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Market Commentary

Reading the Balance Scales

In recent newsletters we have been explaining our expectations for a moderate, but sustainable and accelerating, U.S. and global recovery this year – something we have called the Big Thaw. Data continues to support this view, with May's U.S. employment report showing the economy added 217,000 jobs for the month, slightly beating expectations. The unemployment rate stayed steady at 6.3%. U.S. auto sales rose 11% over May 2013 and the Federal budget deficit shrank by $9 billion compared to a year earlier.

This environment should provide continuing support for **U.S. and foreign equities**, and we expect it will at some point initiate an upturn in global bond yields. We are beginning to see encouraging signs from the global economy. This should work to the benefit of corporate earnings, which can then feed back into more support for equity gains in 2014, which have had a reasonably good year in the U.S. so far, as Figure 1 shows.

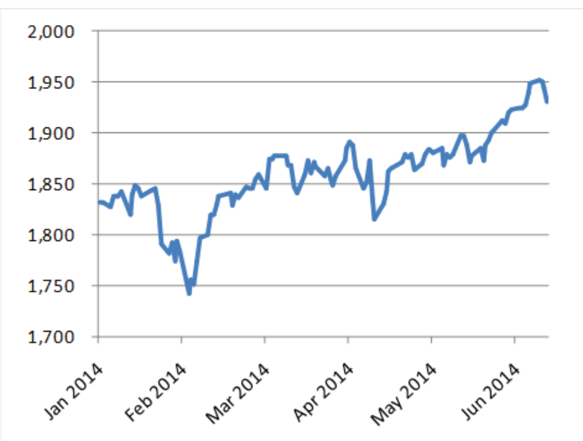

Figure 1. The S&P 500 in 2014 (adjusted close, source: Yahoo Finance)

In what should aid this positive feedback loop, on June 5 the **European Central Bank (ECB)** took a more aggressive posture toward fighting deflationary concerns by cutting its main policy rate and dropping the bank deposit rate to a negative level. These and other steps discussed at the ECB meeting are designed to encourage banks to increase lending and place the European economy more firmly on its recovery track. With Europe having been one of the weak links in the global recovery, these steps can give markets confidence that the policy backdrop in Europe will remain favorable to growth.

Recent data from **Japan** is looking positive as well, with service sector sentiment improving and first quarter GDP growth being revised upward to a robust 6.7% annual rate.

The generally expansionary environment has also provided support in recent weeks for **emerging market (EM)** assets. Positive sentiment toward risk assets is enhancing their appeal while also narrowing EM credit spreads. But as the year advances, we expect these markets may come under pressure. A back-up in yields from a strengthening global economy may deal a negative growth shock to some emerging economies. This will be especially true to the degree that Europe and Japan are successful in reflating their own economies. Because of this risk, we believe EM performance will become more selective in the months ahead and reward those nations that have more favorable fiscal policies and interest rate environments.

In summary form, here are some **key positives** we see in the present environment:

- U.S. labor markets are improving and inflation is low, though moving toward the Federal Reserve's target rate of 2%.
- The U.S. federal budget deficit continues to decline.
- Deflationary concerns in Europe and Japan should be mitigated by recent accomodative policy moves by their respective central banks.
- Concern for China's growth slowdown, a significant issue for the past year, is beginning to lessen with the World Bank's announcement that the nation will likely meet its 7.5% growth target for 2014.
- Low yields in bonds continue to create incentives for investors to increase exposure to

equities and other risk assets.
- Geopolitical tensions around the Russian incursion into Ukraine and the annexation of Crimea appear to be subsiding in light of new peace talks.
- From FACTSET's June 6, 2014 Earnings Insight: "Although companies reported a slight earnings growth (2.1%) for Q1, earnings growth for the S&P 500 is projected to be much higher for the remainder of the year.....For all of 2014, the projected earnings growth rate is 7.6%."

With those positives in mind, let's consider the other side of the coin – risk scenarios that will bear close monitoring in the months ahead. Here are the **principal negatives** we see:

- No sooner does the crisis in Ukraine cool to a simmer, than new events in Iraq raise their ugly head and demand attention. Extremist insurgents have gained control of key parts of the country. The situation seems to be changing rapidly, but at the least represents a threat to oil supplies and prices that could impact the world economy.
- Despite an improving political climate in Crimea, expanded sanctions against Russia could conceivably lead to tighter oil supplies in that region as well.
- If the U.S. Dollar strengthens beyond current expectations, it could bring a negative foreign exchange impact to U.S. based multinational corporate profits.
- U.S. stock valuations, while reasonable given current interest rates, are no longer so good as to provide the downside support we have become used to in recent years. In the event of a rapid downward shift in growth expectations, or a rapid rise in inflation and/or interest rates, the stock market could be in for re-pricing. The current forward P/E ratio for the S&P 500 is 15.6 (per Factset's earnings projections), which is above the 10-Year Average of 13.8.

Among these negatives, the tail **risk from Iraq and Ukraine** (the first two bullets) seem to us to have the greatest potential for changing our outlook. With that said, the good news is that oil prices are increasingly less dependent on the political state of the Middle East, thanks to a growing diversity of supply, especially from U.S. shale sources.

Overall, weighing the positives and negatives on opposite sides of the scale, the most compelling factor we see is that the global economic environment continues to improve. The U.S. economy remains in an expansionary phase and we think this will continue through 2014. Our stance favors a pro-growth position, as it has all year. A growing U.S. and global economy should continue to be favorable for **equities, real estate, commodities** and most risk assets. Select international developed-market equities are especially attractive to us now, being favorably positioned to capture global growth at a cheaper price than U.S. issues.

The search for yield and improving profits will likely squeeze credit spreads in the bond space. We look for continued expansion to push **U.S. interest rates modestly higher**, which may help offset the decline in risk premia. Overall, higher rates should continue to favor corporate and credit-related sectors of the bond market that benefit from an improving global economy and higher relative yields. Accordingly, we prefer credit-sensitive and short duration investments in our fixed income holdings, as they are likely to outperform higher-quality, longer duration securities in the next year or two. Shorter maturity corporate bonds should help blunt the impact of rising rates. We continue to favor high yield and convertible bonds, though they are no longer underpinned by as favorable valuation metrics as we have seen in recent years. We remain underweight in government bonds, which offsets our overweight in equities. This has been our position for the last 12 months we expect it will continue through 2014.

Historically, stronger growth in the U.S. usually increases the value of the **U.S. dollar**. As a result, dollar strengthening seems likely, especially against the Yen and the Euro, which will in all likelihood have looser monetary policy behind them.

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.

The views expressed are those of Byron Green as of June 13, 2014 and are subject to change. The information contained herein does not constitute investment advice or take into account any investor's particular investment objectives, strategies, tax status or investment horizon. Additionally, this publication is not intended as an endorsement of any specific investment. Information contained herein is derived from proprietary and non-proprietary sources. We encourage you to consult with your tax or financial advisor. Please request form ADV Part 2 for a complete list of Green Investment Management's services.

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