressure on global equities, as did alarming rhetoric from U.S. presidential candidates and polls that showed a U. K. referendum to leave the European Union may be a coin toss. Then Europe was hit again, at its heart—Brussels—just four months after terrorist attacks struck the streets of Paris. By the time Fed Chairwoman Janet Yellen sat before Congress on February 11, the markets

were jittery enough to push the intraday 10-year yield down to 1.52% and the S&P 500 to 1,813. Calmer heads prevailed, however, when strong U.S. payroll data alleviated fears of an impending recession. By the end of the quarter, stocks and oil rebounded to new annual highs and bond yields retraced significantly from their lows. A strong U.S. labor market coupled with signs of rising inflation in March has some commentators claiming a recovery is underway, igniting speculation Q2 strength could put a June rate hike back on the table. Like guests at the Mad Hatter’s tea party, it is hard to know which end is up when it comes to the global economy and market outlook right now. For sure, volatility is back, and investors must prepare for this environment of more frequent (though historically normal) market turbulence in a world seemingly full of rabbit holes.

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Volatility is back, as 2016 started with global equity markets in a freefall over concerns about the Chinese stock market, plummeting energy prices, and the rising risks of a global recession, only to reverse course and recover by quarter-end.

2

U.S. consumer activity has softened modestly, but employment data is strong. Overseas, growth momentum remains elusive, with Japan and Europe struggling to maintain a sustainable positive trajectory and China’s slowdown a source of ongoing challenges.

3

U.S. and emerging market equities closed higher while Japanese stocks weighed on international developed indexes. Bonds gained across the board, and high yield and REITs surged on a renewed bid for income oriented investments.

4

Evidence of a firming in economic activity, dovish statements from the Fed, continued action from the ECB, and rising commodity prices all helped to get risk assets back on track. Nevertheless, we are watching carefully for signs of a fundamental deterioration in the economy.

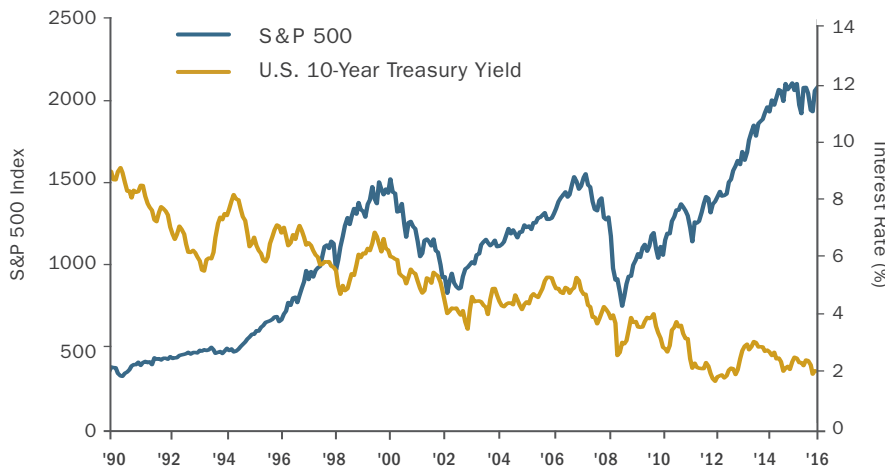
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Since 1990, Investors Have Experienced an Equity Bear Market or Rising Rates Almost Half the Time



SOURCE: Bloomberg.

So what has changed to bring volatility back and how do we handle it?

While many market pundits will argue that volatility is increasing because we at the end of a market cycle, the passage of time in and of itself does not go deep enough. Just like economic expansions don't die of old age, neither do market rallies, if the fundamental underpinnings exist for them to sustain.

The scarier truth is that volatility has been low since 2008 thanks to the synchronized actions of the global central banks dousing the world in liquidity, keeping markets rising despite an anemic global recovery. Extraordinary liquidity has become not just an emergency tool for last-ditch financial rescues, but rather a daily vitamin to buck up ailing stock markets, bleak employment numbers, and overall economic health. Organic pricing based on factors like the cost of capital, risk, and future profitability has been rendered nearly irrelevant in this environment.

Now, global monetary policy, the primary driver of our halcyon days, is moving down disparate, competitive, and unpredictable tracks. As the Fed is lifting off, we have five major central banks not just implementing a zero-interest-rate policy but a negative-interest-rate-policy. Serious discussions about so-called "helicopter money" (printing money and just handing it out to citizens) are on the table in developed and developing economies around the globe.

Policy divergences like these have many implications, the most serious of which is the

potential to set off currency fireworks that, in our fully interdependent globalized economy, create asset price spasms from time to time.

Making matters worse, the impact of those spasms is being amplified by the many trillions of investment dollars on autopilot—namely the high frequency trading models, risk parity strategies, ETFs, robo-advisors—directed by formulas to buy and sell without regard for price or value. Under their influence, ticks are amplified into trends. Simultaneously, we have lost critical financial shock absorbers, like market makers and prop trading desks that, in the past, have distributed and diluted sudden asset flows reasonably well. Case and point: the first three months of 2016 posted twenty-six +/-1% daily moves,

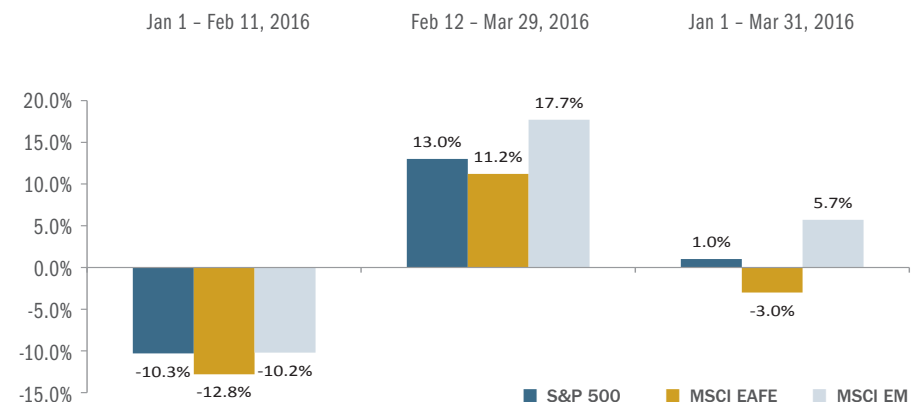
the sixth highest since the S&P 500's first full Q1 in 1958 and double the average since the index's inception.

