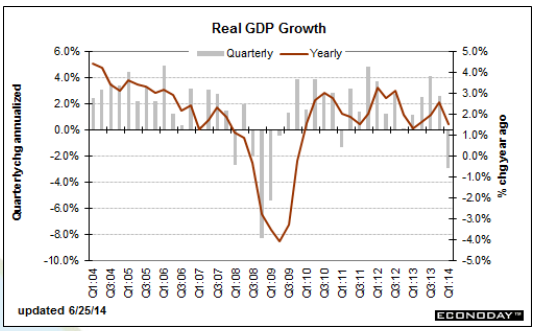
Q2 2014 Commentary
Matt B. Bailey, CFA

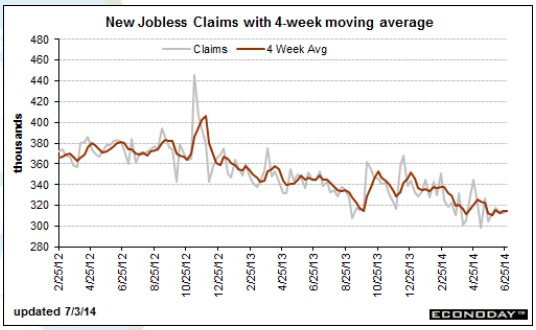
Overview
The second quarter of 2014 turned out to be just as interesting as the first as both the capital markets and economic data continued to provide bullish signals to investors. A few noteworthy highlights from the quarter included the Federal Reserve continuing to "taper" its Quantitative Easing (QE) bond purchase program at a pace of $10 billion per month, mixed US economic data and renewed investor interest in the Emerging Markets.

US Economy
First quarter GDP for the US registered at a disappointing -2.9%.[1] Although surprising, most economists weren't overly concerned and attributed the negative data to the harsh winter storms experienced by most parts of the country. Many experts have also noted that we will likely see improved data during the subsequent quarters due to pent-up demand accumulated during Q1. The gray bars on the chart to the right illustrate how much of an outlier the previous quarter was compared to the past few years. We are not excessively worried but plan to continue watching the data closely for any further deterioration.



Source: Bloomberg.com, Econoday

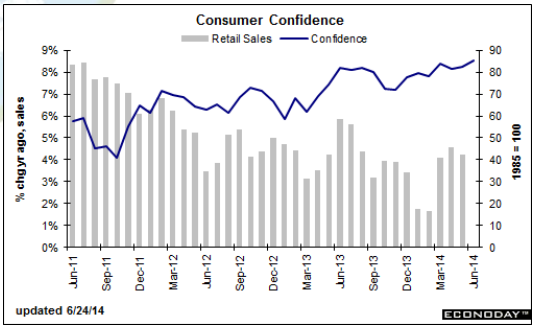
The US employment situation continued to improve as unemployment claims remained relatively low (middle chart) and the unemployment rate fell to 6.1%.[2] The underemployment rate, which tends to give a slightly more realistic view of the job market's overall health, still remains above 12% but is down from over 14% just a year ago.[3]



Source: Bloomberg.com, Econoday

Consumer confidence also remained strong, as seen in the bottom chart. Consistent readings above 80 highlight the positive perception many within the US have about the current recovery and its future prospects. This is important as consumption makes up 2/3's of US GDP.

Housing has been a mixed area of the economy this year as the data has come in weaker than many had expected. Although the numbers have improved some as of late, the euphoric feeling from last year has clearly dissipated. Many areas are still lacking new inventory as not enough new homes are coming online. In other regions, too many sellers are listing and buyers aren't yet willing to pay the newly inflated prices. Overall, the current economic landscape bodes well for the housing market due to a growing population and general need for additional single-family residences. This should correlate to improving data over the next few quarters.



Source: Bloomberg.com, Econoday

Generally speaking, the US economy is strengthening and has recovered from the harsh winter weather. The poor Q1 GDP was to be expected to some degree and we anticipate a rebound during the rest of the year.

