Economic & Market Review

~ First Quarter 2014 Investment Newsletter ~

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Executive Summary

Capital market returns were modest in the quarter, but that result was respectable considering soft economic data, capital flight from emerging markets, and a geopolitical crisis in Ukraine. Developed economy stocks returned 1 to 2% while bond returns were a bit higher. Emerging markets clawed their way back to about even following a rout early in the quarter.

A weak December employment report, in the early days of the new year, kicked off the quarter on a sour note. Initially dismissed by investors, this report proved a harbinger of things to come. Retail sales growth slowed from more impressive levels last fall, and housing trends showed continuing weakness. Various gauges of manufacturing activity were lackluster as well. A muted response by investors was grounded in the widespread belief that observed weakness was simply a reflection of unusually harsh winter weather.

International developments also gave investors pause. Data released in January suggested the tepid euro zone revival was weaker than expected, and Japan's growth acceleration in the first half of 2013 gave way to a disappointing slowdown in the year's final months.

While developed economies had challenges, the epicenter of early quarter difficulties was found in emerging economies. Countries with large current account deficits experienced an exodus of capital. Argentina, Turkey, and South Africa were hit particularly hard, but others such as Russia and Brazil were impacted as well. Federal Reserve tapering, global growth concerns, and political turmoil were all factors in the equation.

As for growth concerns, China was the poster child. The nation's slowdown in December continued throughout the first quarter. Credit growth, manufacturing declines, and intermittent liquidity shortages are all being monitored.

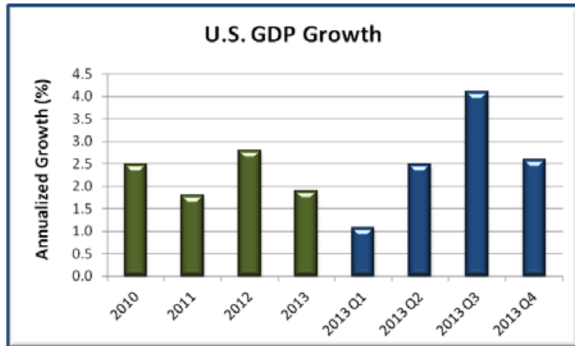
As the quarter progressed, the thesis of weather related U.S. weakness gained credibility. Retail sales rebounded as did consumer confidence, which hit a new post crisis high. The labor market also resumed more positive trends in both February and March.

While U.S. developments were largely positive as the quarter wore on, international issues were mixed. Europe's growth appeared more robust, but Japan's Q4 GDP, already below expectations, was revised even lower. Moreover, the Ukrainian crisis, which first surfaced late in February, appears to be heating up and becoming more violent. At a minimum, the East-West standoff will prove economically disruptive to Russia as well as Europe, which is a meaningful trade partner with Russia.

Economic Review and Outlook

Economic Growth

U.S. economic output rose at an annualized rate of 2.6% in the final quarter of last year. For the full year, gross domestic product grew by 1.9%.

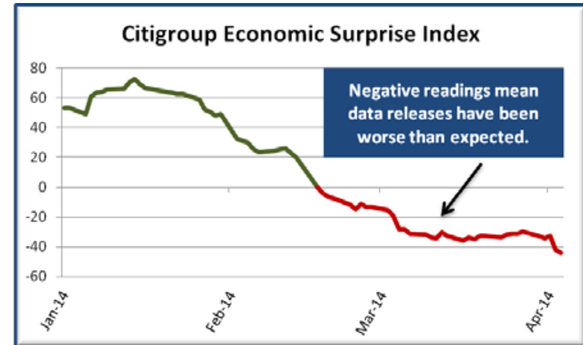


Data Source: U.S. Department of Commerce

Fourth quarter gains were driven by 3.3% annualized growth in consumer spending, the fastest pace in three years. International trade was also a material positive as U.S. exports grew much faster than imports. On the negative side, federal government spending shaved 1.0% from GDP growth and housing investment became a drag for the first time in 13 quarters.

For the full year, consumption and investment spending were both modest positives, net exports were a neutral, and government spending was a drag to the tune of 0.4%.