While a world of diverging and destabilized monetary policy has these frightening aspects, the silver lining will be a return to more fundamentally driven prices. Investors will need to have stamina though, as macro forces that once propped up asset prices will now have the potential to create sharp and unpredictable swings as reactions, and reactions to reactions, get absorbed to the latest developments and news flows.

In this environment, "time in the market" will become more important than "timing the market," as the saying goes. Avoiding extended positioning (large over weights and under weights) will be important to protect against getting caught up in "pain trades" or moments of market capitulation. Finally, it may be a good time to embrace the power of diversification to target a larger and more differentiated investment opportunity set, which may, over time, smooth return streams and create more consistency.

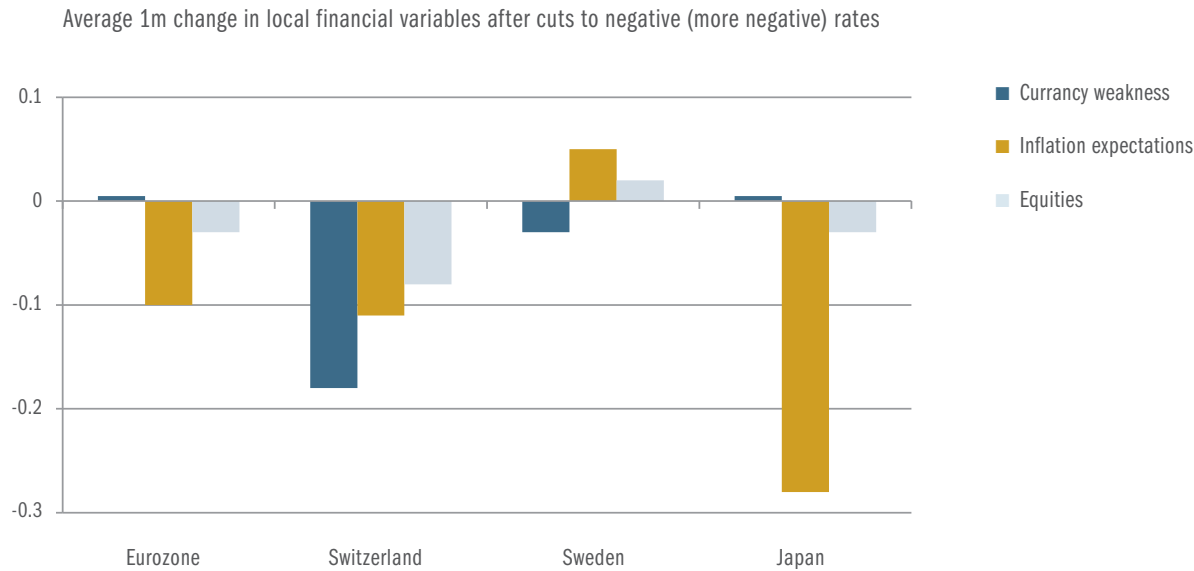
Where we go from here, after the first quarter's roundtrip back to the same place, we hope depends most on improving profits in the second half of the year, an expectation we believe is realistic to attain. But we are mindful that critical to keeping volatility at bay will be stabilizing energy prices and global currencies. For now, investors should hold fast to a steady but cautious outlook, and be prepared for more rabbit holes but also the opportunities that come along with them.

Stock Markets Correct The Correction



SOURCE: Bloomberg.

Negative Interest Rates Have Been Ineffective



SOURCE: Bloomberg.

GLOBAL ECONOMIC OVERVIEW: Damaged Goods

First quarter economic data had an overall uneven tone that, in combination with destabilized currency and commodity price movements, has kicked up concerns about the risks of global recession. While Wall Street economists are still predicting the odds of a global downturn at 30% or less, there are warnings signs that suggest we may be nearing an inflection point.

In Europe, the health of banks remains a major concern, and the region is suffering from low demand despite the European Central Bank's (ECB) aggressive asset purchase program. European authorities' handling of the flow of refugees from the Middle East has also been a cause for concern, not to mention the rising risk of a 'Brexit.' In Japan, inflation expectations have now fallen to their lowest point since Abenomics started in 2013. While Chinese data continues to show the economy transitioning away from manufacturing and towards services and consumption, policymakers are struggling to engineer a soft economic landing while also navigating tricky stock, bond, and currency markets. Domestically, the economic environment was sluggish in the first quar-

ter of 2016, with particularly lackluster results in manufacturing and consumer confidence. However, the employment situation remains an important bright spot, and while vehicle and retail sales have slowed from last year, they are not at a pace that suggests a recession is in the offing.

Exemplifying the risks within the global landscape is the reality that five currencies and twenty-three countries are now practicing some form of "NIRP" (negative interest rate policy) in a desperate attempt to stimulate growth, engineer inflation, or create a more competitive currency for export reasons. Unfortunately, the jury is still out on whether NIRP policies are an effective tool for change, and many economists warn the policy creates a 'doom loop' of negative feedback. So it seems investors may want to brace for at least another year of a growth recession, as there are few, if any, catalysts on the horizon to drive a meaningful shift higher in demand. That said, while the world may present as damaged goods in many ways, the risks of an actual global recession are still fairly low, though our long, hard slog continues.

U.S. ECONOMY: Slow She Goes

After a turbulent start, the first quarter ended on a calmer note. There were moments when the U.S. economy appeared to defy expectations, and there were also moments when the outlook was not so rosy. On net though, forward momentum remains in place.

While a Q4 GDP report of 1.4% was not compelling, economic growth of 2.4% for the calendar year of 2015 matched 2014's performance. The first quarter of 2016 is predicted to show a deceleration of business momentum, but prospects for the balance of the year remain favorable. Consumer spending slowed in the first quarter, likely to a 1.5% rate, after a nearly 2.8% increase in the second half of 2015. Although auto sales are holding at a high level (17.2 million units sold in Q1), they fell about 15% in the first quarter. However, real disposable income rose to an annual rate of 3.8% in the last three months, the best in the past twelve months, in a good sign for the future. And while consumer confidence dipped in February, no doubt in a reflection of the market's turmoil, it rebounded back in March.

