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Market Commentary

The Big Thaw, Part II

Last month, we voiced our expectations that investors would continue to witness a moderate but sustainable global recovery as we move through 2014 – what we called The Big Thaw. Since then, new developments have mostly supported this view.

In the U.S., the economy added 288,000 jobs in April, beating expectations and bringing the **unemployment rate down to 6.3%**, its lowest point since 2008. As Figure 1 below shows, despite the label of "jobless recovery," the unemployment rate has trended steadily lower since its spike in the Great Recession. The main difference from the previous recession is that the spike was much higher (near 10%) this time, which accounts for why we still have slack in the job market after four years of recovery.

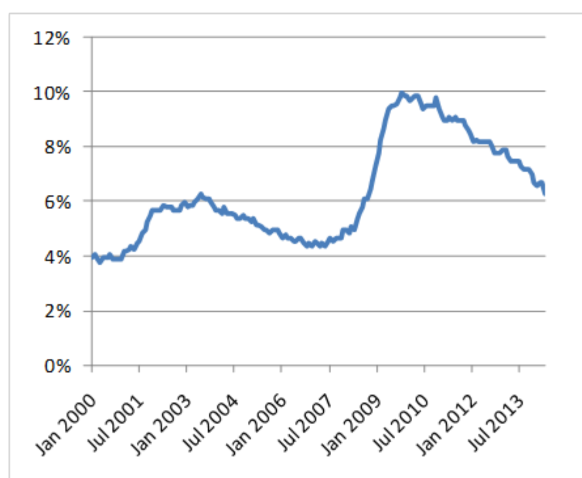

Figure 1. U.S. Civilian Unemployment Rate (seasonally adjusted, source: U.S. Department of Labor, Bureau of Labor Statistics)

The other worrisome labor market issue is that the **participation rate**, which shows the percentage of the adult population that is either working or looking for a job, fell to 62.8% in April. This continues a long downward trend that began in the 1990's (see Figure 2 below). Some have expressed alarm at this trend as being indicative of a general American malaise or decline. But with continued strengthening in the job market we would expect many of the recent labor force "drop-outs" to drop back in. Furthermore, the participation rate has actually been much lower than it is today. Until the late 1960's, in fact, the rate was typically below 60%, as Figure 2 shows. The structure of American society was different then, with more women working in the home. But that didn't prevent the economy and markets from being strong. Likewise, as American society continues to evolve today, with a rising proportion of retirees as baby boomers age, those changes may be reflected in a lower labor force participation rate. But that doesn't necessarily mean that the economy and markets can't be strong.

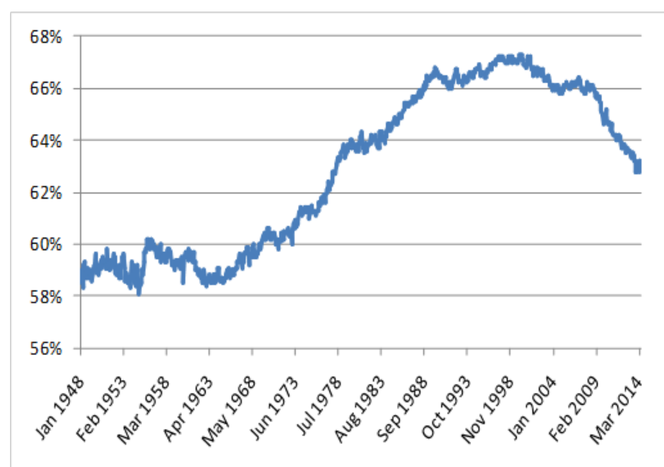

Figure 2. U.S. Civilian Labor Force Participation Rate (seasonally adjusted, source: U.S. Department of Labor, Bureau of Labor Statistics)

Globally, the economic picture still looks positive from where we stand, though **geopolitical tensions** such as in Ukraine will continue to create downside risk in the near term. We expect reasonably steady economic growth to allow the U.S. and other developed economies to gather economic momentum that should gradually spread to emerging nations. Goldman Sachs projects global GDP growth of 3.3% in 2014 quickening to 3.9% in 2015. For the U.S., its projections are 2.6% and 3.2%, respectively.

