Market Commentary

Second Quarter 2014

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Equity markets continued grinding higher, with major indices setting several new record highs during the second quarter of 2014. The benchmark S&P 500 index rose by a healthy 5.2% during the quarter on a total return basis. This brings the year-to-date total return to 7.1%. The benchmark 10-year US Treasury note yielded 2.52% on June 30 at the end of March, down from the 2.72% yield at the start of the quarter. Rates on the 10-year note are now approximately 50 basis points lower than when the Federal Reserve began tapering of Quantitative Easing (QE).

Economic and Market Outlook

The Federal Reserve is now six months through its thus far well-organized tapering of QE. If the Fed maintains its current course of tapering at each Federal Reserve meeting, the Fed will end its purchase of assets in late 2014. This will remove some of the extraordinary factors affecting interest rates, but not all. As long as the Federal Funds rate is pinned near zero, pricing distortions in several asset classes will persist. Recent trial balloons from the Fed hint that short-term interest rates might be increased late in 2015. However, we remain skeptical of these projections, recognizing that many variables will impact the Fed's actions with respect to interest rates.

The United States corporate tax rate is the highest in the developed world. In the past few months, Pfizer, Medtronic and Walgreens all considered or attempted purchases of foreign companies for the stated reason of reincorporating in Europe to lower their taxes. Apple, the company with the largest balance sheet cash hoard in the US, recently raised $12 billion in debt in order to repurchase stock while it keeps over $100 billion in cash overseas, untouched by US taxes. This should be a clarion call for a change in the US corporate tax system. Over $2 trillion in foreign earnings sit outside the United States. Allowing companies to repatriate this cash hoard without subjecting it to taxes of 35% would provide a strong impetus to hire workers and purchase new equipment.

Mid-term elections will be held in four months and based on the results of the primary season we see the divide between the two parties becoming more pronounced. This obviously means very little will be accomplished legislatively for the remainder of 2014 as both sides wait to see how the fall elections change the balance of power in Washington. Positive news on the budget deficit continues to push expected deficits lower. Fiscal 2014's deficit is now projected to be approximately $492 billion, down from $680 billion in Fiscal 2013. This would equal 3.0% of GDP, in line with the average for the past 40 years. However, the forecasts after Fiscal 2015 are far less rosy, with deficits expected to steadily increase towards $1 trillion annually by Fiscal 2022. The higher deficits will come from increased spending on non-discretionary programs such as Social Security and Medicare/Medicaid, along with significantly higher spending on healthcare due to the Affordable Care Act's full implementation.

On the geopolitical front, we continue to monitor the strife in both Iraq and Ukraine. Escalation in either situation would likely lead to higher oil prices globally. The International Monetary Fund (IMF) estimates that each $10 per barrel increase in the price of oil reduces US GDP by about 0.5% annually. With an economy that has been sputtering at close to stall speed for the past five years, an exogenous shock from an oil price spike could be detrimental to consumer spending.

Portfolio Positioning

From current levels, we do not expect equity returns to be more than modestly positive over the next 12 to 18 months. We point out that investors have continued to be surprised by the strength in equities since late 2012 with buying seemingly spurred by a lack of alternatives, rather than a focus on valuations. Volatility within the equity markets has reached multi-year lows, with the S&P 500 going over two months without a 1% move in either direction. There are many theories as to why volatility has diminished so sharply. We believe there are several factors contributing to the low volatility. One is a multi-year movement into passive investment vehicles like exchange traded funds (ETFs). Others include several quarters of lackluster GDP growth and investors marking time until the Fed ends its QE tapering later this year. Interest rates continue to remain much lower than most market experts had predicted, but we continue to believe rates will be moving higher over the next 18-24 months. The only unknowns are the timing and what the catalyst will be to push rates upwards. We remain in favor of those sectors and industries that will benefit from higher domestic growth along with those that maintain some pricing power in a low inflation environment. While emerging market equities have rebounded in the latest quarter, over the past three years, they have significantly lagged US equities.

Conclusion

We believe equities need continued earnings growth to support increases from current price levels. Valuations are slightly rich and are discounting mid- to high-single digit earnings growth for the next few years. Any shortfall in earnings below current estimates would likely cause a pullback in overall equity pricing and valuations. We have now gone nearly three years without a 10% pullback in the major US equity indices. A pullback should be expected at some point in the next 12 months, although the catalyst and duration remain unknown. A modest pullback would be a healthy event, eliminating fears of an overheating market, and possibly bringing more investors back into equities after having sat on the sidelines during the most recent advance.

While there continues to be some small areas of froth in the equity markets, the resurgence of large-cap, dividend paying blue chip companies over the past few months has been reassuring. After a long period where risk was underpriced by investors, we are beginning to see delineation again between companies with strong balance sheets and those whose prospects are less secure. Thus while equity market averages may show little growth from here, there are specific industries and sectors where we believe growth prospects are not yet fully appreciated.

June 30, 2014

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