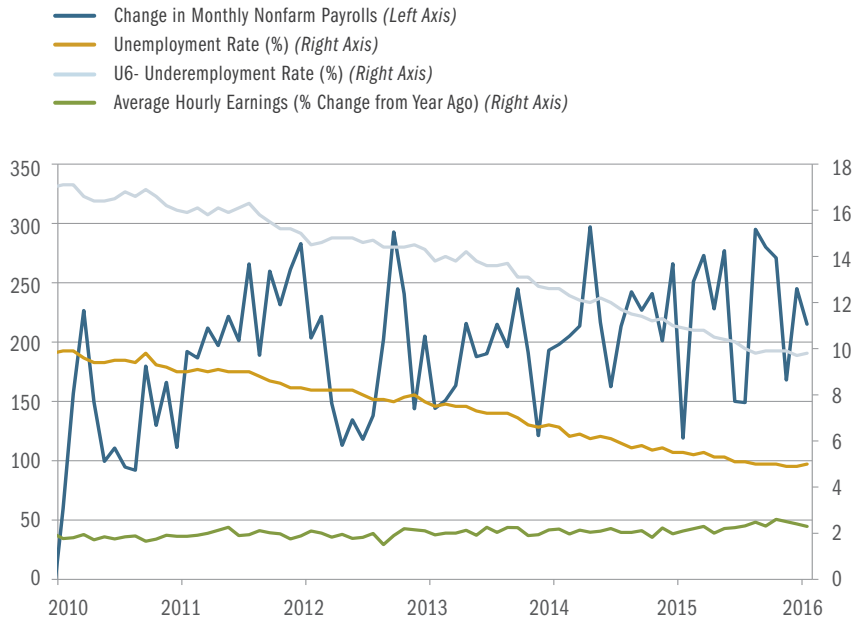
The most critical barometer of U.S. economic resiliency is the labor market, which has maintained its strong momentum. Indeed, the U.S. economy added about 209,000 jobs on average in the last three months. While there was an increase in the unemployment rate to 5.0% in March, it was for good reasons, as there has been an ongoing increase in the labor market participation rate. Both hiring and quit rates rose in February and March, and the so-called “U6” measure of underemployment broke below 10% for the first time since 2008. Only wages remain depressed, growing at only 2.2% year-over-year and barely above inflation.

While employment and consumer activity reflect a fairly healthy economy, manufacturing has been hammered by the dollar’s strength, weak global demand, and capital spending cuts. Waning demand for U.S. exports reached a crisis point when the Purchasing Managers Index (PMI) of U.S. manufacturing activity fell to its lowest level since 2009 in December and has barely rebounded. Other barometers like industrial production and durable goods orders also remain depressed. Most troubling of all, the weakness seems to be spreading to the much larger and domestically focused U.S. services sector, which has fallen off since the start of the year.

The pace of gains in the housing market has cooled some, to be expected given the fairly robust recovery this segment has experienced. Looking ahead, there is reason to be optimistic as the Mortgage Purchase Index advanced in the past month as mortgage rates declined. Likewise, the Pending Home Sales Index, a leading indicator of sales of existing homes, moved up in February. On the supply side, housing starts rose in February after two consecutive monthly declines. Home prices have maintained a gradual upward trend.

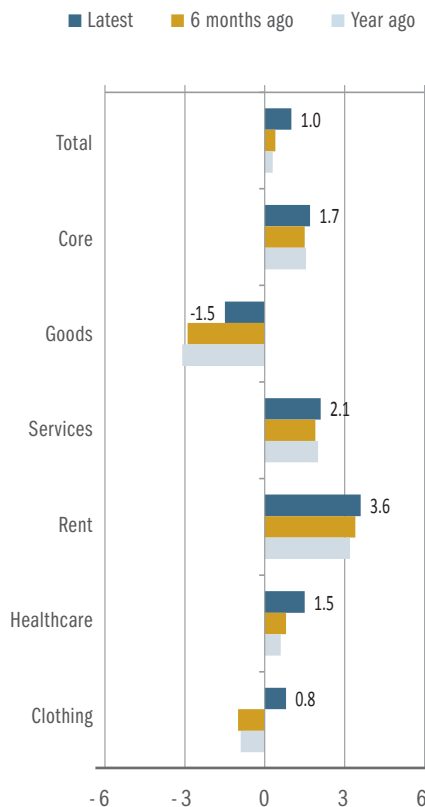
As for inflation, while declining energy prices have kept headline and producer prices low, core inflation is much higher than it was a few months ago. In fact, the year-over-year change in the core personal consumption expenditure index, which excludes food and energy, is now close to the Federal Reserve’s 2.0% target. Although Fed Chairwoman Yellen has expressed doubts about the durability of recent gains in inflation, it is hard to see inflation readings moving lower as the economy moves toward full employment.

U.S. Job Market Strong But Wages Remain Stagnant



SOURCE: Bloomberg.

First Stirrings of U.S. Inflation Show Through



SOURCE: Bloomberg.

At both its January and March meetings (it did not meet in February), the Federal Open Market Committee determined that overall economic conditions were not sufficiently improved to justify a further interest rate hike. The last time the Fed increased rates was December, when the Committee raised the target range for the federal funds rate to 0.25%-0.50%. In support of its decision to maintain interest rates at their present level, the FOMC noted that strong labor market conditions, improvement in the housing sector and increased household and business spending were offset by slowing economic growth, soft exports and low inflation. The Fed also acknowledged that “global developments have increased the risk associated” with the outlook for the U.S. economy. Since then, incoming economic data have not raised new red flags about global economic conditions. As such, we think the data-dependent Fed will find enough evidence to support a higher policy rate by the June FOMC meeting. It may also be the most politically palatable time to give rates another boost, ahead of a fall presidential election that is shaping up to be full of fireworks and focused on the economy.

DEVELOPED INTERNATIONAL ECONOMIES: A Need for NIRP

The international economy outside of the U.S. continues to experience low demand and lots of risks. In the Eurozone, concern over the health of financial institutions persists and the refugee crisis remains ongoing. Japan's navigation out of deflation continues to go poorly. 'Brexit' risks are rising and stalling momentum in the U.K.

Desperate times call for desperate measures, and global central bankers have responded to the call with unconventional and extended monetary policy. In January, the Bank of Japan (BoJ) introduced a negative interest rate of -0.1% on part of excess reserves. The central banks of Denmark, Sweden, and Switzerland had already adopted negative interest rates in an effort to depreciate their currencies. Over in Europe, the ECB delivered a significant easing package in March to bolster its chances of raising inflation back to target and support the recovery. Besides making further cuts to the policy rate (with the deposit rate now lowered to -0.4%), ECB President Mario Draghi also increased the amount of bonds they will purchase by €20 billion per month, and

announced that the central bank will buy non-financial investment grade corporate bonds. Potentially even more significant was the ECB's new scheme for encouraging bank lending directly. Banks that can show they have increased their private non-mortgage lending will be able to borrow at negative interest rates with a maturity of four years—in effect, the central bank will be paying them to lend money out to the broader economy.

