Virginia Capital Strategies

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First Quarter 2016 Investment Commentary

First Quarter Market Activity

It was a tale of two halves in the first quarter of the year for the global financial markets. Stock markets plunged early on, falling 10% to 15% or more, but then sharply reversed, staging a furious rally into the quarter-end. Emerging-markets stocks led the charge, gaining 5.9% for the quarter. Larger-cap U.S. stocks also finished in the black, up 1.3%, though domestic small-cap stocks trailed, down 1.5%. Developed international stocks also failed to keep pace in the rally, ending with a 1.9% loss for the quarter. And while the 10-year Treasury yield rose around 15 basis points from its mid-quarter low, it was still 49 bps below where it started the year. As such, core bonds gained 3.1% year to date.

March Benchmark Returns (Preliminary)

Large Cap Benchmarks	Mar	1Q	YTD
Vanguard 500 Index	6.8%	1.3%	1.3%
iShares Russell 1000	7.0%	1.2%	1.2%
iShares Russell 1000 Growth	6.7%	0.7%	0.7%
iShares Russell 1000 Value	7.3%	1.6%	1.6%
Mid-Cap Benchmarks			
iShares Russell Mid-Cap	8.1%	2.2%	2.2%
iShares Russell Mid-Cap Growth	7.2%	0.6%	0.6%
iShares Russell Mid-Cap Value	9.2%	3.9%	3.9%
Small-Cap Benchmarks			
iShares Russell 2000	8.0%	-1.5%	-1.5%
iShares Russell 2000 Growth	7.6%	-4.6%	-4.6%
iShares Russell 2000 Value	8.3%	1.8%	1.8%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	7.2%	-1.9%	-1.9%
MSCI World ex USA Index	6.9%	-1.8%	-1.8%
Vanguard FTSE Europe ETF	7.0%	-2.2%	-2.2%
Vanguard FTSE Emerging Markets ETF	12.7%	5.9%	5.9%
Vanguard REIT Index	10.4%	6.2%	6.2%
Vanguard Total Bond Mkt Index	0.9%	3.1%	3.1%
BofA Merrill Lynch U.S. High Yield Cash Pay	4.4%	3.2%	3.2%
Vanguard Intermediate-Term Tax-Exempt	0.3%	1.6%	1.6%
S&P/LSTA Leveraged Loan Index	2.8%	1.5%	1.5%
Citigroup World Govt. Bond Index	2.7%	7.1%	7.1%

Broadly speaking, the stock market decline in the first half of the quarter was due to

- Ongoing fears of a hard landing in the Chinese economy, possibly accompanied by a sharp and sudden devaluation of the renminbi;
- A continuing plunge in oil prices to under $30 per barrel, using the WTI benchmark, from $40 at the start of the year;
- Some weaker-than-expected U.S. economic data and growing fears of a global recession, if not also a U.S. recession; and
- A contagious loss of market confidence (whatever little remained) in the ability of global central banks to stimulate real economic growth and increased concern that current monetary policies (e.g., NIRP, negative interest rates in Japan and Europe) are now causing more harm than good.

Then, beginning on February 12, everything changed. Oil prices spiked higher. Stock markets started moving higher. The renminbi stabilized, and then started appreciating a bit. High-yield bond prices started moving higher and credit spreads fell. Core bond prices fell and the 10-year Treasury yield moved higher.

These broad market trends continued through March, as shown in the table below.

A Tale of Two Halves			
Asset Class	**1/1/16–2/11/16**	**2/12/16–3/31/16**	**YTD 2016**
U.S. Stocks	-10.3%	+12.9%	+1.3%
Developed Int'l Stocks	-12.2%	+11.8%	-1.9%
European Stocks	-12.1%	+11.3%	-2.2%
Emerging-Markets Stocks	-10.9%	+18.8%	+5.9%
Core Bonds	+2.4%	+0.7%	+3.1%
High-Yield Bonds	-5.1%	+8.8%	+3.2%
Floating-Rate Loans	-1.4%	+3.0%	+1.5%
Managed Futures	+9.0%	-5.4%	+3.1%

Source: Morningstar. Data as of 3/31/2016.

