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WEEKLY INVESTMENT COMMENTARY

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Liftoff Takes Backseat as Oil Drives Sentiment

A Week of Sharp Swings

Last week, stocks fell sharply and bond yields dropped as investors recalibrated their appetite for risk. The Dow Jones Industrial Average dropped 3.26% to close the week at 17,265, the S&P 500 Index lost 3.77% to 2,012 and the tech-heavy Nasdaq Composite Index fell 4.06% to close the week at 4,933. Meanwhile, the yield on the 10-year Treasury fell from 2.27% to 2.12%, as its price rose.

The selloff means year-to-date returns for U.S. equities are once again negative. Many international markets also surrendered the majority of their 2015 gains. Investor sentiment has turned more cautious, with market volatility rising to a two-month high, despite the continuation of the mergers and acquisitions boom — chemical giants DuPont and Dow announced Friday they have agreed to merge — which has frequently helped stocks this year.

Investors seem prepared for the Federal Reserve (Fed) to raise interest rates for the first time in nine years later this week. As such, the negative market sentiment is not being driven by the Fed, but by the collapse in oil prices. Paying less at the pump might seem like a good thing, but the drop in crude has reinforced fears over slow economic growth and deflation, placing pressure on a range of asset classes related to energy.

Countdown to Fed Liftoff

Investors currently place the odds of Fed liftoff this week at approximately 75%, as indicated by the futures markets. With a rate hike largely expected, investors will instead be focused on the language the Fed issues around its path going forward. Our base case is that the Fed will go out of its way to stress that the tightening cycle will be gentle and gradual.

An initial hike, particularly one as well-telegraphed as this one and which will still keep rates at very low levels, is not a tremendous threat. However, other factors are raising investor anxiety. In particular, the recent collapse in oil prices raises more questions over asset classes ranging from high yield bonds to emerging markets.

The latest drop in oil accelerated last week following a painfully indecisive OPEC meeting. The gist of the problem continues to be a glut of supply. U.S. drillers are becoming more and more efficient. Despite a greater-than-60% collapse in the U.S. rig count, domestic production is down less than 5% from its recent peak. And the problem is not limited to oil; other commodities are also struggling. Natural gas prices are back below \$2 per BTU, their lowest level since October, while iron-ore trades below \$40/metric ton, a record low.



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Why Worry?

To the extent lower oil prices are supportive of consumption, why are investors reacting so negatively to what should be good for global growth? Part of the problem is what the collapse in oil suggests about the growth outlook and the potential for more disinflation. Concerns over deflation are once again manifesting, with U.S. 10-year inflation breakevens (the difference between the yields of a 10-year Treasury and a comparable inflation-linked bond) falling back toward multi-year lows.

In addition, the collapse in oil prices is reviving concerns over energy issuers in the high yield market. Last week, the spread between the yield of high yield bonds and that of comparable Treasuries continued to widen as high yield sold off. Meanwhile, volatility rose and investor flows into the asset class once again turned negative. The fall in oil is also putting more pressure on already **battered emerging market** oil-exporting currencies, including those of Mexico, Russia and Colombia.

Finally, and not surprisingly, most if not all companies in the energy space are feeling pressure. This includes not only oil production and service companies, but also Master Limited Partnerships (MLPs). While most MLPs have business models built around natural gas and storage, the companies are still reacting primarily to the drop in oil prices. Fears concerning the MLP space were exacerbated when Kinder Morgan, an energy pipeline company, announced it was slashing its dividend by 75%.

Given the abundance of supply and bulging inventories, we hesitate to **call a bottom** in oil. To the extent oil has more downside, energy-related names are likely to come under more short-term pressure. That said, valuations are now the cheapest in decades. As such, for investors underweight the sector, it may make sense to add to positions, particularly in those exploration and production names levered to low-cost shale deposits, such as those within the Permian Basin in West Texas, as well as some of the midstream MLPs.

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