At April month-end, the BoJ will meet again, and it is expected they will take their quantitative easing a step further, buying equities rather than government bonds as they seek to drive inflation and economic activity higher. There is also talk that President Shinzo Abe will once again delay a planned increase in the value-added (VAT) tax scheduled to go in effect in 2017.

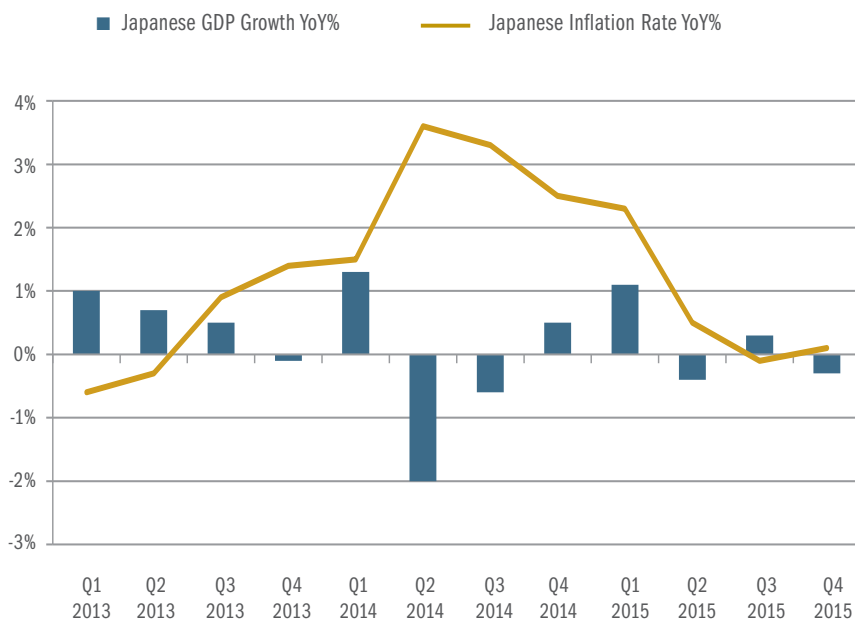
All of these policy moves reflect last-ditch efforts to forestall another economic downturn in Europe and Japan. While euro zone and Japanese manufacturing PMI readings are still above 50, momentum has been falling in recent months. Inflation expectations in the euro zone and Japan are

also falling and drifting away from their central banks' inflation target of 2%.

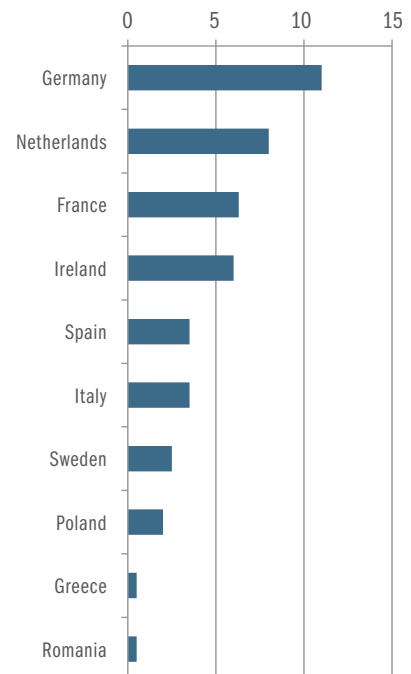
That said, leading economic indicators (e.g. purchasing managers' indices) for both core (e.g., Germany and France) and peripheral European countries (e.g., Italy and Spain) are still showing positive growth momentum, albeit with some deceleration. Consumer confidence remains high, boosted by low interest rates and oil prices, and the unemployment rate continues to trend lower. In Japan, household spending surprised to the upside in February, reversing a sharp contraction witnessed in January, as spending on medical care, cars, eating out and mobile phones drove gains.

Turning to the U.K., while the British economy decelerated last year, it did grow at the second-fastest pace in seven years, thanks to low inflation and an improvement in employment opportunities. However, all focus remains on the June 23 referendum on whether Britain should remain in the European Union. If there is a vote to leave, it is estimated UK growth could be reduced by as much as half over the coming years.

Japan Struggles In a Search for the Right Stimulus



51.4% of British Goods Exports Go to the EU



SOURCE: Bloomberg.

CHINA & EMERGING ECONOMIES: Severe Situations

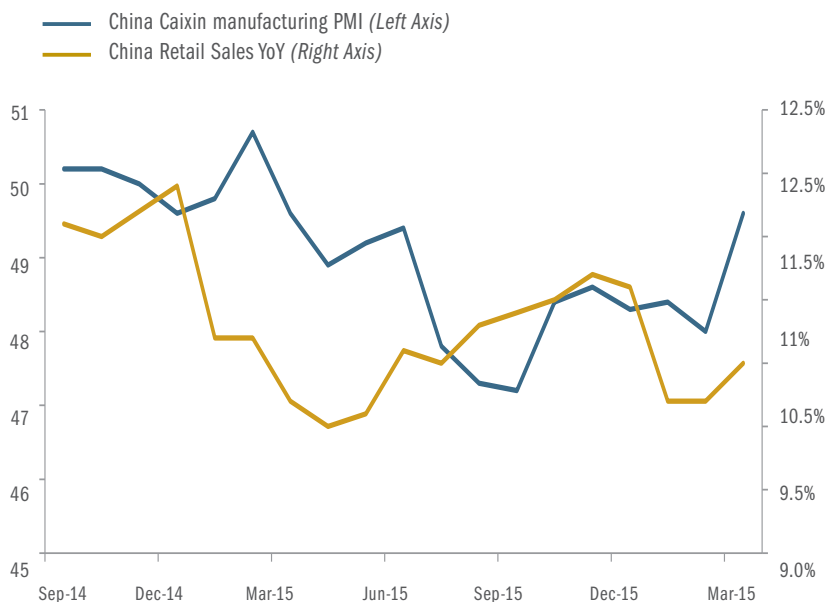
China experienced a bumpy start to the year amid turbulence in the domestic A-share stock market and further depreciation of the renminbi currency. Despite all the commotion, the latest data continues to show an economy transitioning away from manufacturing and towards services and consumption. The rate of economic growth is slowing gradually, but the economy is not collapsing. Retail sales continue to grow rapidly at over 10% a year, supported by annual urban employment growth of 13 million jobs and increases in household disposable income (8.2% in 2015, outpacing nominal GDP growth of 6.4%). While the stable expansion in consumption-related activities helps cushion downside growth risks, the transition towards the service sector still requires policy support to offset the overhang of the manufacturing sector. We are encouraged that Chinese officials have prioritized growth in 2016. In March, China's main legislative body set out an annual economic growth target of 6.5% to 7.0%—signaling that it would pursue pro-growth measures rather than a more painful retrenchment. We would not be surprised to see further liquidity injections into the financial system to stimulate growth, and are encouraged by the recent rapid growth in Chinese money supply in the wake of the

People's Bank of China's fifth cut to the reserve requirement ratio (RRR) for domestic banks in the past year.

