Market Commentary

First Quarter 2014

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Equity markets exhibited increased volatility during the first quarter of 2014, with full-quarter results masking some of the intra-quarter gyrations in equities. The benchmark S&P 500 index rose by a modest 1.8% during the quarter on a total return basis. However, within the index more than 25% of individual stocks moved either up or down by 10% or more during the quarter. Clearly, investors are becoming more discerning with their selections. The benchmark 10-year US Treasury note yielded 2.72% at the end of March, down from the 3.03% yield at the start of 2014. This decline in rates countered conventional wisdom that the beginning of Federal Reserve tapering of Quantitative Easing (QE) would lead eventually to higher interest rates.

Economic and Market Outlook

The majority of the United States has dealt with a colder and wetter winter than usual. This will cause distortions at many companies when first quarter earnings are reported during April and early May. In fact, 39% of S&P 500 companies mentioned weather during their fourth quarter conference calls when discussing the current business climate. This will likely result in weaker than expected GDP, sales and earnings for many companies.

The Federal Reserve is three months into its tapering of QE. The current rate of monthly bond purchases stands at $55 billion, down from the $85 billion per month pace as recently as December 2013. While early in the tapering process, there are signs that the economy is benefiting already. Commercial and Industrial bank loans rose at a 21% annualized rate in the first two months of 2014 compared to a paltry 7% during 2013. As the Fed continues to reduce the amount of QE, banks have more funds to lend to companies and individuals. The 21% annualized loan volume increase in January and February came despite the winter weather and bodes well for the rest of the year. The continuation of QE tapering has not led to higher rates as concern over weak economic growth, particularly in foreign markets, has kept a lid on interest rates. The continuation of inflation running lower than expected (or desired by the Federal Reserve), also leads to slack in the economy which in turn also serves to depress interest rates.

Russia's annexation of Crimea is another example of global markets being able to absorb geopolitical events with minimal disruption. Although coordinated economic sanctions from the G7 nations (G8 less Russia) continue over Crimea, the financial consequences remain unknown. It appears markets may be currently underpricing risk as tensions remain elevated.

While many in the financial media claim the stock market has been on a five year run and "has" to decline in the short-term, we look at this market rally a bit differently. Pundits state that at more than 60 months in duration, the bull market is already 20% longer than the average bull market which lasts for 50 months. However, we choose to use history as a guide. While the stock market hit a nominal price low in December 1974, no financial professionals use that to mark the start of the long bull market than ran until early 2000. Rather they use the August 1982 valuation low to mark the start. Using similar logic, we

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would point to October 2011 as the start of the current rally. That is when the US equity market sold at multi-year lows in P/E ratios, Price to Book values, etc. If we start the current rise in October 2011, then it is coming up on 30 months in duration, with plenty of staying power behind it. In fact, after "major" lows in the S&P 500 index (1942 and 1974), equity markets moved higher for 18 and 26 years, respectively; rising over 500% in each instance. If we believe that 2009 was a "major low", we could be at the early stages of a multi-year rally in the equity markets. Lest you think we have suddenly become euphoric, we fully believe that further upside will need to be driven by earnings growth as the bulk of the P/E multiple expansion is already behind us.

Portfolio Positioning

We expect equity returns in the mid to high single digits over the next 12 to 18 months, although it is likely that these returns will come in short "mini-cycles" rather than in a methodical steady pattern. With the short-term slowdown in economic activity that is likely weather-related to an extent, 10-year US Treasury yields have pulled back and are trading in a narrow band of 2.6% to 2.85%. A gradual move towards higher rates is still the path of least resistance, although the timing of this move is more open to question than it was three months ago. We continue to prefer those sectors and industries that will benefit from increasing economic activity both domestically as well as abroad. Emerging market equities have meaningfully lagged US equities over the past 18 months. A significant portion of this underperformance is tied to concerns China will face a hard economic landing. We believe China is going through a long cycle of moving towards a more consumer-oriented economy and away from a focus on cheap labor and low-priced manufacturing. This will be a global positive over the next few decades but getting to that point will require some volatility and uneven growth in the Chinese economy. While there are some encouraging signs of growth in emerging markets, we continue to believe US equities have more compelling valuations currently.

Conclusion

To summarize, we expect the volatility witnessed during the first quarter of 2014 to continue. Valuations on equities are fair to slightly rich, although nowhere near overvalued. Foreign purchases of US stocks are well below levels seen at the peaks in 2000 and 2007, which means international buyers could provide another source of buyers for US equities in the next several quarters.

With mid-term elections in seven months and Congress showing no signs of working towards common goals, we believe posturing and rhetoric will be the norm in Washington for the balance of 2014. Stronger economic activity continues to shrink the US budget deficit, with Fiscal 2014's deficit now projected to be approximately $514 billion. This would equal 3.0% of GDP, in line with the average for the past 40 years.

Some small areas of froth have appeared in the equity market, specifically in social media and some early-stage biotechnology companies. As long as investor euphoria remains confined to a few distinct industries, the broader market can continue to trade at reasonable valuations, providing solid upside potential in the coming years. As always, please contact us if you have questions or if we can provide any assistance to you with your investments.

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