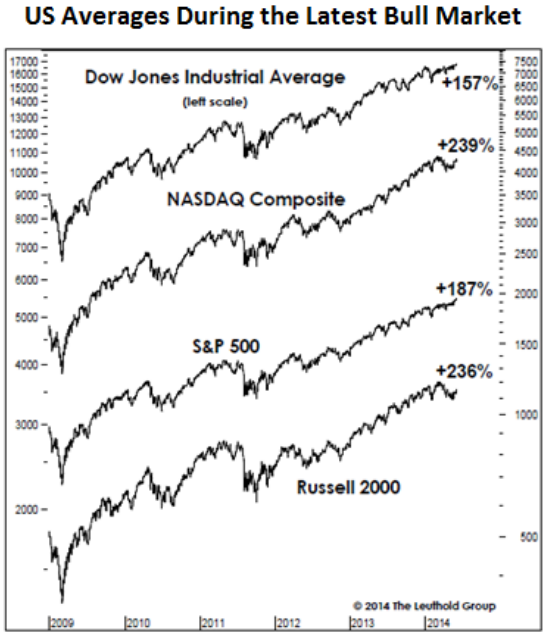
Global Economy
The global economy continued to recover during the quarter with global manufacturing registering its 19th consecutive positive reading as of June.[4] This expansion has been led by the US, UK and more recently the Eurozone area which received additional support from the European Central Bank (ECB) during the quarter.

Japan, which experienced positive growth over the previous few quarters, has seen a modest slowdown after implementing a new Value Added Tax (VAT) in April. This recent development will be watched closely by economists in the coming months as Japan's "Abenomics" plan is still under close scrutiny. Lastly, the Emerging Markets (EM) remain the biggest question mark as growth has been mixed within this group. With that being said, many economists have pointed towards developed market growth as a potential catalyst for many EM economies. Overall, the global economic outlook remains positive and continues to receive support from central bank liquidity.

US Equities

The S&P 500 large cap index remained in risk-on mode during Q2 as it made new all-time highs and finished the quarter up 5.23%. The Russell 2000 small cap index and NASDAQ Composite index ran into selling pressure at the beginning of Q2, but were able to turn it around and finished up 2.05% and 7.42% respectively. [5]

Going back to early 2009, the US markets have been on a powerful bull market run. The chart to the right produced by the Leuthold Group shows some of the performance figures over the last 5 years. This strong performance has caused equity valuations to become increasingly expensive relative to the rest of the world and historical averages. Also, as we noted last quarter, the S&P 500 has still not touched its 200 day moving average or had a 10% correction in over 18 months. Although these points might suggest a more cautious approach, they also lend credence to the overall strength of the US economy and current equity bull market.



Source: Leuthold Group
Data as of: 06/05/2014

We still maintain a slight overweight to US equities and will continue to monitor our indicators and the entire market for signs of deterioration. If necessary, we will make reductions to our US allocation in order to seek out more attractive investment opportunities.

International Equities

As we expected, the international developed equity markets have been gaining more traction and performed well during Q2. Developed market equities within Europe, represented by the STOXX Europe 50, finished the quarter up 3.26%, while the Japanese Nikkei equity index was up 3.95%. Both of these indices are also up significantly off their Q1 lows, returning over 9% and 11% respectively from early February until now.[6]

The Emerging Markets, as represented by the MSCI EM index, outperformed its international developed counterparts and was up 6.6% during Q2.[7] This strong performance comes after many investors all but wrote off the asset class over the last 18 months. Much of this dismay was attributed to EM's weak relative performance to most developed equity markets. Additionally, many investors had a negative view on select Emerging Market economies and felt they were not in a position to offer attractive growth opportunities. (Click here to read more about EM's recent turnaround on our Investor Blog.)

We remain overweight international developed equities and are considering an overweight allocation to Emerging Markets. Both are still trading at attractive levels and have positive momentum on their side.

In addition, the European Central Bank (ECB) recently announced that they are increasing their accommodative measures and are considering a Quantitative Easing program. Their easy money policy, coupled with the continuation of Japan's "Abenomics" should be very supportive to global asset prices.