Outside of China headlines, Brazil was the emerging market economy most in focus in Q1 2016. The country is experiencing a perfect storm of lower oil prices, a prolonged recession, wide scale political corruption involving the state-owned oil company Petrobras, and now the probable impeachment of President Dilma Rousseff. Adding to the negative headlines, Moody's took the opportunity to slash the country's credit rating below investment grade. While Indian GDP cooled from 7.7% in Q3 2015 to 7.3% in Q4, inflation also eased to 5.2% in a welcome downshift. Prime Minister Modi continued his reform agenda, meeting most recently with French President Francois Hollande to sign a bilateral business and investment relations agreement to support urban sector development, alternative energy, and the "Make in India" initiative.

Finally, Indonesia also made headlines for its reform initiatives, notably their efforts to court foreign direct investment in previously-protected industries such as film, restaurants, and pharmaceuticals while raising limits for 40 other industries such as warehousing and telecommunications.

Chinese manufacturing bounces back while retail sales rise again



SOURCE: Bloomberg.

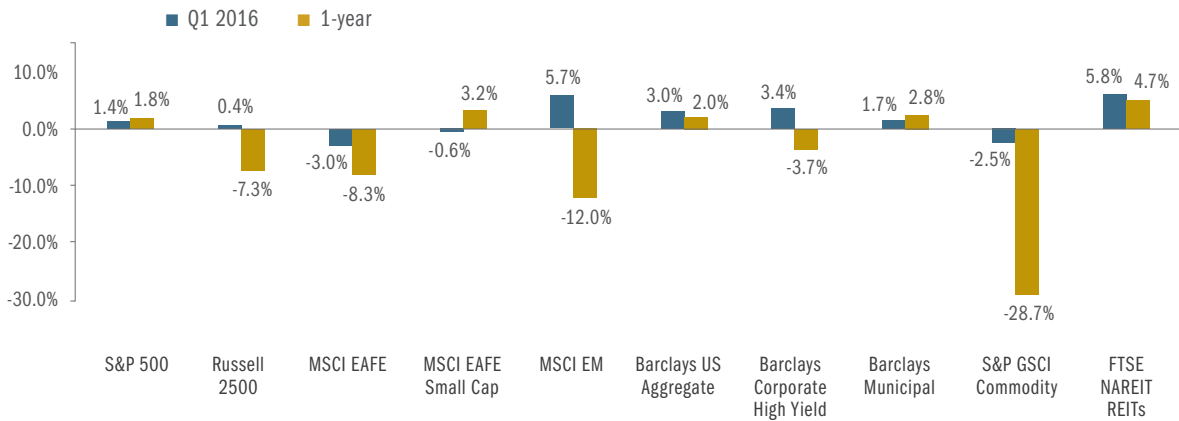
GLOBAL MARKET OUTLOOK: Don't Call it a Comeback

It was a wild ride in the first quarter of 2016 – a tale of two halves. Asset prices collapsed in the first part of 2016 as investors reacted to poor manufacturing data out of China and worries about tensions in the Middle East. A renewed decline in oil prices early in the quarter also weighed on energy stocks and overall market sentiment and growth expectations. After having shown some resilience in late 2015, oil prices fell back as production continued to outstrip demand and investors braced for the arrival of more Iranian oil in the market following the lifting of U.S. and European sanctions in mid-January. Domestic oil prices touched a 13-year low on February 11, following news of a surge in supplies at a key U.S. delivery hub. As it turned out, however, February 11 marked an important inflection point for both oil prices and the stock market. Oil prices climbed over the following days as reports emerged that OPEC members might agree to freeze or even cut output. In March the Federal Reserve gave markets a further leg up by reiterating its accommodative stance. A dovish Fed, in combination with Draghi's QE bazooka and some positive economic reports, moderated recession fears to drive bargain hunters back to the markets. The big winners on the turnaround were emerging markets and commodity-based equities. While returns from equities in the developed markets ended Q1 down modestly to up slightly, this was a significant accomplishment given they had been down 10% or more earlier in the quarter.

U.S. stocks rebound but with wide sector dispersion

Worries that the slowing global economy might be dragging the U.S. down caused markets to get off to a poor start in 2016. Gains in the second half of the quarter more than compensated for earlier losses for the large-cap benchmarks. The technology-heavy Nasdaq Composite and the small-cap Russell 2000 indexes ended the quarter with modest losses, however. Sector performance was widely dispersed. The small utilities and telecommunication services segments within the S&P 500 recorded strong gains, rising over 15% for the quarter. Consumer staples, industrials and business services, energy, and materials shares also performed well. Health-

Markets End a Tumultuous Quarter (mostly) on a Flat Note



SOURCE: Bloomberg.

