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Market Commentary

At the Mid-Point

As we enter the second half of the year, the **U.S. economy** remains in the middle stage of an expansion that we believe still has plenty of room to run. Private sector job creation reported early this month reflected acceleration and the strongest six month readings since 2006 - dropping the unemployment rate to 6.1% (see Figure 1 to the right). This and other supporting data reinforces the need for a cyclical bias in equities for the remainder of 2014.

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 to the right shows.

While **strong jobs growth** is very supportive of a continued recovery, there remain risk scenarios from geopolitical turmoil, most notably of late in Iraq and Israel. And in terms of economic data, the labor participation rate (the percentage of people either working or looking for work) remains at its lowest level in years. Secondly, those who are working are finding their wages growing at only a 2% annual rate, slightly below inflation, meaning aggregate purchasing power is stagnant. This may impede the expansion from being as robust as it might otherwise have been, though an expansion is still an expansion.

U.S. stocks have generally been keeping up with positive news. The S&P 500 has begun to flirt with (though it has yet to reach) the milestone of 2,000. Globally, many other nations' equities are trading at high levels as well.

To get a feel for how high, Figure 2 on the next page illustrates the 20-year range (in blue) of the price-to-earnings (PE) multiples for the designated countries, based on 12-month-forward earnings. The red diamond reflects the PE as of July 8th, 2014. The black symbol represents the 20-year average PE.