Turning to the outlook for 2014, it remains to be seen whether the slowdown across many domestic economic indicators in recent months was simply a reflection of unusually harsh winter weather or something more enduring in nature. Retail sales, job creation, factory output, and housing markets have all shown weakness. Furthermore, despite more mild weather of late, economic releases are failing to meet expectations and have done so at an increasing pace.



Data Source: Bloomberg

Regardless of the trend above, the majority of economists are still betting weakness is nothing more than the manifestation of poor weather. On that point, following a forecast of 1.5 to 2.0% annualized growth in the first quarter, consensus expectations call for an acceleration in economic activity to 3% for the remainder of the year.

On a global basis, faster growth is expected as a result of fading headwinds. These include reduced government austerity, less economic uncertainty, and a generally healthier financial system. Interestingly, a reversal of economic drivers is also in the making. Specifically, the U.S. and other developed economies are expected to contribute *more* to global GDP growth this year while emerging nations will likely contribute *less*.

Developed Nations

Europe's recovery looks to be gaining momentum. The final quarter of 2013 was the first since Q1 2011 that Germany, France, Italy, and Spain all grew. Moreover, the ECB expects 1.1% euro zone growth

in 2014. European manufacturing is expanding and interest rates in many countries are at pre-crisis levels. On that note, Portugal, Ireland, Italy, and Spain are each raising money in the debt markets, and Greece did so following quarter end. So much for the so-called "PIIGS" of Europe.

Japan is a mixed bag. Although inflation targets are progressing well, last year's initial gains from Prime Minister Shinzō Abe's expansionary programs (dubbed Abenomics) have given way to slower growth in recent quarters than expected. Consumption, business investment, and exports were all disappointing toward year-end. The nation is also experiencing diminishing, if not negative, returns from massive depreciation of the yen over the past year or so. Related issues include a record trade deficit in 2013 and lackluster exports. More recently, in contrast to Japan's economic goals, the yen has actually strengthened. Lastly, to add uncertainty to the outlook for Japan, a long awaited hike in consumption taxes (from 5% to 8%) took place at the start of the second quarter. The last time Japan raised this tax, the nation went into an 18 month tailspin. Japan's economy is expected to contract at an annualized pace of 4% in Q2.

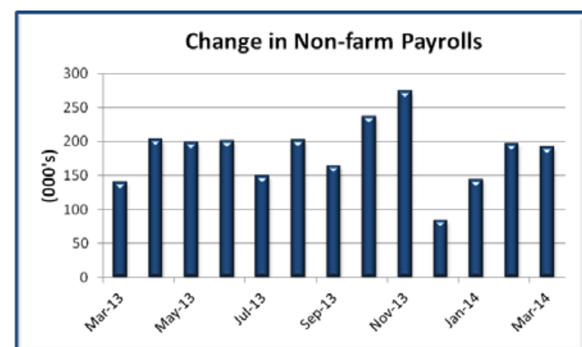
Emerging Nations

China's economy, already expected to grow in 2014 at its slowest pace in 24 years, is showing disturbing signs of weakness. The nation's manufacturing contracted at an accelerating pace in Q1 to reach an eight month low. Export growth, retail sales, and industrial production have all been weak, and credit concerns are mounting. Considering most economists see a slowdown in China as the biggest threat to the U.S. recovery, developments in the world's second largest economy should be monitored closely.

China is not the only developing nation under the microscope. Other emerging economies, particularly those with pronounced current account deficits, have been susceptible to changes in U.S. monetary policy. Dependent on external financing, these nations became fat on capital inflows over the past few years as investors sought higher yielding assets outside of the U.S. Now that the Fed is unwinding unconventional monetary support, that trade is becoming less attractive. Emerging market capital outflows have ensued. At the same time, slower Chinese growth has diminished the demand for a number of commodities, many of which come from resource rich emerging nations. This perceived "end to the commodity super cycle" adds yet another negative to the investment premise of many emerging economies.