An improving global economy is positive for corporate earnings and should provide sustenance for further stock market advances this year. Once again flirting

with record highs, U.S. valuations no longer provide the same level of support to downside shocks that we have had in recent years. The 12-month forward P/E of the S&P 500 now stands at 15.2. So there is a greater need to stay on top of geopolitical or other unexpected developments (such as an inflation spike) that could cause downward volatility. Earnings reports continue strong, with some 75% of S&P 500 firms beating estimates. This is what we expect will drive additional equity gains this year. We continue to be overweight on U.S. and selected global equities.

After several years of lagging the global economy, **Europe** is finally showing signs that it may be able to reignite moderate GDP growth. Goldman Sachs projections for Euro area growth are 1.0% this year and 1.5% for 2015.The governments of Europe are moving forward with improved fiscal balances, and it looks as though Europe has room for additional measures to rekindle growth and ward off deflationary concerns. The European Central Bank has indicated it may undertake new stimulative action (likely to include bond purchases and rate cuts) this summer in the hopes of creating some limited inflation.

Consumer sentiment in Japan has weakened significantly after the recent tax hike. This may well be a temporary effect. Regardless, we expect the Bank of Japan to respond with more measures to spur growth and a desired increase in inflation.

In the emerging world, **China appears to be losing growth momentum** and may pursue an easier monetary and fiscal stance in the coming months to prevent too drastic a slowdown. In India, markets continue strong as the election has brought a victory for **Narendra Modi** as Prime Minister. His party's campaign has focused on kick-starting the economy and creating jobs.

Overall, more than $50 billion flowed out of emerging stock and bond funds in the first quarter of 2014 as rising U.S. yields, China's economic slowdown and political uncertainty drove investors away from higher-risk assets. But the tide appears to have turned. In recent days emerging stocks have approached their highest level in almost six months. We believe there are **tactical opportunities in emerging markets**. Lower U.S. bond yields and hopes of more liquidity to come from the ECB and Japan are contributing to value and making the emerging market carry more attractive.

Oddly enough, given the generally positive economic and equity news, **U.S. Treasury yields have declined** in the past month, with the yield on a ten-year note now below 2.5%. This is below our forecasts. Like Europe, Japan appears likely to take additional stimulative action and the UK, widely expected to be the first to raise rates in Europe, has indicated it is in no hurry to do so. Furthermore, U.S. Federal Reserve Chair Janet Yellen seemed to walk back earlier comments about monetary tightening beginning sooner than had been expected. We think all these factors have contributed to an expectation of continued global looseness that explains the lower Treasury yields. A flight to quality in the face of ongoing trouble in Ukraine may also have played a role. Regardless, we do not expect such factors to stop an eventual rise in bond yields over the course of the year.

We continue to prefer **credit-sensitive and short duration fixed income** investments, as they are likely to outperform higher-quality, longer-duration securities in the next year or two. This is in keeping with our expectations for an improving world economy accompanied by rising rates. In particular, we are staying underweight long-duration government bonds.

Commodities have posted gains in 2014 largely on the backs of agricultural commodities and natural gas, particularly coffee (the result of a drought in Brazil). We don't see a reason to expect any major additional broad-based moves in the near-term. But if the global recovery accelerates into 2015 as we think it will, that should eventually bring better performance to commodities in general.

Historically, stronger economic growth in the U.S. usually increases U.S. interest rates versus other countries. Combine this with further expected monetary easing in Europe and Japan, and we are expecting the **U.S. Dollar** to generally strengthen against other currencies, especially the Yen and the Euro.

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 May 15, 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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