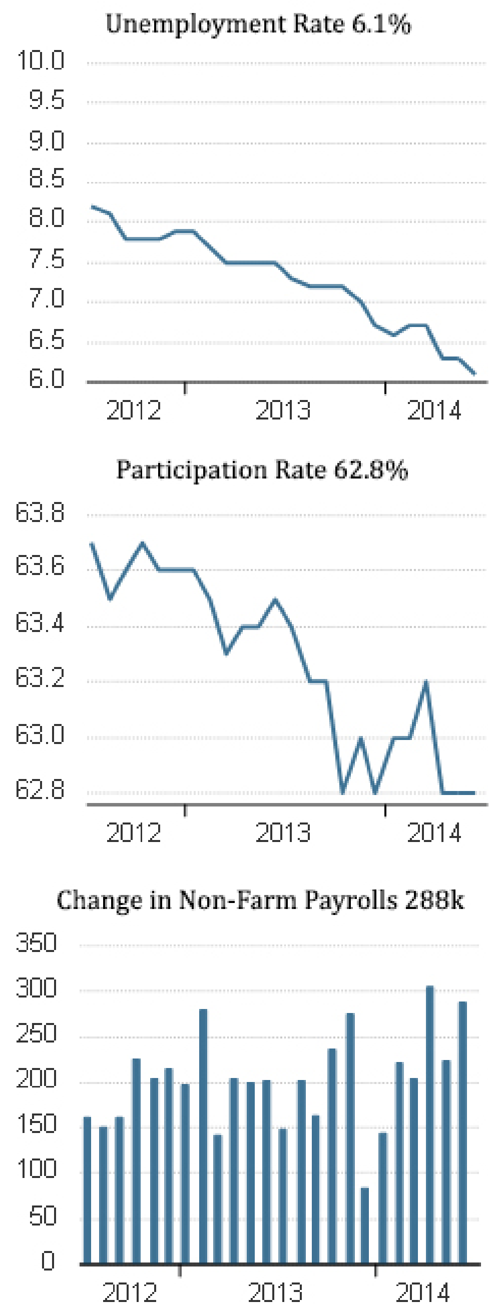

Figure 1. Key Employment Data

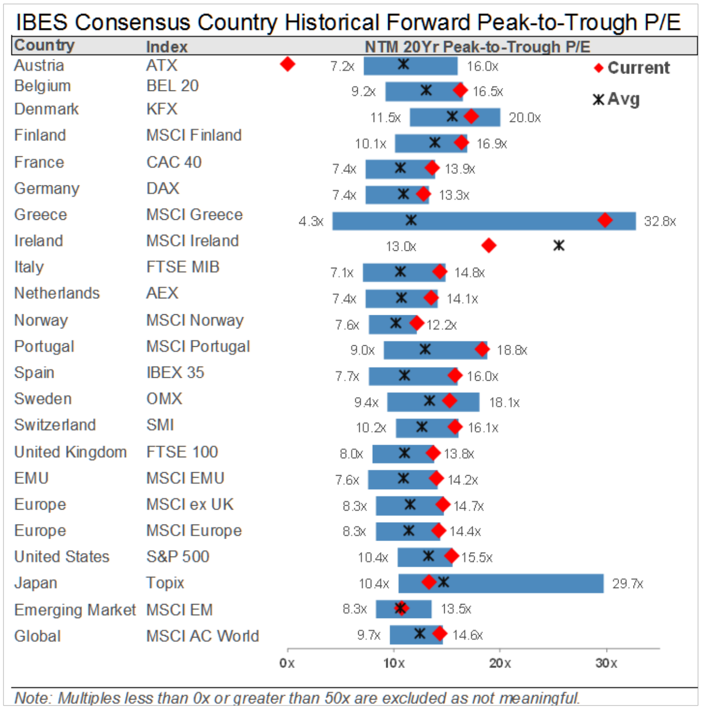

Figure 2. Current global PE ratios vs history. (Source: IBES and DataStream)

While stocks are clearly not as cheap as they have been in recent years, we feel that in the current low yield environment they still offer value relative to bonds and money markets.

Speaking of the global scene, additional stimulus coming from the **European Central Bank** and the **Bank of Japan** should continue to bolster recoveries in those areas. Unlike the U.S. they remain in the very early stages of their expansion cycle. This means the earnings of companies in these regions have the potential for upward revision in the months ahead as long as the recoveries gain traction. This should ultimately be reflected in market valuations.

	1 Week	1 Mth	3 Mths
United States	-4.7	3.6	21.7
Euro-Zone	-2	-2.8	-28.5
China	-1.6	24.8	139.4
Asia-Pacific	6.6	17.4	47
Emerging Markets	3.2	1.7	17.5
Japan	-36.8	-30	43.9
United Kingdom	-15.9	-16.5	-56.4
G10	-8.8	-5.2	-1.2
Latin America	-1.1	-17.4	-26.4
CEEMA	-2.8	-26.4	-27.1
Canada	-18.4	-4.4	-23
Australia	5.8	-19.1	-114.5
Norway	-5.1	-47.4	-23.8
Switzerland	-25.8	-6.2	-16.1
New Zealand	6.9	5.8	-22.9
Sweden	25.2	6.8	-8.8

Figure 3. Citigroup Economic Surprise Index as of 7/14/14

Concerns about **China's economy** have reduced enthusiasm for her equities in recent quarters. But new economic data is beginning to alleviate fears, as China's efforts to stimulate seem to be working. Figure 3 shows the most recent Citigroup Economic Surprise Index for several countries and regions. The index measures economic data releases against their consensus estimates. A positive number indicates data beating estimates, while a negative number indicates data undershooting estimates. The index for **China** shows that the latest data is well above expectations. This should offer relief to those who had been concerned about further economic deceleration in the world's second largest economy. It should also imply a friendlier environment for investors anxious to participate in China's long-term growth story.

It is always interesting to look back from the mid-point of a year to see how the laggards of the prior year have performed so far.

Figure 4 confirms what we all have come to expect – that there is a tendency for the returns on broad asset classes to revert to the mean. In other words, assets that have outperformed fall back and those that have underperformed play catch up. Sometimes the wait for this to happen is longer than at other times, but it inevitably happens.

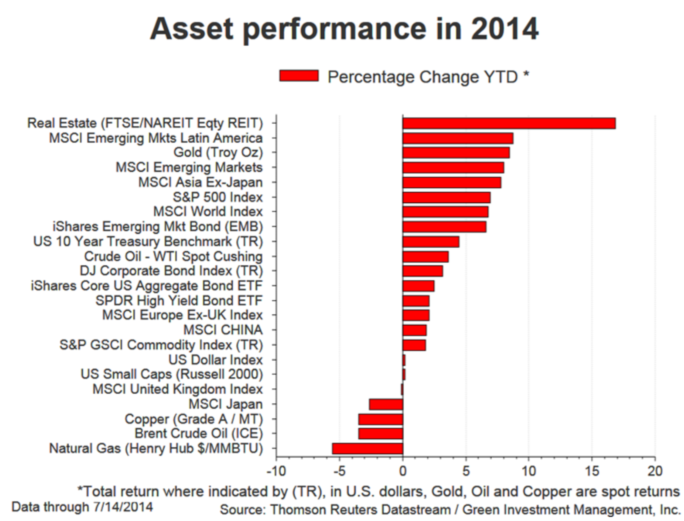

Figure 4. Performance for various asset classes in 2014

As the figure shows, this year we have seen **publicly traded real estate (REITS)** perform strongly, after underperformance in 2013. The same holds true for **gold**, which has performed near the top of the pack this year. Emerging market bonds and Treasuries have also made a pretty good come-back. Conversely, we see Japan struggling this year (especially in local currency terms) after a stellar 2013.