As is often the case, there was no single obvious catalyst for the turnaround that began on February 12 other than speculation in the news that major oil producers might be ready to cooperate to cut oil output. At the same time, the head of the Federal Reserve Bank of New York dismissed the likelihood the Fed would need to adopt NIRP given the U.S. economy's strength and momentum. Then, over the following weekend, the head of the Chinese central bank stated it saw no basis for further yuan depreciation.

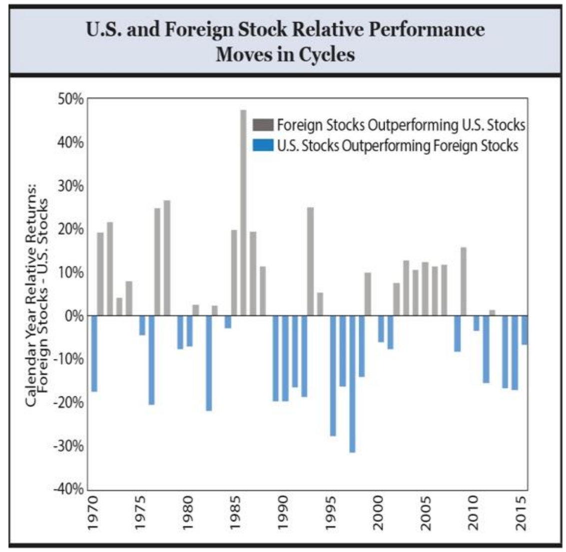
The rally continued in March, on the back of better economic news in the United States. Markets also reacted positively to dovish ECB and Fed actions during the month, as well as additional monetary and fiscal stimulus in China. In the United States, the Federal Open Market Committee held its mid-March meeting and did not raise the federal funds rate, stating that "global economic and financial developments continue to pose risks." But it also highlighted solid U.S. economic fundamentals. The FOMC also lowered its projection of the number of rate hikes for the rest of the year (from four to two) and longer term, communicating both a slower pace and a lower trajectory of rate hikes than what it had projected in December. This was broadly consistent with the market's views (e.g., as reflected in Treasury futures markets), which had already discounted a high likelihood of just one or two hikes this year.

Financial markets responded positively to the Fed announcement, with stocks and oil/commodities continuing to rally and the dollar falling. After peaking in late January, the dollar (whose prior rise was likely driven in part by anticipated higher U.S. rates) ended the quarter down more than 4% for the year.

Current VCS Strategy

Relative to other managers, VCS tends to lean towards the conservative side, especially for our investors approaching retirement or currently retired. Recognizing the almost 15% rebound in stock prices which has taken place, we recently rebalanced accounts, removing up to 10% from stock investments and rotating the proceeds into fixed income instruments. Clients may recall we increased stock exposure in January of 2013, and were rewarded for doing so. However, we now feel comfortable reducing risk and we'll explain why during the remainder of this commentary.

Also, VCS emphasizes broad diversification, which has resulted in some investment in underperforming asset classes, such as international stocks. While this has modestly negatively impacted our short-term performance, we remain confident the current market cycle *will* turn. The chart to the right shows the relative performance cycles for both US and foreign stock markets. Our portfolios are positioned with the view that over our five-year tactical investment horizon, U.S. stocks are likely to deliver below-average returns (low to mid-single digit), whereas developed international and emerging-markets stocks are poised to produce much higher returns. This has been a headwind to our portfolio performance as the current cycle of U.S. stock outperformance versus foreign stocks now ranks as the longest relative performance streak for U.S. stocks since the inception of the international stock index in 1970.



Source: Morningstar. Data as of 2/29/2016. Foreign stock returns tracked using the MSCI World ex USA Index from 1970 to 1987 and the MSCI ACWI ex USA Index from 1988 onward.

On the valuation side, we see little room for market-multiple expansion in the United States. The 12-month trailing price-to-earnings ratio for the S&P 500 is 24x, and the 12-month forward P/E ratio is 18x (using analysts' consensus forward earnings estimates). These are both historically high levels. Our base case scenario assumes the P/E multiple contracts over time, bringing it in line with longer-term historical averages. Putting it all together, it means below-average expected returns for U.S. stocks. Sluggish profit growth, an unpredictable election, the reemergence of terrorism as front page news, and a still wobbly commodities complex are certainly issues to watch. Perhaps the largest concern is the fact that the world's central banks are out of ammunition and will have difficulty boosting growth despite ongoing stimulus policies.