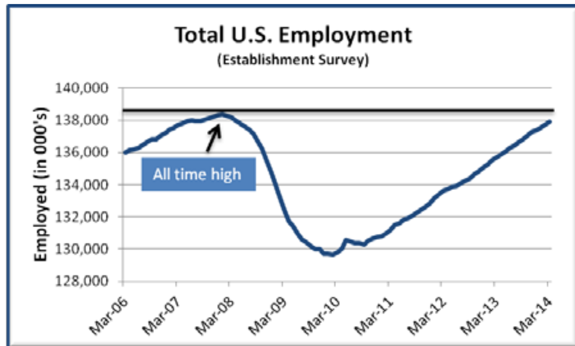
Employment

Following weather related weakness in December and January, the U.S. labor market showed improvement in February and March. Initial jobless claims resumed a downward trajectory and payroll growth expanded to its previous range.



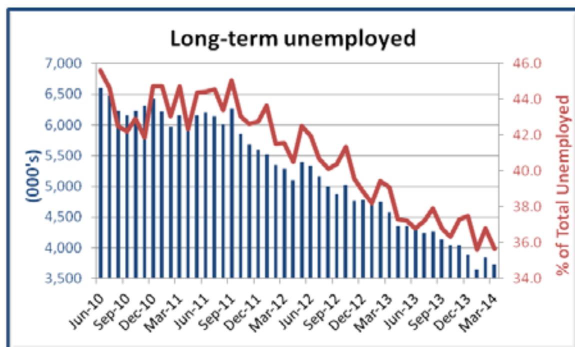
Data Source: U.S. Department of Labor

Additionally, the labor force participation rate ticked ever so slightly higher, the ratio of job openings to job seekers improved, and total U.S. employment is nearing the previous peak.



Data Source: U.S. Department of Labor

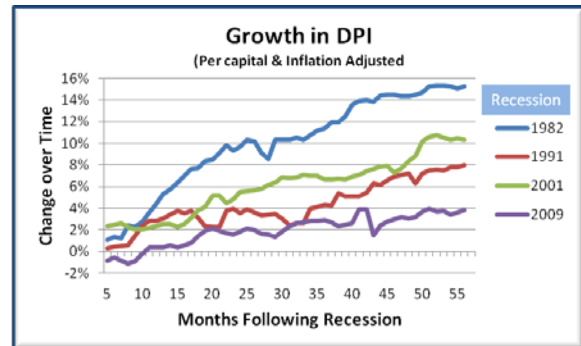
Indeed, aside from recent hiccups, there are definitely labor market positives when viewed through a longer term lens. Perhaps most notable, particularly because it is on Federal Reserve Chair Janet Yellen's radar screen, is the improvement in the number of long-term unemployed (out of work in excess of 27 weeks).



Data Source: U.S. Department of Labor

As shown, the number of long-term unemployed has nearly cut in half from the peak. This cadre of individuals now makes up little more than one-third of the total unemployed compared to almost half at the highest point.

It would be a relief if recent economic weakness is weather related, but the labor market needs more than just a change in seasons. The number of unemployed individuals remains high, and the labor force participation rate is back to 1978 levels. Additionally, and of particular concern, inflation adjusted per capita disposable personal income has hardly budged compared to the experience of past economic recoveries.



Data Sources: U.S. Department of Commerce, Summit

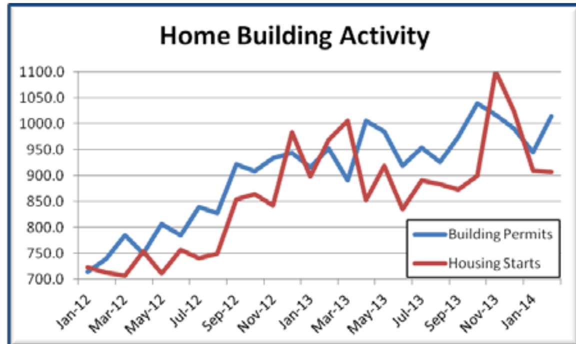
Much of the blame for a thus far tepid economic recovery is embodied in the previous graph.

The Consumer

Notwithstanding poor income growth, the consumer is in reasonable shape. Confidence hit a new post-crisis high in March, and household wealth notched new all time highs throughout 2013. The savings rate stabilized last year, albeit at a relatively low level, and debt service capabilities are quite healthy. Personal consumption expenditures also accelerated in last year's final quarter to the fastest pace in three years. As for winter weakness in auto sales specifically and retail sales generally, this too appears to be waning as more mild weather surfaces. That said, as of yet, there has been no evidence of hoped for "pent up demand" causing a temporary burst in consumer spending.