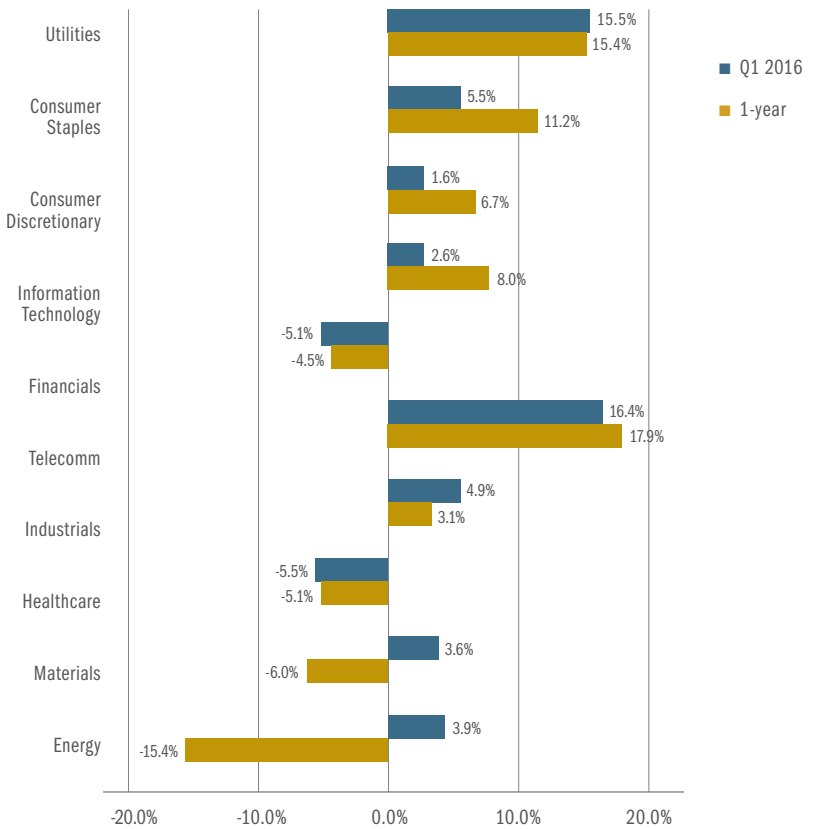
care and financials sectors performed poorly, however, falling more than 5%.

The rebound in commodity prices and energy and materials stocks helped value stocks outperform growth shares for the quarter. However, we believe that the longer-term downswing in the commodity cycle is likely to continue, and that the recovery in some energy stocks may have been overdone. In contrast, we see opportunity in growth-oriented stocks at current levels. As well as being less dependent on high commodity prices—if not even benefiting from lower ones—faster-growing companies in areas such as consumer discretionary and technology are often less reliant on the business cycle and should fare better if economic growth moderates in 2016.

Developed international equities struggle with macro overhangs

International markets greeted 2016 with a rout amid intensifying concerns that growth in China was worse than government officials were indicating and that our fragile global economic health would suffer as a result. Developed international equity markets, as measured by the MSCI EAFE Index, slid throughout January, with most hitting bottom by mid-February. Moves by central banks in Europe, Japan, China, and other regions to aggressively stimulate their economies and tamp recessionary fears sparked a stock market recovery that began in mid-February and continued in March. The EAFE index, which had fallen by 8.9% through February, ended the quarter with a loss of 2.88%. Weighing on further gains were increasing concerns about the

S&P 500 Rallies, But Sector Returns Show Defensive Bias



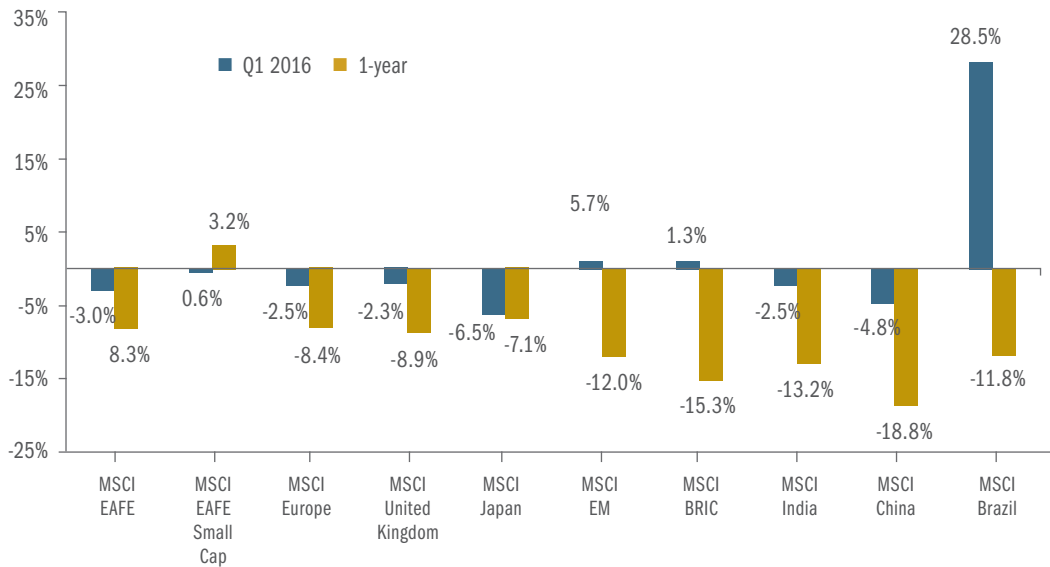
SOURCE: Bloomberg.

risks of a "Brexit"—a British exit from the euro zone—and stubbornly low Japanese inflation.

In terms of sectors, energy, fueled by a rebound in oil and gas prices, led advancing sectors in the EAFE index with a 4.9% rise. Consumer staples, materials, industrials,

utilities, and telecommunication services all logged gains. Low interest rates and European banks' exposure to flagging energy companies weighed on the financials sector during the quarter. Heavily leveraged Italian banks were some of the weakest financial stocks in

Developed International Markets Lag While EM Is Buoyed by Brazil



SOURCE: Bloomberg.

the region. Healthcare stocks were laggards, due to mounting political pressure to question dramatic rises in pharmaceutical drug prices. The sector logged a 6.13% loss in the quarter. In contrast to the U.S., growth stocks extended their fourth-quarter 2015 outperformance versus value shares through the first quarter of 2016, while large-caps outperformed small-caps.

Looking ahead, signs of improvement in Europe are supported by aggressive quantitative easing, low energy costs, and an improving credit environment. However, high unemployment, elevated debt levels, geopolitical uncertainties, and lingering structural issues remain near-term concerns. As for Japan, short-term catalysts may exist in further BoJ moves, as well as changes to the implementation of the 2017 VAT tax increase.

Emerging markets finally go on a bull run

Emerging markets stocks rose in the first quarter of 2016 after a rally in March erased declines in the year’s first two months. The MSCI Emerging Markets Index entered a bull market—defined as a 20% rise from a recent low—after the Federal Reserve left short-term rates unchanged at its March policy meeting and said it expects to raise its key rate twice this year, down from the four increases it previously predicted. The index’s rise marked a turnaround from January, when the benchmark fell to its lowest level in more than six years as collapsing oil prices

and mounting signs of China’s slowdown unnerved investors. Over the rest of the quarter, however, emerging markets assets benefited as oil rebounded and developing world currencies stabilized. Brent crude, the global oil benchmark, rose roughly 6% over the quarter to end at nearly \$40 a barrel, after falling to its lowest level in almost 13 years in January. Almost all major emerging markets currencies strengthened as risk appetite returned. Currencies of oil exporters Brazil, Russia, and Malaysia appreciated the most, with each country’s currency gaining at least 9% against the dollar. The MSCI Emerging Markets index ended the quarter at a four-month high when Fed Chair Janet Yellen said the bank would “proceed cautiously” in raising rates. All 10 sectors in the index advanced, led by energy and materials shares.