One good lesson is that a broadly diversified global portfolio gives you a greater chance of owning some of the stand-out assets while diminishing the risk of being concentrated in the worst performing assets.

The biggest story in the **fixed-income** space so far this year has been the generally unanticipated drop in yields in the intermediate to long end of the curve, sending the benchmark 10-year U.S. Treasury yields from 3.1% to 2.5%. This resulted in returns of 3.93% on the Barclays Aggregate Bond Total Return Index for the first half of the year. Investors that took on greater credit risk in the form of lower-quality corporate securities or emerging market debt may have enjoyed even better returns, as the search for yield pushed prices higher and credit spreads tighter.

The second half of the year may be more challenging for the bond market as Treasury issuance will increase and the Fed's QE purchases will likely come to an end. Stronger economic growth could increase inflationary concerns and weigh on the price of bonds. But based on where we believe we are in the business cycle, we continue to expect **low default rates and solid earnings**. This should continue to reward U.S. corporate and high yield debt over Treasuries. We do not find compelling values in emerging market debt at this time, especially local currency debt, preferring to stay closer to home for now. We continue to recommend short duration.

Signs of an anticipated pick-up in **price inflation** are beginning to show up in commodity markets, especially industrial metals. These are natural demand-driven changes as the global economy expands. Also reflective of a rising demand for goods is the fact that factories that were operating at just 67% of capacity in mid-2009 are now back to 79%, the highest figure since early 2008. Levels above 80% have commonly been accompanied by inflationary pressures.

In addition, consumers are beginning to be faced with rapidly rising **rental prices for housing** – the largest single component of consumer spending. Effective rent growth was up 2.4% and occupancy rates averaged 95% across the country in the second quarter of 2014 (source, Axiometrics). That was the highest quarter-to-quarter rate increase and occupancy rate in over 12 years.

Actual inflation as reflected in the U.S. consumer price index remains moderate, but the coming months may bring a meaningful uptick. Figure 5 to the right shows global inflation rates that could be at the beginning of this uptick, with the likely exception (for now) of the Euro zone. We will watch developments especially closely, as they could have meaningful implications for future interest rates and allocation decisions.

The **U.S. Dollar** will likely trend higher relative to most of our major trading partners over the coming months. The U.S. economy continues to be in a more advanced stage of recovery than most of Europe and Japan, which are still trying to stimulate and fend off deflation. As we move into autumn, the U.S. Federal Reserve is expected to end its QE bond buying program. This will likely be followed by rate hikes, possibly as early as the first half of 2015. This expected rise in rates should increase demand for dollars. Combine this with the current U.S. shale oil boom that is reducing our need to export dollars overseas for foreign oil and you have a pretty good recipe for a strengthening greenback.

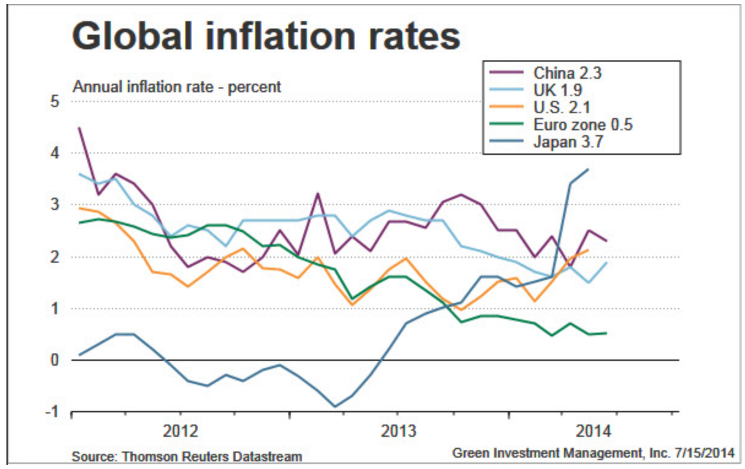

Figure 5. Inflation rates across the globe

The United States is already the largest producer of petroleum in the world and is expected to increase **natural gas production** by 56% between 2012 and 2040 (Source: United States Energy Information Association or EIA). We see this as tremendously favorable for American industry in the long term. It will allow the U.S. to become increasingly energy independent and to balance our international trade with rising energy exports. On a sectoral level, it could especially benefit rail and transport firms as well as pipelines and oil and gas exploration companies.

In the near term, the prospect for an increasingly synchronized global expansion bodes well for **oil and other commodities** that provide the raw material of economic growth. But with growth expected to be relatively moderate, we are only moderately bullish on the commodity complex currently.

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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