Real Estate

Although much has been written and discussed about a slowing in housing, the data suggests more of a stabilizing trend than any type of pullback. Housing starts are down slightly from last year, but building permits, a better reflection of future activity, are up nicely.



Data Source: U.S. Department of Commerce

Inventories of both new and existing homes have also risen to more healthy levels. This improves the buying process for home purchasers and helps to contain price spikes - a deterrent to a healthy marketplace. As for price, data through January showed each of the 20 market segments covered by the S&P/Case-Shiller Home Price index experienced sequential price gains every month since August. The only exception was a temporary one month drop in the Cleveland market. In aggregate, year-over-year price gains have been running in excess of 10% for nearly a year and by over 13% in recent months.

In terms of affordability, higher home prices and about a 1.0% jump in mortgage rates have put a modest dent in the ability to buy a home. That said, as the following graph shows, affordability has actually been rising from a low last August and is presently better than it was in 2010.

Data Source: National Association of Realtors

Monetary Policy

Janet Yellen was confirmed by the Senate in early January and became Chair of the Federal Reserve at the end of that month. With minor exceptions, the transition has been smooth and markets have been comfortable with Yellen at the helm.

January also marked the first month of Fed "tapering" (a reduction of bond buying, also known as quantitative easing). Since that time, the Fed has reduced its monthly bond purchases by $10 billion at each of its last three meetings. Presently at a pace of $55 billion per month, expectations are for the Fed to complete this final program of quantitative easing later this year.

As widely expected, at their March meeting, the Fed migrated away from a specific unemployment target to a broader set of economic metrics. Unexpectedly, however, Fed members also intimated that rate increases could come as soon as next spring - materially sooner than consensus expectations. Not only that, but individual Fed member projections for future monetary policy also suggested a faster *pace* of increases than anticipated by markets. These revelations were not well received by investors; market volatility spiked, and stocks were weak.

Monetary policy in Europe is equally under the microscope. Weak and slowing inflation in the euro zone has been a prevalent concern. Not only does lower inflation pose a potential challenge to future spending behavior, weak inflation diminishes nominal growth which hinders the capability of leveraged nations to grow out of high indebtedness. At present, the European Central Bank's appetite to use unconventional tools is uncertain. ECB President Mario Draghi stated repeatedly throughout the quarter that negative rates, and other unconventional monetary tools, were options for the ECB if needed. Meanwhile, investors have heightened hopes of follow through rather than rhetoric.

Fiscal Policy

Government headwinds were material in 2013. The 2% increase in payroll taxes amounted to a $160 billion hit, and other taxes totaled another $104 billion. All told, the fiscal drag last year cut GDP growth by about 1.5%. Fiscal impacts in 2014 should amount to one third of that level, or less.

Fiscal restraint last year reduced both paychecks and economic growth. In the process, however, the government's fiscal health did improve. Increased receipts and reduced outlays resulted in a deficit of $680 billion or 4.1% of GDP. Of course, tax revenue also rose simply as a result of economic growth. Likewise, an unexpected slowing in the growth rate of healthcare expenditures helped on the cost side.

For fiscal year 2014, the Congressional Budget Office projects a $514 billion deficit, or 3% of GDP.

Governments, Politicians & World Events

In late February, a crisis erupted in Ukraine. Mass protests led to the ouster of President Viktor Yanukovych and the formation of a new government. Russia, concerned about the new government's pro-Western leanings, seized control of, and annexed, the Ukrainian peninsula of Crimea. The result has been the most charged East-West confrontation since the cold war.

Western nations have banded together to implement a host of measures to exert pressure on Russia. This includes the exclusion of Russia from G7 meetings and implementation of at least two rounds of increasingly punitive economic sanctions. More are on the drawing board. The intent is to compel Russia to extract a combined force of as many as 50,000 soldiers from within Crimea and along the Ukrainian border.

In addition to the violation of its sovereignty, Ukraine is in economic peril. Negative trends from years of economic mismanagement have accelerated as a result of the crisis. In response, the European Union, United States, and International Monetary Fund have collectively pledged as much as $30 billion in aid for the country.

