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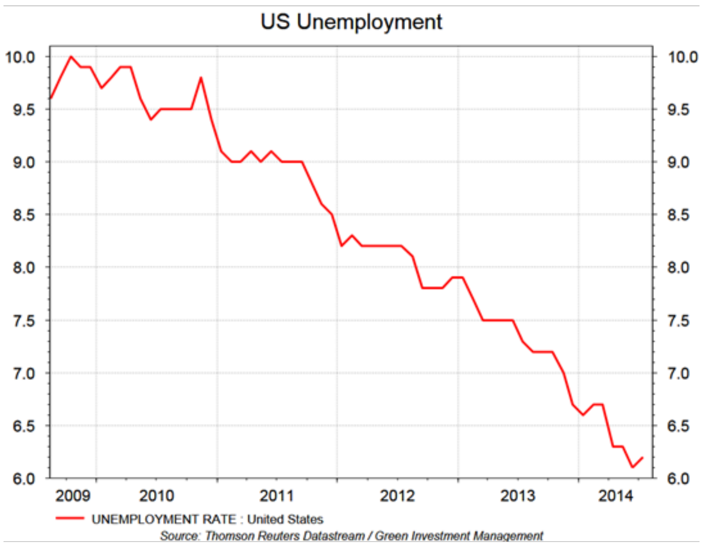
# Market Commentary

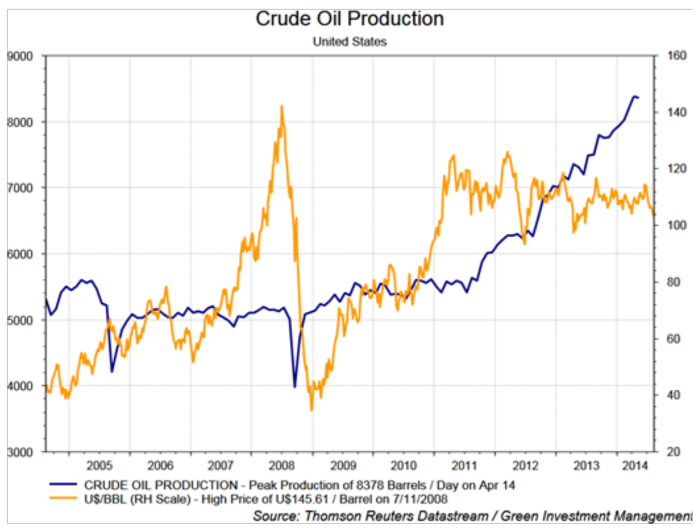
*A softening in Europe, but strength in the U.S.*

In our July update, we observed that the **U.S. economy** appeared to be in the middle stage of an expansion. Nothing in the last four weeks has happened to dramatically change that outlook on the domestic front. We were a little disappointed with June's retail sales growth of just .2%, but think it will rebound in the months ahead. Strong average monthly job growth of 200,000-plus over the last six months overshadows the limited negative data we see.



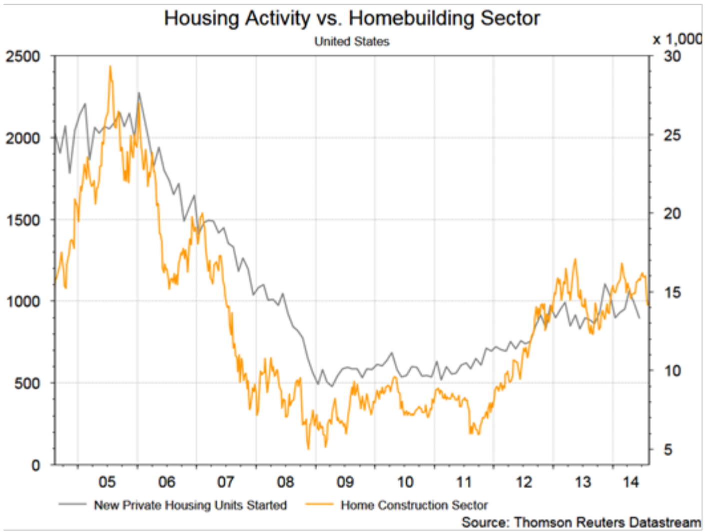

Consumers seem to be playing it relatively safe with regard to **credit**, which bodes well for the durability of the expansion. Meanwhile, the lending environment is improving. The Federal Reserve's third-quarter senior loan officer survey revealed that loan standards have been easing while demand for loans has grown. At the same time, the share of Americans' debt that is significantly past due has fallen to 4.5%, the smallest percentage since early 2008.

