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Market Commentary

When Teddy Bears Go Rogue

Did you see the closing ceremony of the **Winter Olympics** in Sochi? A teddy bear as large as a building, representative of Russia, shed a tear and blew out the Olympic flame. Since then, the Russian bear has grown a good deal more aggressive. Russian troops now occupy the Crimean peninsula of Ukraine, where a vote was taken to split from Ukraine and align with Russia. Some fairly minor sanctions by the U.S. and Europe immediately followed. More serious economic sanctions are under discussion.

And this is only one piece of a very complicated geopolitical puzzle. China and Japan continue to rattle swords over islands claimed by both (China recently announced a 12.2% increase in military spending in 2014). Civil war is ongoing in Syria, and we can't forget about Iran and its nuclear ambitions. We are investors, of course, not diplomats or politicians. But there is no doubt that geopolitics impacts markets. So how worried should we be about all the political turmoil in the world?

First, an overview of the economy and markets:

Globally, economic numbers appear reasonably healthy. Figure 1 below summarizes global manufacturing and trade in recent years, where a trend of positive growth, albeit small, remains the norm.

In the U.S., economic data remains hit and miss. Manufacturing statistics are pointing up, with the **Purchasing Managers Index** (PMI) accelerating to 57.1 in February, from 53.7 in January. But services, which make up the larger part of the U.S. economy, have underperformed. This is partly due to the intense winter weather, though just how much we will learn in the spring.

Among the positive indicators, corporate earnings have been coming in above expectations. This has fueled stocks, with the **S&P 500** reaching record territory in early March before pulling back a bit since then. We are by no means down on U.S. stocks, but they do seem fairly valued now given the underlying fundamentals. We see more equity value in other **developed-world** markets such as Europe (particularly UK and Germany), and Japan, in spite of recent softness in the Nikkei.