In terms of regional performance, Chinese shares retreated as the yuan came under renewed pressure and continued signs of economic weakness raised fears that growth was slipping faster than China’s government was letting on. Indian stocks declined after the government pledged in March to stick to a deficit-reduction path in the current fiscal year’s budget. Southeast Asian stocks rose as currencies in the region stabilized and economic growth picked up in some countries.

In Latin America, Brazilian stocks climbed nearly 29% as the country’s unprecedented corruption scandal deepened and

momentum built for President Dilma Rousseff’s impeachment, raising investor optimism about a change in government. Brazil’s economy contracted 3.8% last year in its biggest drop since 1990, and risks are high that the country will enter a depression this year. Another strong emerging market segment was Mexico, with stocks up 8.5% as the peso recovered after hitting a record low against the dollar in early February. To shore up the currency, Mexico’s government and central bank simultaneously announced plans to cut budget spending and an unexpected interest rate increase. Andean markets posted double-digit returns as copper and other commodity prices rebounded.

Turkish stocks rallied nearly 22% due to a combination of an unexpected interest rate cut and the news that GDP grew a surprisingly strong 4.0% last year, its highest annual growth since 2013. Russian stocks rose close to 16% as oil prices rallied and the ruble rebounded from a record low level against the dollar in January. Despite a growing political crisis surrounding President Zuma, South African stocks climbed nearly 14% as the rand strengthened from a record low in January.

This rebound in emerging markets is long overdue, and there are reasons for future optimism. Most have stronger financial positions, larger foreign exchange reserves, and more flexible currencies than they did in previous decades. Compared

with developed markets, demographics are attractive and there is a stronger tailwind from rising consumption as the middle class expands and real wages increase. And, after years of underperformance, valuations are compelling in comparison to the developed world.

High yield gets hot

In the bond market, intermediate- and long-term U.S. Treasury yields decreased sharply in the first quarter, as risk aversion at the beginning of the year benefited safe-haven securities. Yields on long-term Treasuries finished at their lowest quarter-end levels since 2012’s first quarter. The 10-year Treasury note yielded only 1.78% at the end of March, down from 2.27% at the beginning of January. A strong reversal in sentiment toward riskier asset classes in February boosted high yield bonds and emerging markets debt in the second half of the quarter, but ongoing demand for Treasuries—possibly from investors looking for higher-yielding alternatives to other high-quality government bonds—kept yields low.

Likewise, government bonds from non-U.S. developed markets rallied strongly as both the ECB and BoJ supplemented their stimulus efforts by cutting some lending rates into negative territory and increasing the size of quantitative easing programs. The German 10-year note’s yield decreased to nearly 0.10%, while the yield on Japan’s 10-year note fell below the level of the BoJ’s negative deposit rate. The U.S. dollar weakened against the euro and the yen—breaking a long trend of greenback strength and boosting returns on euro zone and Japanese sovereign debt in dollar terms. The dovish outlook for the Fed’s monetary policy and the rebound in oil prices drove gains in emerging markets bonds.

Investment-grade corporate bonds produced solid returns for the quarter after recovering from selling pressure at the beginning of the year. Credit spreads on investment-grade corporate bonds widened early in the quarter as energy price volatility, ongoing concerns about weakness in China, and worries about European financial companies contributed to a sell-off in asset classes with credit risk. Later in the quarter, credit spreads retraced their widening as risk-seeking sentiment ticked up. As conditions improved, issuers rushed to sell new bonds, but strong investor demand easily digested the supply.

The rebound in high yield bonds from their January lows was even sharper than in the investment-grade segment. The energy and metals/mining sectors, which account for a large proportion of the noninvestment-grade bond market, led the recovery. New issuance of high yield bonds was down substantially from the same period last year, but the primary market became active again late in the quarter as a result of the turnaround in risk sentiment, and investor appetite for the new debt was voracious.

Asset classes with less credit risk, such as municipal bonds and mortgage-backed securities lagged the strong gains of riskier bonds. New issuance of municipal debt was heavy. Investor demand for municipals was more tepid than in 2016 because valuations were less attractive after the sector’s strong outperformance last year.

Hedged strategies hiccup again

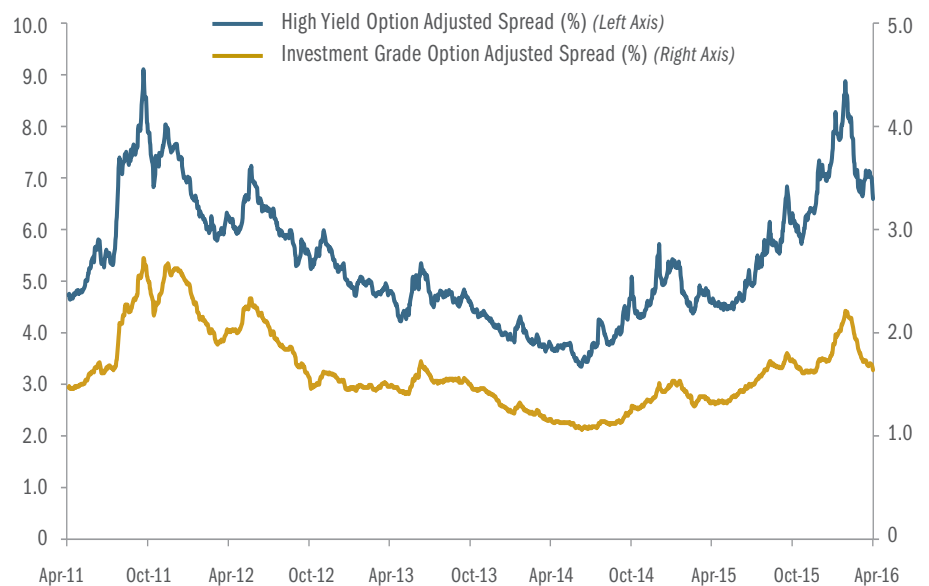
Hedge funds had another bout of weak performance against the choppy first quarter market backdrop, with equity hedge and event driven strategies leading weakness. Macro and CTA strategies had a strong start, benefitting from long positions in fixed income and the U.S. dollar and shorts in commodities and equities. But, as the markets reversed to a more risk-on tone, these strategies failed to respond by shifting to long

positions in equities. Notably, activist hedge funds, increasingly in the news lately as a result of several high-profile activist engagements, produced their best monthly performance in March since 2010.

