first allied | Asset Management

Market Insight

GLOBAL CROSSCURRENTS AFFECTING THE MARKETS

Currency markets were again a major driver of asset class returns during April. In contrast to most of the past year, however, it was a sharp decline in the value of the dollar that contributed to a mixed month for global asset class returns. The U.S. Dollar Index fell 3.8% during April, partially reversing its large first quarter gain. In addition to bullish sentiment regarding the dollar becoming extreme, the decline may be attributable to signs of improvement in the European economy, a sharp rise in European government bond yields, and some signs that inflation in the U.S. is ticking up. Commodities were a beneficiary of the dollar's decline, with oil prices jumping approximately 25% during the month, triggering a 6.6% gain for energy stocks, the top performance of all S&P 500 sectors.

Emerging markets were another beneficiary of the dollar's weakness, as the MSCI Emerging Markets Index gained 7.7% in dollar terms. The developed market MSCI EAFE Index also outperformed domestic stocks, gaining 4.2% compared to the S&P 500's 1% gain. Meanwhile, U.S. small-cap stocks were laggards for the month, falling 2.6%. The newfound weakness in small-caps is perhaps partially explained by their lack of overseas revenues and foreign currency exposure. Interest-rate-sensitive stocks also lagged on the month, led by a 5.9% decline in the REIT sector which wiped out its year-to-date gain.

Fixed income ended the month showing some weakness, a trend which accelerated in early May. The increase in yields has been highlighted in European sovereign debt. Most notably, the yield of the 10-year German bund has been on a remarkable tear higher in recent weeks after reaching a record low yield of just 0.059% on April 17. At its near-term peak, the yield of the 10-year bund reached 0.799% on May 7, the highest level since November and one of the sharpest rises in decades. A combination of improving economic data in Europe, speculation that the European Central Bank (ECB) will cut short its quantitative easing program and a general lack of liquidity in some bond markets has contributed to the incredibly quick rise in yields. For the month of April, the Barclay's U.S. Aggregate Bond Index fell 0.4%, led by a 3% drop in long-term Treasuries. The best performing areas of fixed income were emerging markets and high-yield bonds, both of which benefited from the recovery in the energy sector.

Asset Class Performance

	% Apr	% 2015
Emerging Market Equity Index - MSCI Emerging Market Index	7.7%	10.2%
Developed Foreign Equities - MSCI EAFE Index	4.2%	9.4%
Global Equities - MSCI World Index	2.4%	4.9%
US Dollar - DXY Index	(3.8)%	4.8%
Bonds - Barclays US Corporate High Yield Index	1.2%	3.8%
US Equities - S&P 500 Index	1.0%	1.9%
US Equities - Russell 2000	(2.6)%	1.7%
Bonds - Barclays US Aggregate Bond Index	(0.4)%	1.2%
Gold - Front Month Future	(0.1)%	(0.1)%
Commodities - RJ Commodities Price Index	8.3%	(0.2)%
Real Estate - Dow Jones-Wilshire REIT	(5.9)%	(1.6)%

Source: Morningstar, Bloomberg

ECONOMIC NEWS

April was a month marked by generally disappointing economic data and numerous cross-currents in bond and currency markets. The month began with another slew of evidence that the domestic economy slowed further in March. The ISM Manufacturing Index continued a recent trend of disappointing manufacturing data. At 51.5, it was the lowest reading for the index since May 2013 and the number missed consensus expectations for the fourth straight month, the longest string of disappointments since August 2012. Among the headwinds cited by the survey's respondents were references to the West Coast port shutdown, a harsh winter, and the strong U.S. dollar. Later in the month, industrial production and the Empire State Manufacturing Survey confirmed the weakness of the ISM report. Industrial output fell 0.6% in March, more than the 0.5% decline expected by economists. As a result, production declined at an annualized 1% rate in the first quarter – the first quarterly decline since the second quarter of 2009 when the economy was still in recession. Separately, the Empire State Factory Index for April fell into negative territory for the first time since December. The first quarter's economic weakness was officially confirmed by the initial reading for Q1 GDP, which indicated the economy barely grew during the first three months of the year with the potential that future revisions will take the number into negative territory.

FIRST ALLIED ASSET MANAGEMENT
15051 North Kierland Boulevard, Suite 200 • Scottsdale, AZ 85254
Fax: 480-607-2146 • www.firstallied.com

The jobs report for March was another reality check for the U.S. economy, with nonfarm payrolls increasing just 126,000, undershooting consensus expectations by nearly half. The prior two months of job gains were also revised down by 69,000 jobs and the average workweek shortened by 0.1 hours. Positively, April's jobs report was released on May 8 and was the first economic report that has fit the "Goldilocks" description in several months. The headline number showed a gain of 223,000 jobs during April, which was in line with expectations and a nice rebound from the weakness evident in March. However, the already weak March job gains were revised even lower and now show just 85,000 jobs were created during the month. Wage growth also remained very subdued, with average hourly earnings growing only 2.2% year-over-year and slightly missing expectations. The lack of wage growth and very soft revised jobs numbers for March likely eliminate any chance of the Fed raising rates in June. In fact, the futures market in the hours after the report was released significantly reduced the odds of the Fed hiking rates in September or December as well.

One positive in the jobs report was in the housing sector, with jobs in home construction surging the most since January 2006 – partially reflecting a weather-related bounce back. Softness remains in manufacturing, however, and the energy sector continues to adjust to lower oil prices. Stocks and bonds both rallied strongly in the hours after April's jobs numbers were released as investors embraced the report as being encouraging for growth but likely not strong enough to elicit a hawkish response from the Federal Reserve.