The **shale oil and gas** phenomenon that has taken hold in the U.S. has significantly changed the dynamics of our economy. We now have access to some of the cheapest energy supplies in the world. Our increased production (see accompanying chart) has reduced energy expenses for companies across America and made our manufactures more competitive internationally. It has also raised the ceiling for economic expansion. We don't have to worry as much about energy demand outstripping supply and triggering sharp price increases. Additionally, shale production should help diminish the effects to the U.S. of oil shocks from military conflicts in places like Ukraine and the Middle East. All these factors are potentially favorable for equities and future inflation rates.




Not all of the data is encouraging. While new private **housing** starts are much improved over the last three or four years, they have flattened out of late (see accompanying chart on the next page). Larger down payments, increased mortgage-insurance premiums and stagnant wage growth are playing a role, especially for younger adults looking to get into a first home.

Unfortunately, **Europe** is not faring as well as the U.S. Their tepid recovery appears to be losing strength. Recently reported second-quarter gross domestic product (GDP) data under-shot expectations. Interestingly, the three largest economies of the Eurozone—Germany, France and Italy—put in especially poor performances. Germany has been the dynamo and most influential economy for the region. But it is now in contraction mode, and this does not yet even reflect the negative impact of sanctions with Russia.

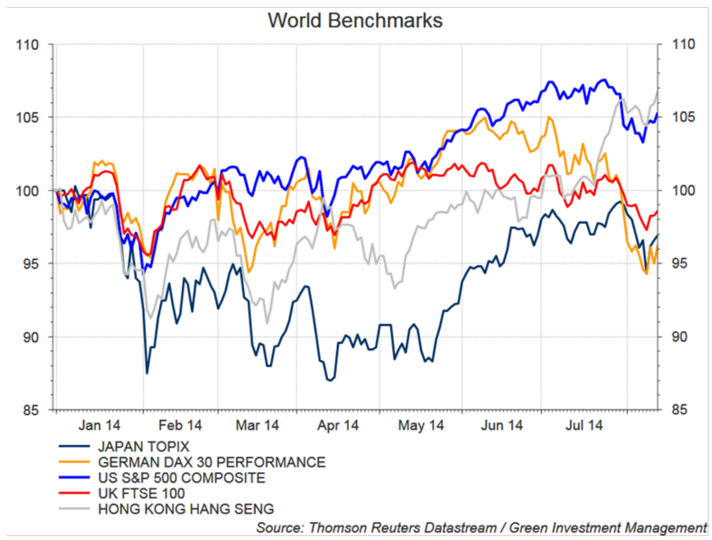



In **Japan**, economic activity has picked up significantly since its Quantitative Easing (QE) program began early last year. But more recently conditions have softened. Economists responding to a monthly Reuter's survey expect the Japanese economy contracted by 1.4% in the second quarter. This was likely due to increases in the consumption tax. In October, growth and inflation will be benchmarked against the Bank of Japan's (BOJ) target levels. If the data is short of expectations, the BOJ has indicated it will accelerate QE further. According to the Reuter's survey, only 9 of 21 economists expected such additional easing to be necessary this year.

Consistent with this weaker international data, on July 24th the International Monetary Fund cut its forecast for **2014 global economic growth** to 3.4 percent from 3.6 percent. On top of this, there is no present shortage of geopolitical hot-spots flashing around the globe. Tensions remain high in the Russian/Ukraine standoff. The Islamic State's advance in Iraq and the conflict in the Gaza Strip continue. There is also increasing unrest in Pakistan as protestors try to unseat the current government. All of these situations, while disturbing on many levels, do not appear to be significantly impacting global markets yet. We will monitor each situation as it develops.

On the positive side, **China** seems to be having some success tempering the effects of a sluggish housing market. Government stimulus has buoyed growth in parts of the economy. The recently reported July HSBC-Markit manufacturing Purchasing Managers Index (PMI) for China hit an 18-month high of 51.7, signaling expansion. Industrial production rose 9% in July from a year earlier. The data was not as healthy on the services side of the economy, where the PMI fell to 50.0, the dividing line between expansion and contraction. But overall, the data reflects a hopeful, albeit uneven, response to recent stimulus. Based on these returns, we expect stimulus may expand in the weeks ahead.

All told, the softer data coming from Europe and Japan, and troubling geopolitical situations, contributed to a sharp **equity** (and high-yield bond) correction that started at the end of July. The decline has since stabilized and is staging a modest recovery (see accompanying chart). Some say the market was just overdue for a correction. But we are watching carefully to monitor if it is reflective of a more significant change in the prospects for global growth. At the moment, we believe that the global expansion is alive and well, if a bit uneven. Fortunately, those of us in the U.S. remain on the strong side of it.