A golden age for commodities

It was a quarter of fear, uncertainty, losses, and redemption for the commodity sector. During the first six weeks of the year, many major commodities made new multi-year lows as fears gripped the markets about the risks of a global recession. In February, crude oil traded to its lowest price since 2003. In January, copper traded to its lowest level since 2009. The market reversal saw a surge in commodity prices generally, but with some differentiation. For example, the best performing commodities were two industrial raw materials: iron ore gained 24.2% and lumber was up over 21% for the quarter. Gold was a major winner in 2016, moving from \$1,060 at the beginning of the quarter to over \$1,233 by March 31—a gain of over 16% for the quarter. Crude oil (WTI), on the other hand, began the quarter selling at around \$37 per barrel, then fell to under \$30 per barrel by mid-January, only to rise to close to \$40 per barrel by mid-March, ultimately closing the quarter at \$37.49 per barrel as of the 31st. Whether or not OPEC would cut production drove the outlook, and continues to do so.

High Quality and High Yield Credit Spreads Rip Tighter Since Mid-February



SOURCE: Bloomberg.

In the middle of February, Russia and Saudi Arabia agreed to a temporary production freeze—a somewhat token gesture, and even then, countries haven’t been following the production agreement.

The worst performing sectors during the first three months of 2016 were agricultural commodities. The grain sector was down 5.5%. Rough rice was down 16.2% and oats lost 14.6%. Corn fell just over 2%, but all of the losses came on the final trading day of the quarter when it plunged over 4%. CBOT wheat gained just under 1% while soybeans rose 4.7% as it was supported by product prices. Soybean meal was up 2.3% and soybean oil was the best performer in the grain sector, adding just over 12% on shortages of palm oil in Asia and increased demand from China.

Real estate rises to the top

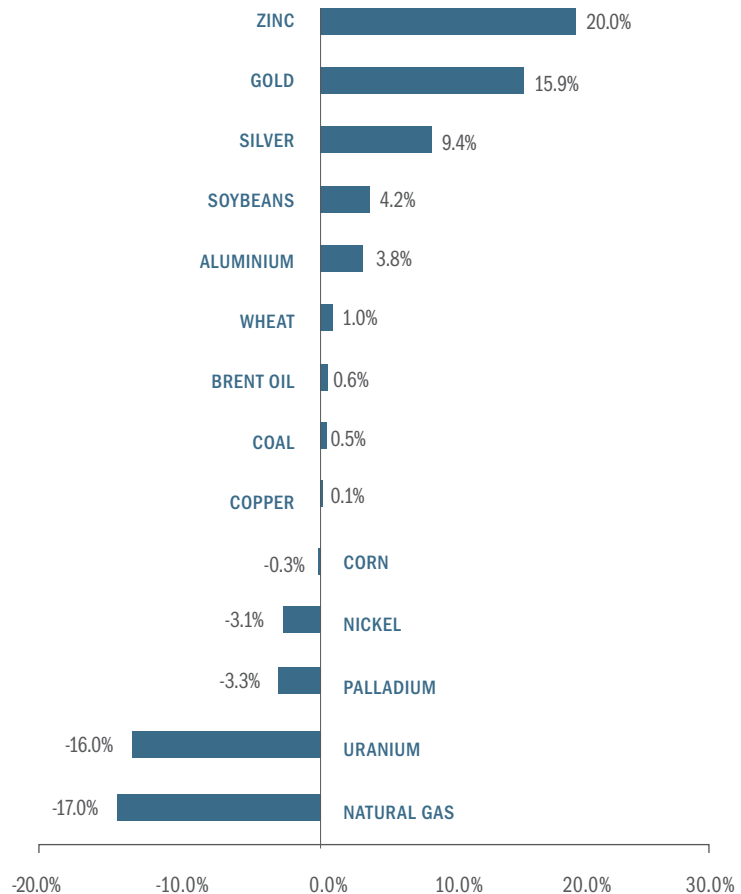
Real estate investments experienced a strong upswing in March, outpacing broader market gains as concerns about global macroeconomic issues eased during the month, and investors reached for securities offering both growth and income in a volatile market environment. REITs specifically benefitted from comments made by Federal Reserve Chairwoman Janet Yellen suggesting the timing of further interest rate hikes this year would be delayed. Additional factors supporting REITs in March included a strong earnings season and an abundance of 2016 guidance raises issued by REIT management boards. Turning to specific REIT segments, returns for free-standing retail REITs were up 18.4% in the quarter, while returns for data center REITs gained 14.7% in the same period. Self-storage REIT returns returned 10.7% in the quarter, benefitting from their defensive characteristics and demographic-driven trends and demands.

Looking ahead

Uncertainty caused by NIRP, volatile energy prices, China’s economic transition, and geopolitical events, such as the UK’s referendum on European Union membership and ISIS terror threats, are all potential sources of market unease in the near-term. The majority of these risks are unlikely to be swiftly resolved, which portends overall higher levels of market volatility than what has been the recent norm. As we move forward into the second quarter, we continue to see positive trends in the U.S. economy which should support modest growth through the end of the year. In addition,

Precious Metals Surge on Flight-to-Quality

Q1 2016 commodity price change (%)



SOURCE: Bloomberg.

with the U.S. dollar slightly weaker, we believe there is a potential for positive gains in equities here in the U.S., but perhaps even more so in international and emerging markets. We remain focused on the fact that much of the positive impact of lower energy prices and enhanced fiscal and monetary accommodation has yet to transmit to the markets in this most recent part of the cycle. It may be because we are in later stages of an economic expansion that their impact is muted, or that the unprecedented scope of policy actions and declines in commodity prices have overreached. It may be that policy actions like NIRP, rather than alleviating risks, are creating a negative feedback loop of uncertainty. The latter scenario is the one we worry most about, and for this reason we are taking a very measured approach to risk assets today, and have and will continue to pare back extended exposures on market strength. While a continued low rate

environment is supportive for equities, upside is being constrained by flat earnings, which are running at about the same level as they were in both 2014 and 2015. Until they improve, it will likely be difficult for the global equity markets to sustain a directional upward bias. Always, we invest for the long-term, for decades not days, and yet we recognize we have a dual mandate of preservation and growth that calls for thoughtful short-term positioning that may be needed now more than ever in these volatile times.

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