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Volume 23, Issue 4 April 15, 2014

Market Commentary

The Big Thaw

The first day of spring, March 20th, was a welcome sight after a long, hard winter in most of the country. The transition to warmer, friendlier weather is coming at a time when the economic climate seems to be improving as well. **Recent data** is coming in much stronger after a winter lull in which consumers were forced to dig in (or rather dig out) from the harsh cold and snow of the winter.

The word equinox is derived from Latin words (aequus and nox) meaning "equal night," as day and night are becoming approximately equal in length at this time of the year. Likewise, the U.S. economy seems to be moving toward a healthy balance, with an average of 195,000 jobs created for both February and March. Retail sales in March grew at the quickest rate in a year and a half. March car sales reached their fastest pace in seven years, and **manufacturing order backlogs** reached a three-year high.

All of these indicators paint a very optimistic picture of improving underlying strength, and we are seeking exposure to this growing cyclical recovery. But as a skeptic might say, "one swallow does not make a spring." It has been a long time since we experienced a "normal" economic expansion, one that can stand on its own without support from the Federal Reserve. Are we really almost there?

Let's consider the evidence, as well as some downside risks. On April 30th, the advanced release first-quarter GDP data will likely reflect an **economy** that grew at a slower rate from the fourth quarter's annual 2.6 percent pace, probably around 1.5%. Based on the latest observations, we now believe this anemic figure was largely a result of the extreme winter weather and likely transitory. Our expectations are for a moderate but sustainable global economic recovery as we move through the year. In the U.S., we expect acceleration in growth to the 3% range for the remainder of 2014. The environment should provide continuing support for U.S. and foreign equities and likely initiate another upturn in global bond yields.

Federal Reserve tapering that began at the first of the year has contributed to volatility in the capital markets and will likely continue to do so. **Janet Yellen** has now hinted that rate increases could come as little as 6 months after QE tapering ends. This could translate to as early as the second quarter of 2015, sooner than markets had been anticipating.

As markets get used to this winding down of stimulus followed by eventual tightening, we do not expect it to prevent increases in stock prices or bond yields over the course of the year. We expect reasonably steady economic growth in the US and other developed economies to gradually spread to parts of the emerging world. This should in turn be positive for **corporate earnings** in developed economies and provide sustenance for further stock gains in 2014.

As Figure 1 below shows, the **S&P 500** has backed off significantly from a recent record high (1897 intraday on April 4). While the market is fairly valued in our view, earnings strength could create significant room for advances this year, with P/Es remaining in the 15-16 range. Periodic downward volatility can create buying opportunities in such an environment.

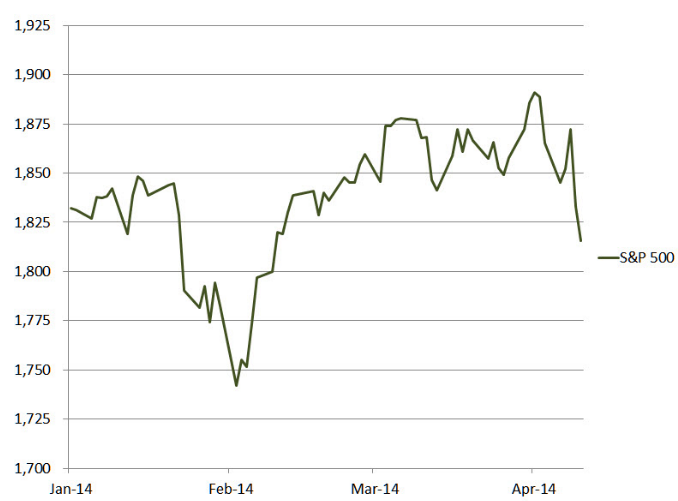

Figure 1. The S&P 500 in 2014
(daily adjusted close, source: Yahoo Finance).

In **Europe**, despite continued geopolitical risk from Ukraine and structural adjustments in the periphery, we expect ongoing emergence from recession, with modest but positive economic growth for 2014. At present, we believe European equities are generally a better value than those of the U.S., and have them overweighted in our portfolios.

One of the big stories since the last newsletter is that we have seen four consecutive up weeks for **Emerging Market** equities. While China still faces near-term hurdles (see risk bullets below), we see a good chance for economic growth for 2014 in the significant 7% range, with ample resources and policy flexibility helping them avoid a more material slowdown. Brazil, while still facing growth challenges, has likely entered the late stages of its credit tightening cycle, and its equities are showing value with a 12-month forward P/E of only 9.8. India's equity market has outperformed this year, relative to other EMs, and could be poised for more growth in the rest of 2014 as markets appear excited by Narendra Modi as leading candidate for Prime Minister. We are currently maintaining exposure to both Brazil and India in our **Guardian Country** Allocation.

In **bonds**, expect spreads to tighten over 2014 and make returns harder to come by, particularly at the lower end of yield spectrum. We maintain a short duration and a tilt to high yield. While **commodities** could benefit from rising global growth this year, there is also considerable potential for weakness, especially in copper and gold.

In the **U.S. Dollar** we expect to see some moderate strength in 2014 relative to other developed market currencies, a number of which will still be in monetary easing mode throughout the year. Escalation of the tensions with Russia could trigger greater strength from a flight to quality.

While our outlook is optimistic, here are the largest **risks** that we see, along with our take on them:

- *Will the growth rebound we are beginning to see continue to gain steam?* We believe it will.

- *Can China successfully engineer a soft landing from its real estate bubble and shadow banking problems?* Probably, but de-leveraging and restructuring the financial system will create economic headwinds in the near-term, even if done right.

- *Will Russia further escalate tensions in Ukraine?* If so, the economic effects could spread and investment markets globally could price in more geopolitical risk. With Crimea lost, pro-Russian separatists are now destabilizing eastern Ukraine. As a result the country's economy is faltering. Prices rose 3% in March alone, leading the Ukrainian central bank to sharply raise interest rates. The U.S. and EU will continue to employ economic sanctions (and the threat thereof) in the standoff with Russia.

- *Will inflation in the developed economies surprise to the upside with improving economic growth?* We don't think so, but if it does happen it would bring the potential for short circuiting the expansion.

- *As U.S. monetary policy normalizes, will rising rates lead to volatility in equity markets and headwinds for EM assets?* Possibly, but primarily if rates rise faster than expected.

- *Will the recent sales tax increase in Japan damage their economic rebound?* Possibly, if it damages consumer spending, which accounts for 59% of Japan's economy. But, the Prime Minister of Japan, Shinzō Abe , could potentially pull more "arrows" from his quiver in the form of offsetting stimulus and structural reforms, not to mention monetary easing being pursued by the central bank. We will be watching closely as this situation unfolds in the coming months.

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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