Fixed Income

The bond market continued to receive well deserved attention during the quarter as rates put in new lows and pushed bond prices higher. The 10-year US Treasury rate finished Q2 at 2.52%, and the Barclays US Aggregate Bond Index finished the quarter up 2.04%.[8]

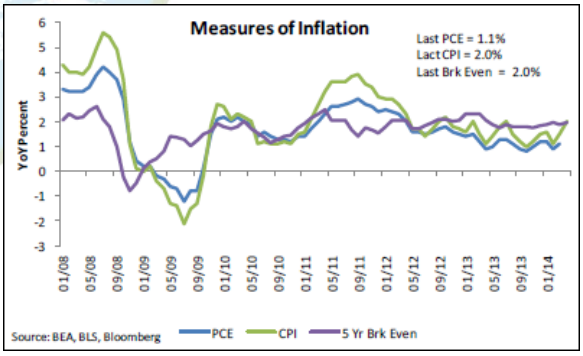
Other areas of fixed income performed equally as well. High yield and global bonds, as represented by the BofA ML US High Yield Master Index and Citi World Government Bond index, both finished up 2.57% and 2.64%, respectively.[9]

As we stated last quarter's commentary, "we continue to underweight both domestic and international fixed income in our portfolios, as we think that interest rates will likely normalize over the coming years as the Federal Reserve removes liquidity from the markets. This normalization should benefit less interest rate sensitive investments as rates rise. Within the space, we favor credit focused managers with shorter duration (less interest rate sensitive) portfolios. Additionally, we like managers who have the flexibility to hedge risk within their portfolio as rates can be volatile and are not likely to rise in a linear fashion. This includes investment strategies that can tactically invest in less risky bonds such as Treasuries and Agency MBS and managers who can actively short (sell) high-risk areas of the market when they see fit."

Commodities

Commodities as a group used much of the second quarter to digest the gains seen during Q1. The Dow Jones UBS Commodity Index finished the quarter up a mere .08%.[10] During Q2, the attention of many investors was turned away from commodities and back towards equities as they continued their march higher. A few notable exceptions included copper and silver, which finished the quarter up 6.42% and 4.51% respectively. Agriculture related commodities, one of the strongest groups during the first quarter, struggled to maintain its positive momentum and finished Q2 down 2.82%.[11]

As we noted in our Q1 commentary, inflationary data continues to be non-supportive of commodity price increases. The chart to the right, which we recently featured on our website, shows that inflation has been relatively muted since late 2009.[12] Commodities tend to perform well during inflationary periods as investors use them in hopes of protecting the purchasing power of their portfolios. As central banks around the world continue to provide liquidity through loose monetary policy, we see the long-term risk of inflation appearing as a real threat and see commodity related investments as a potential hedge.



Source: DoubleLine Capital

First Trust recently noted in a research briefing that commodities tend outperform both stocks and bonds during the second half of business cycle expansions.[13] Fidelity Investments estimates that we are currently near the midpoint of the current business cycle which would indicate that now may be a good time to consider allocating to commodity related investments.[14]

We currently have minimal assets directly invested in commodities or commodity related investments, but plan to add them to many of our portfolios in the near future. We believe the risk of inflation appearing in the next

few years is a real threat and that commodities will provide a meaningful hedge. Lastly, continued global expansion should be supportive of many commodity prices as demand increases and supply is finite.

Outlook

Our positive long-term view of the US and global economy remains intact. The majority of economic data being released still points towards global expansion, and the loose monetary policy utilized by many central banks encourages and supports this growth. Equities are still atop our list of highest conviction ideas, with developed international and emerging market equities possessing the most attractive valuations. Although fixed income has rallied so far this year, we firmly believe that rates will rise in the future and plan to keep an underweight allocation. Lastly, commodities are starting to slowly garner investor attention and offer access to an uncorrelated asset class that has historically performed well around this point in the business cycle.

As always, please feel free to contact us with any questions you may have.

Matt B. Bailey, CFA
Portfolio Manager

Source:

1. bloomberg.com/markets/economic-calendar
2. Ibid
3. bloomberg.com/quote/USUDMAER:IND
4. Markit.com
5. Morningstar.com
6. Ibid
7. Ibid
8. Ibid
9. Ibid
10. Ibid
11. Ibid
12. DoubleLine Capital
13. First Trust
14. Fidelity Investments

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