The situation is growing increasingly heated; violence and bloodshed have ramped higher. The world waits to see Russian President Putin's ultimate intent while his nation faces the reality of sanction driven contraction and a surge in capital flight.

Capital Markets Review and Outlook

Perhaps in acknowledgement of a world migrating away from Fed induced euphoria, investors re-evaluated risk early in the first quarter. Emerging countries, particularly those running current account deficits, experienced a rout early on. Capital flowed to traditional safe havens such as the U.S. dollar, Treasuries, and gold. Although subsequent rallies restored early losses, there is no question that market sentiment has changed materially in 2014.

Japan also experienced a reversal of sorts during the quarter. Following currency declines and a rapidly rising stock market in 2013, Japanese stocks fell into correction territory and the yen gained strength. Both outcomes are concerning in relation to the nation's goals of higher inflation and a resumption of economic growth.

Numerous data points suggest slowing in China and greater uncertainty as to the nation's economic potential and health. This has weighed on markets globally as has the Ukrainian crisis discussed in the previous section.

Considering the challenges, market returns were good. Commodities and real estate did particularly well following relatively disappointing results last year. Developed stock markets were up slightly, and fixed income returns progressed at a reasonable clip. Capital markets in Europe were of particular note. Interest rates for sovereign debt in Portugal, Italy, Ireland, Greece, and Spain fell to euro era record lows and the stock market in Europe rose to a six year high.

Capital Market Returns

	1st Qtr 2014
U.S. Treasury Bills	0.0 %
Barclays Aggregate Bond	1.8 %
Barclays Municipal Bond	3.3 %
Wilshire 5000	2.0 %
S & P 500	1.8 %
MSCI ACWI ex. U.S.	0.9 %
MSCI EAFE (Int'l Equities)	0.7 %
MSCI EM (Emerg. Mkts)	-0.4 %
DJ UBS Commodity Index	7.0 %
DJ US Real Estate	8.7 %
HFRI FOF Composite	0.2 %

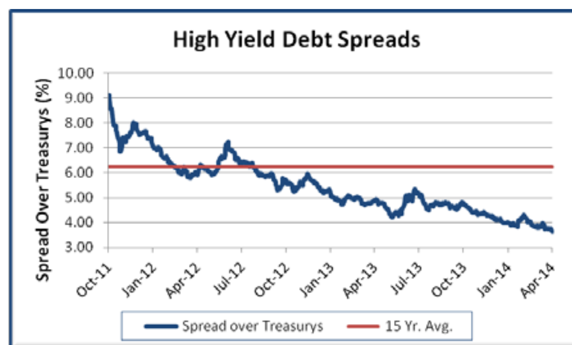
Data Sources: Morningstar & Hedge Fund Research, Inc.

Looking forward, greater volatility is likely to flow from greater uncertainty. Moving parts, both economically and geopolitically, will create systemic shocks and headline risk. Dollar strength is likely and widely expected in 2014. The U.S. economy is outpacing others, domestic monetary policy is becoming less expansionary, and easy money policies elsewhere in the world will serve to reduce the attractiveness of related currencies - namely the euro. Negative Ukrainian developments would push capital to the dollar as well.

Considering dramatic valuation expansion last year, stock gains in 2014 will be more dependent on corporate profit growth. Expectations, as a result, should be modest. Earnings growth is slow, as evidenced by expectations of 0% growth in Q1. This stands to reason considering anemic revenue growth and unusually high profit margins. It is also validated by corporate insiders, who are the most bearish they have been since 1990.

While the resolution to such circumstances may be a stock market decline, another potential outcome is simply more modest returns in coming years. In either case, investors ought to temper expectations. On that note, a tactical shift to overweight stocks in a portfolio may prove untimely.

As for bonds, interest rates are expected to end the year somewhat higher than where they started, but any rise should be contained. Despite these forecasts, by quarter end the 10 year Treasury yield had actually fallen by 31 basis points in 2014 to 2.73%. High yield credit spreads also fell during the quarter to a new post crisis low of 3.77%, a full 2.5% below the 15 year average.



Data Source: Bank of America Merrill Lynch

As a group, hedge funds returned low single digits. Sector and fixed income focused funds were top performers while short biased and emerging market funds were challenged.

Disclaimers

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