August 2014

Ignore the Noise and Stay the Course

Disease, defaults and destruction have been dominating the headlines, spurring a substantial sell-off in the markets during these dog days of summer. Panicked investors, fearing a market correction, withdrew $16.4 billion in equity in just the first week of August alone. Despite the ongoing violence in the Middle East and eastern Ukraine, Argentina defaulting on its debt once again, and the Ebola scare in West Africa, we believe that the markets are ignoring the underlying fundamentals which continue to signal strong economic growth.

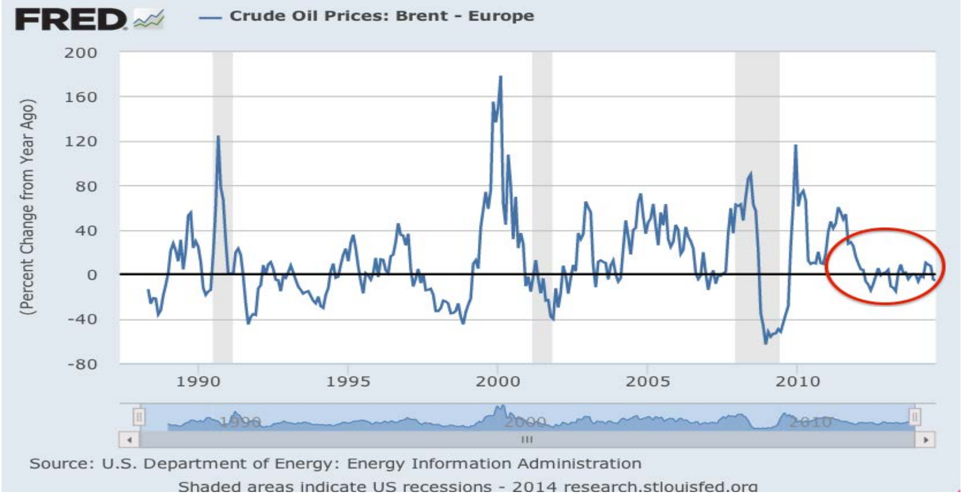
Striking a Nerve

After a quiet spring, when the S&P 500 enjoyed its longest extended period without a 1.0% or more daily price change in almost 20 years, the volatility ramped up this summer. The VIX index, often referred to as the fear index, rose +52.8% since dipping to a 52 week low on July 3rd. Meanwhile the S&P 500 fell -2.2% in July, including a -2.0% decline on the last trading day of the month. The summer downturn has been driven both by both fears abroad and at home, yet we believe that these events are not cataclysmic to the point where a significant downturn is imminent.

For one, the most recent clash between Hamas and Israel in the Gaza territory is winding down after a month of ferocious fighting. While tensions will remain high in the region after such a bloody conflict, the upside is that the standoff did not pull in other Middle East powers as it had in prior engagements.

Meanwhile, the geopolitical chess match squaring off Russia and the western world over the fate of Ukraine is inching closer to a resolution. The Ukrainian forces have surrounded the last rebel strongholds while EU and US sanctions have systematically choked the wallets of Putin's inner circle. Putin's most recent ban on food imports from the EU and the US could end up being a self-inflicted KO to his proxy war as the ban is expected to lead to extreme food shortages in Russia. While there is always a probability that the situation could escalate, we believe that neither side is resolute on launching a full scale war.

Unresolved still is the fate of Iraq, as the advance of the Islamic State has shaken the state's nascent democratic structure to its core and dragged the country into yet another sectarian war. While this new extremist Islamic group has had success on the battlefield in the northern half of the country, it is unlikely that the US and its Iraqi allies will allow the group to lay siege on Bagdad or the country's vital oil fields in the south. Despite the expanding violence in the Middle East, oil markets have been relatively calm, as seen in the chart below. In fact, the price of London traded Brent crude oil is actually down $5 since mid-May and the global supply increased by 230,000 barrels in July.



On top of all of the headwinds from abroad, investors are already getting squeamish about the Fed's first rate hike, expected in early 2015. In July, Fed policymakers agreed to reduce purchases of treasury bonds and mortgage backed securities to $25 billion a month, which puts it on pace to end its quantitative easing policy in October. However, rate hikes should not spook investors. Increasing short term rates from near 0% to 0.5% or 1% will not make the Fed's monetary policy tight; it will just be less loose. The Fed policy will not be tight until short term rates reach 3%, which is not foreseeable in the near future.