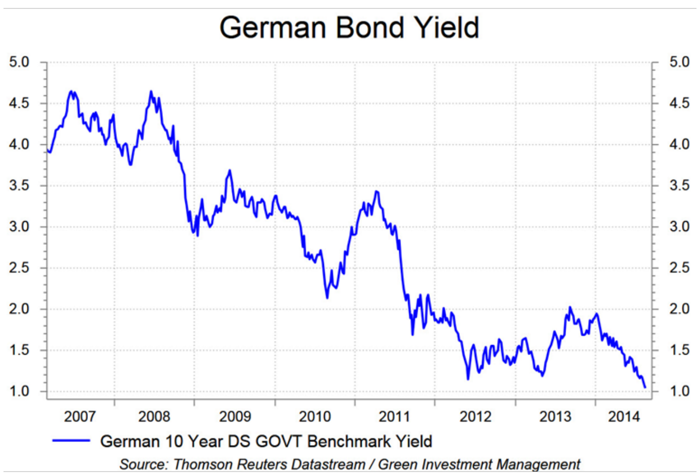

Second quarter corporate profits for the **S&P 500** are coming in robust. FactSet data shows a 7.6% increase in earnings, when estimates were 4.9% just two weeks ago. The latest (8/14/2014) 12-month forward P/E ratio is 15.3.

In the coming weeks, equities will likely be sensitive to developments in Europe. We expect continued and increasing stimulus from the **European Central Bank** (ECB), given recent weak data and Russian/Ukraine tensions. Markets should view improvements in either driver favorably. Unlike the U.S., the Eurozone remains in the very early stages of their recovery. The earnings of companies in these regions have the potential for upward revision in the months ahead as long as economic expansion regains traction. This should ultimately be reflected in better market valuations.

Another focal point of the markets over the coming months will be the U.S. Federal Reserve's winding down of bond purchases, and the timing of its next interest rate move. We may get some insights into this from Federal Reserve Chair Janet Yellen and ECB President Mario Draghias when they speak at a conference on the economy and monetary policy in Jackson Hole, Wyoming, in late August.

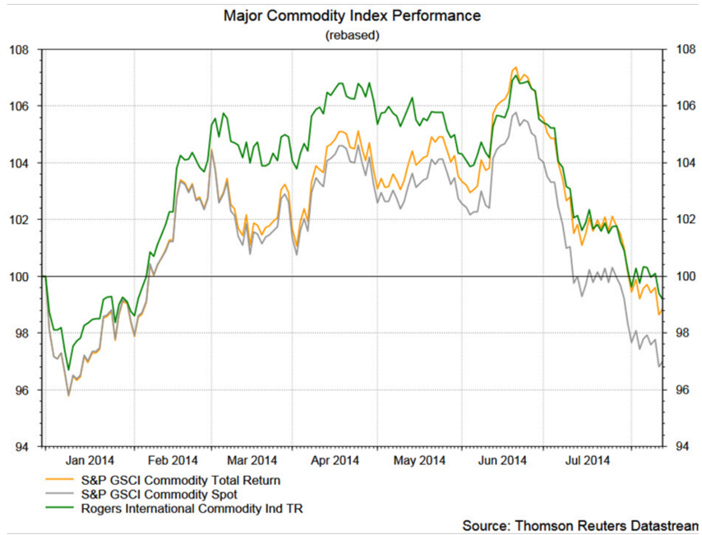
In the **bond markets**, corporate credit volatility—particularly a dip in the price of high-yield bonds, convertible bonds and other lower quality debt—came from the same weak data and geopolitical concerns that have jolted equity markets recently. The prices of these types of bonds have now recovered somewhat, along with the stock market, and investors seem to have moderated their fears of increased default rates and diminished balance sheets. For now, the softening of prices may have only improved the attractiveness of these sectors.

As investors pulled money from high yields, interest rates fell even lower on 10-year Treasuries (2.4%) and other **sovereign, safe-haven bonds**, which experienced a nice rally. This was especially evident in the 10-year German government bonds (Bunds) that broke below 1% (see accompanying chart). Two-year German bond rates went negative. The market is clearly aware that the ECB will continue its efforts to revive the European economy by printing money and buying bonds. This should be a positive for risk assets in general.




Looking ahead, a strengthening U.S. economy will be positive for the rest of the world. An improving labor market should eventually lead to accelerating wage growth and more consumer spending. We believe this will also lead to concern about when the Fed's first **interest rate increases** will come. As a result, fixed income volatility may be with us for a while.

In **commodities**, broad indexes started the year rising, were mostly stable in the 2nd quarter, but have weakened considerably since the end of June (see accompanying chart). Much of the decline is in response to softening global growth estimates. This affects the demand side of the commodity price equation. But the low correlation of commodities with stocks and bonds continues to make them a good complimentary holding for diversified portfolios. Potential supply disruptions from conflicts in the Middle East may make energy commodities an especially desirable hedge to geopolitical risks in the current environment.




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 August 18, 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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