A number of noteworthy global monetary events took place during April. ECB President Mario Draghi managed to sound increasingly bullish about Europe's improving economic outlook at his regular press conference that is held every six weeks. At the same time, he shot down recent rumors of an early exit from the quantitative easing (QE) program which began in early March. The speculation of an early end to the asset-purchase scheme has focused not only on a very weak euro currency, potentially creating an inflation overshoot, but just as importantly on concerns that the ECB will struggle to find enough eligible debt to complete the asset-purchase program. The key takeaways from Draghi's comments were a growing confidence that the European QE program is improving the outlook for growth and that the ECB remains committed to maintaining the program through at least September 2016. Despite Draghi's assurances to the contrary, speculation that the QE program will be cut short continued to contribute to bond-market volatility throughout the month.

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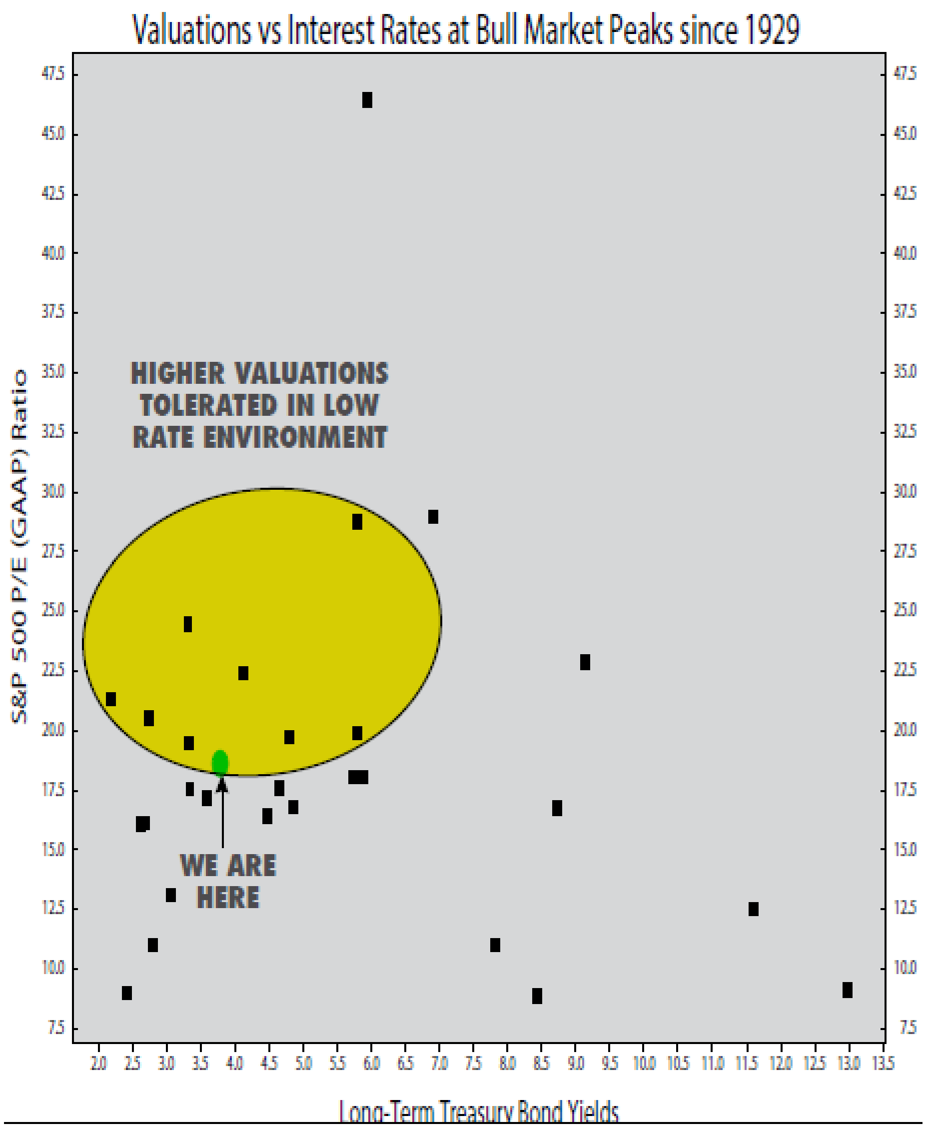
LONGER-TERM OUTLOOK

The S&P 500 made a new all-time high on April 24, extending the length of the current bull market past the six-year mark. Using the April 24 closing high, the current bull market is now the fourth longest on record. One potential risk for the current bull market is stretched valuations, as the S&P 500 is currently trading at 18.1x estimated 2015 consensus earnings estimates of $116.29 per share – considerably above the long-term average of price-earnings (P/E) multiple of 15.8x. However, should the low-interest-rate environment continue, history suggests that this bull market's peak P/E multiple may be above average when it finally comes. The accompanying chart shows peak P/E multiples of prior bull markets since 1929 (vertical axis) as compared to long-term Treasury bond yields (horizontal axis). The S&P 500's current valuation is denoted by the green circle and the fact that numerous other bull markets peaked at higher multiples amid a low-interest-rate environment is supported by the dots in the yellow circle.



Source: Ned Davis Research

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First Allied Asset Management, Inc.

Craig Columbus, President & CEO
Jeff Mindlin, CFA, Chief Investment Officer
Tom Samuelson, CFA, CMT, Senior Portfolio Manager
Lon Gerber, Chief Operating Officer
Brian Wright, CFA, Senior Portfolio Manager
Collin Martin, CFA, Assistant Portfolio Manager

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