Our primary US stock investment approaches are Blackrock Equity Dividend, Jensen Quality Growth and Vanguard Strategic Equity. These three funds emphasize high quality and keep a close eye on valuation. We are particularly pleased with Jensen Quality Growth, which has beaten the S&P 500 by almost 400 basis points so far this year, as the market has recently begun to focus on the quality of earnings due to the challenging conditions that exist.

In contrast, developed international and emerging markets are almost a mirror image of the U.S market, with below-normal earnings and the potential for faster earnings growth from current levels. We also expect valuation multiples to expand somewhat from current levels as earnings improve. On this point, one additional supporting factor is that foreign markets have already suffered a steep decline, as if the markets expect a global recession even though it isn't at all clear we are in such a recession or about to fall into one—although that's one reasonable near-term scenario. In other words, at the low in February, foreign stocks had discounted a lot of negative news, setting them up for a potential rebound if actual events turned out to be no worse (let alone better) than expected, which seems to be what we've seen over the past month. We continue to recommend Dodge & Cox International Stock, American Funds Europacific Growth and American Funds New World Fund in the foreign stock and emerging markets categories.

It will be interesting to see if the reversal in the markets that started in February may mark the beginning of a rotation into foreign stocks. From the February 11 low, the MSCI ACWI ex USA Index is up 13.2% beating the S&P 500 by 21 basis points. Furthermore, emerging-markets stocks have rebounded 17.7% (and are up 21.9% from their January low).

Possibly, our approach to fixed income investing is beginning to pay off as well. Over the last several years, we've employed a combination of interest rate sensitive products (Dodge & Cox Income) and specialty bond funds more influenced by credit conditions, and less sensitive to rising interest rates. These specialty bond funds, such as Osterweis Strategic Income, Weitz Short-Intermediate and Templeton World Bond performed well during the second half of the quarter, whereas the Dodge & Cox Income Fund made most of its returns during January and early-February. Specifically, our specialty bond funds made between 2% and 7%, while the core bond index returned less than 1% since the February market low.

Concluding Comments

Looking ahead, however, with consumer price inflation and market inflation expectations rising, stock and credit markets and oil prices rebounding, and the dollar no longer appreciating, the Fed may soon turn more hawkish again. (In fact, just a few days after the March announcement, several Fed governors suggested the Fed could raise rates at the April meeting.) Such a move could trigger market reactions that reverse recent positive trends.

More generally, we note that global monetary policy is moving deeper into uncharted, historically unprecedented territory, bringing with it unknown and unintended consequences. This continues to be a key uncertainty and a risk as we move forward.

Markets are cyclical, and for the past several years our portfolios have been facing some meaningful cyclical performance headwinds given our conservative tactical asset class positioning and, more broadly, our long-term, active, valuation-driven investment approach. As discussed, the sharp reversal in the markets beginning in the middle of the first quarter may indicate the market pendulum is starting to swing in our favor. Hopefully, our specialty bond funds and foreign stock investments, for example, will offset below-average returns in US stocks that may be forthcoming. On a relative basis, our first quarter returns were as strong as we've seen in a number of years, and we anticipate continued strong relative performance the rest of this year and beyond.

Even if the recent positive market trends turn out to be short term and reverse course, we remain confident that our disciplined investment process and risk-management process, consistently executed over time, will pay off over the completion of this *full* cycle, and through future cycles as well.

Despite our best efforts to match-up clients to appropriate investment strategies, we've recently had several clients express a desire to have little or no market risk whatsoever. Consequently, we now are exploring Schwab's annuity options and would be glad to discuss these products with you.

In summary, it is impossible to consistently time short-term market moves, trends, and reversals. As always, patience, discipline, and fortitude remain the keys to achieving one's long-term investment goals, and to avoid getting swept away by the pendulum's unceasing swings.

Sincerely,

Stephen J Bowery, CFA, CFP