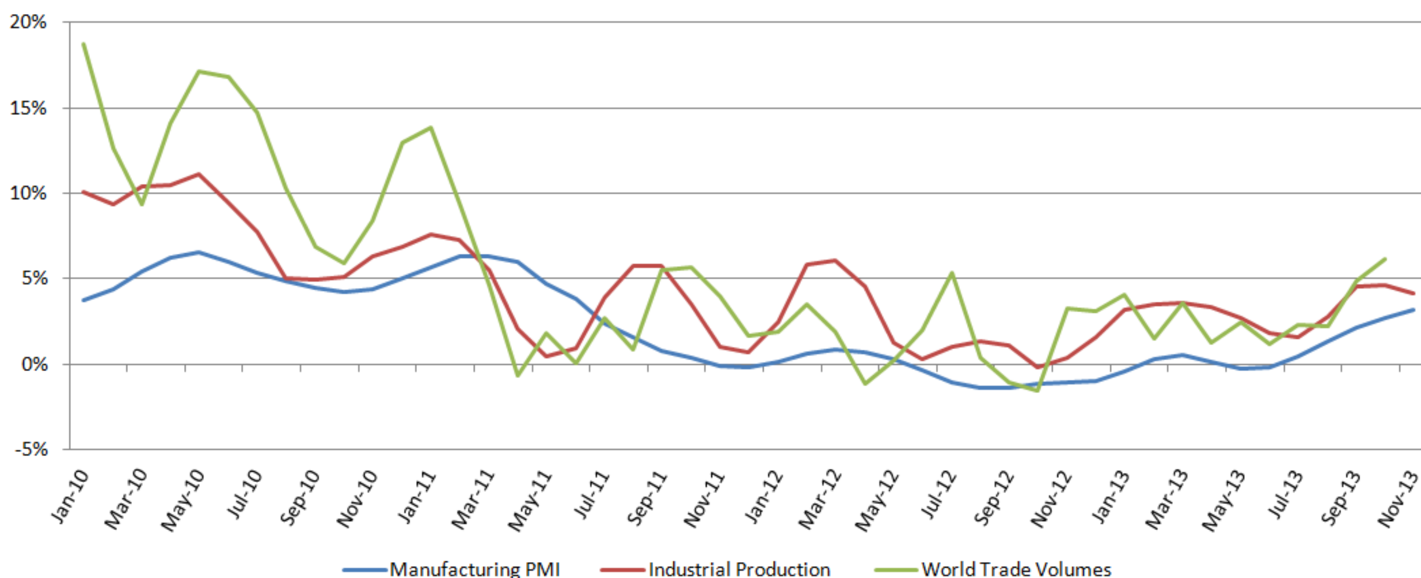

Figure 1. Annualized percent change in three measures of global economic activity, since 2010 (annualized 3-month moving averages, source: Markit Economics, Haver Analytics, CPB World Trade Monitor)

In Europe, Russia's Crimean gambit is especially vexing, because Europe is dependent on **Russian gas and oil**. That makes sanctions a delicate business, as Russia could, in theory, turn the spigots off at a critical time in Europe's economic recovery. But Russia would be loath to lose that source of revenue, and rising production from shale deposits in the U.S. could also enable offsetting moves by America.

Emerging markets remain generally weak, and China's most recent manufacturing PMI reading was 48.5, signaling contraction. Increasingly, the emerging world appears segmented, with some parts healthier than others. But China remains the largest of the group and something of a bellwether, and concerns there seem to be putting a damper on Asian markets generally. The good news is that the talk from Chinese leadership indicates they are pursuing structural reforms needed to return to long-term growth, rather than trying to pump up short-term numbers.

Federal Reserve **tapering** continues, and according to Fed Chair Janet Yellen this is likely to go on for several months. Overall, we continue to see 2014 as an up-period for interest rates, though geopolitical events such as the Crimean crisis have the potential to start flights to quality that temporarily reverse the up-trend. The upshot is that Treasury bonds still have a place, albeit a small one, in a balanced portfolio. Overall, we continue to favor high yield in our **Fixed Income allocation**, though returns to these are likely to moderate as the credit spread narrows. We recommend keeping duration low.

The dollar should be relatively solid this year, with U.S. exports rising. And speaking of currencies, the virtual one known as **bitcoin** has been in the news recently with its largest virtual exchange, known as Mt. Gox, collapsing into bankruptcy. The exchange lost nearly half-a-billion U.S. dollars worth of bitcoins to hacking, which brought on the crisis. Fortunately, while bitcoin has been growing, it has not reached wide enough use that something like this can significantly spill into other markets and the wider economy—the way a sovereign currency collapse might. But the Mt. Gox collapse does raise the question of whether bitcoin will ever be able to compete with sovereign currencies.

The extremely cold winter weather, and the Crimean crisis, has benefited most commodities, including **gold**, which is up some 14% this year. Others such as copper, are off with Chinese economic weakness. Even if China were to begin improving tomorrow, its de-emphasis of infrastructure spending would still negatively impact copper.

As the Crimean crisis, as well as other geopolitical hot spots continue to develop in the coming weeks and months, volatility in markets can be expected. Considered together, these geopolitical issues are posing the biggest downside risk to the global economy right now. Not that long ago, it was the European sovereign debt crisis. How quickly things change!

Right now, the impact on the economy and markets from these things is mostly, like the bitcoin, virtual—an issue of intangible worry rather than economic reality. So while the issues bear close watching in the weeks to come, don't let your investment strategy be ruled by fear. We believe the U.S. and global economic expansion will keep its footing through these dilemmas, and that there will likely be faster growth this year than last.

Those are the most prominent and pressing issues on our radar right now. Going forward, we can always be certain of uncertainty, so we will be monitoring the situation closely and getting back to you as the situation warrants. We send thanks to those of you who are our clients. We value the trust you have placed in our firm and we sincerely appreciate your business. Please do not hesitate to call or email us if you have any questions or concerns.

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Active-Defensive Investing