A Recipe for Success

Even if a Fed rate hike occurs earlier than expected, we do not anticipate it to stunt economic development. The underlying economic fundamentals, which are the rudiments for growth, are continuing to strengthen.

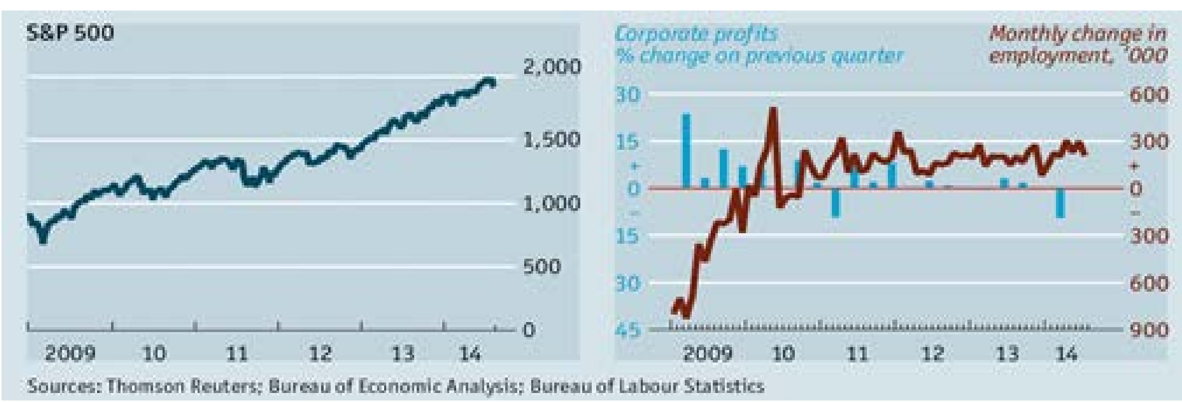
- Real GDP grew at +4.0% in the second quarter after a weather-related drop in Q1 of -2.1%. The strong performance was boosted by increased personal consumption and private investment, which bodes well for the upcoming months. The Consumer Confidence Index rose to 92.7 in July from 86.4 in June (1985=100) signaling that consumers are becoming more upbeat about the health of the economy.

- Additionally, the labor market continues to post steady gains, with another 209,000 jobs added in July. It was the sixth straight month that over 200,000 jobs were created, the first time that's happened since 1997.

- Furthermore, US factories are humming. The ISM manufacturing index, which measures factory sentiment, rose to 57.1 in July, the highest level in more than three years (Levels above 50 signal expansion, levels below 50 signal contraction). The number of new orders also picked up during July signaling that production should remain strong for the months ahead.

Looking Forward

Despite the mid-summer downturn, we still believe that the US equity markets have more upside and can finish the year in the high single digit range. The driving force of this growth will continue to be corporate profits, which have pushed price to earnings ratio on the S&P 500 to 17.5, the same level it was a decade ago. Q2 extended this upward trend as seven out of ten S&P 500 companies reported higher profits than analysts projected. Q2 earnings are on track to climb 10% over the year before. To capture these forecasted gains, we added more weight in our portfolio to IVW (iShares S&P 500 Growth ETF).



The Euro area suffered a halt in GDP growth in Q2, as the Ukrainian crisis hurt trade. Assuming the conflict in Ukrainian does not escalate, we expect the European markets to rebound with a strong second half. To reflect this reversion to the mean, we increased our exposure to the bloc's stalwart, Germany via EWG (iShares MSCI Germany ETF). Even though the ETF was down -8.8% in July, we foresee it rallying as political and economic relations normalize between Germany and Russia.

Given the improving economic conditions, we believe that the Fed will stay on track to finish their tapering program by the end of October. Although 10 year bond yields have declined this year from 3% to 2.3%, we do not expect that rates will necessarily spike in the very near term. Even at these low yield levels, we believe that international buyers will continue to seek out US treasuries as a better alternative to other bond investments (German and Japanese 10 year bonds are currently yielding below 1% and 0.5% respectively). In our diversified portfolios, we continue to favor short/intermediate term municipal and corporate debt holdings.

The summer has been anything but slow as the grim headlines continue to create unrest on Wall Street. Yet we caution that while these events are significant, they will not undermine the market's recent success. The macroeconomic numbers still point to an economy that is picking up steam, not one headed for a downturn. While the upcoming months may take investors for a roller-coaster ride, we believe that in the end, the markets will end the year with a noteworthy gain.