EMERALD ASSET ADVISORS, LLC

Investment Strategists for **Successful Families**

Second Quarter 2014

Thank you for reading GreenThought$. It is our privilege to provide you with our insight on current financial market events and our outlook on topics relevant to you.

Second Quarter 2014 Commentary and Outlook

As we put together this review it is 1,031 days into a bull run without at least a 10% correction. This is the fifth longest run in the market without a correction in the past 50 years. The talk on every financial news channel and most conversations is "when will the equity markets correct?" We are in a pattern where good news is bad news, and bad news is good. We continue to be in a low interest environment, lower interest rates go hand-in-hand with slower economic growth and it is important to remember that slower economic growth begets lower rates of return on financial assets. As such, expectations for portfolio returns should be adjusted accordingly.

1st Half 2014 Review

Robust equity returns in 2013 reflected an improving economic environment and expectations for the same or better in 2014. As it turned out, an extraordinarily severe winter brought a chill to the US economy and with it the worst January since the financial crisis began. The Q1 freeze resulted in a 2.9% GDP contraction and a chorus of "sell in May and go away" rang through the canyons of Wall Street. The downturn in the markets in Q1 reflected some meaningful bear-market corrections (>20%) in small cap, biotechnology, and social media stocks, as well as a sell-off in the Emerging Markets and Japan.

However, hope springs eternal and spring brought new life to the economy with marked improvement in corporate spending, job creation, and consumer confidence. Interestingly, there was similar improvement worldwide and the global equity markets rebounded in unison in the second quarter. In particular, the Dow Jones Industrial Average ended Q2 above 17,000 for the first time in history and the S&P 500 made 25 new highs in the first half of 2014. For the first half of the year the DJ Industrial Average, the S&P 500, and the MSCI World Index had total returns of 2.7%, 7.1%, and 6.5%, respectively. We have now gone nearly three full years without a 10% correction in the US equity markets and, in the absence of such a correction, rolling industry, market cap, and geographic market corrections are healthy happenings for an equity market that we believe will move higher. That said, given the challenges at the beginning of the year, investors are delighted with the second quarter economic rebound and equity market appreciation in the first half of the year.

Coming into 2014, the consensus expectations among major fixed income investors (two notable exceptions were PIMCO and Jeffrey Gundlach at Double Line) were for an increase in interest rates from 3.0% to 3.5% for 10-year Treasuries and a related waterfall effect on bonds with different maturities and risk profiles. However, the deep freeze in the US, some European credit issues, a slowdown in China, as well as tepid inflation, pushed the 10-year Treasury yield down to 2.5%. The discussion above regarding a secular slowing of global economic growth, stable inflation, and a decrease in real yields provides further explanation for nominal interest rates not moving up in the first half of the year. The elevation in stock prices and other risk assets indicates either an unwillingness of investors to lower their expectations of future economic growth or a willingness to hold riskier assets in hope of higher yields and appreciating stock prices.

From a global perspective, the first half of the year was mixed. GDP growth in the UK is on track to reach 3% for the year and may be the first of the developed countries to raise rates. The Eurozone continued its "whatever it takes" quantitative easing program and it appears to be working as GDP growth has gone positive, even if only marginally so. Inflation continues to run at a sub 1% rate, which leaves the threat of deflation on the table and a potential interruption to improving economic growth. Japan and the Emerging Markets stumbled in the first half of the year, though they are now showing some signs of improvement.

In summary, it was a positive period in the financial markets globally, despite some headwinds, mostly geopolitical (such as developments in Iraq, Ukraine and Russia). Asset classes such as bonds and commodities, which didn't work for most of the last year, provided significant support in times of stress this year and helped to keep the portfolios in the positive territory. This outcome once again proved that prudent diversification, combined with a disciplined, long-term investment plan, has a potential to reduce volatility caused by external factors, such as geopolitics. According to the Asset Allocation theory, which has been in use by pension fund managers for many years, the selection of asset classes (percentage mix between stocks, bonds, commodities, real estate and cash) determines 91.5% of the portfolio results. Only the remaining 8.5% is determined by a combination of market timing, security selection and other factors. If you have questions how the Asset Allocation program relates to your portfolio, please give us a call to discuss.

2nd Half 2014 Preview

The second half of 2014 is likely to bring continued improvement across the economic landscape. Of paramount importance is a continuation of the last month trend in employment gains. The addition of generally positive 200,000 plus monthly additions to non-farm payrolls will likely moderate over the balance of the year, but should be sufficient to continue the downward trend in the unemployment rate. While job creation has been encouraging over the past several months, we need more full time jobs created and we need an increase in hourly wages, both of which should be possible as the labor market begins to tighten.

The housing market is of significant importance as well, as home equity is the largest source of wealth on American balance sheets. While we have seen improvement in the housing market, there are fundamental challenges that are of some concern. Chief among the concerns has been a significant tightening of standards related to residential mortgage issuance coincident with an increase in property prices, the result of which negatively impacts home ownership affordability. Historically low long-term mortgage rates are helping the equation, but the prospects for a strong housing market going forward are unclear. An improving jobs picture would certainly facilitate an improvement in the housing market.

Corporate balance sheets remain strong and management teams now seem ready to increase business investment. Years of underinvestment in property, plant, and equipment have created the need to replace tired assets and capital spending will likely begin to rise. Moreover, as the employment picture and the economy improve, aggregate demand should rise, compelling companies to increase business spending. This is a virtuous cycle that seems close to being kick-started, but hasn't yet had the catalyst to do so.

We expect inflation to average in the 2-3% range for the foreseeable future and don't expect it to be a driver of higher interest rates. Rather, we expect economic strength will drive Federal Reserve (the FED) action to raise rates, but we don't think this likely until well into 2015. We subscribe to the belief that economic growth will remain muted relative to historical standards and, given our view of inflation, we see no reason for the Fed to move aggressively on rates. That said, the Fed has announced the termination of their bond buying in October, the result of which may be an upward migration in interest rates even before the Fed raises their policy rate. Ultimately, the Fed will raise short-term rates and while it will have an impact on bond prices, we don't think that it will impact equity valuations in a meaningful way.

While we are relatively sanguine about the prospects for economic improvement over the next 6-12 months, there are enough variables, both economic and political, that could dislocate global economic conditions that are still relatively fragile.

Enjoy the rest of your summer.

As always, if you have any questions please do not hesitate to contact us.

The Emerald Team

Disclosure
Green Thought$

The information herein has been obtained from sources believed to be reliable, but Emerald Asset Advisors, LLC ("Emerald") does not warrant its completeness or accuracy. Prices, opinions and estimates reflect Emerald's judgment on the date hereof and are subject to change at any time without notice. Any statements nonfactual in nature constitute current opinions, which are subject to change. Projections are not guaranteed and may vary significantly.

Currency trading may involve significant risks, including market risk, interest rate risk and country risk. Funds or strategies that use leverage or shorting may experience substantial losses. The investment strategy presented is not appropriate for every investor and individual clients should review with their financial advisors the terms and conditions and risk involved with specific products or services. As with all investments, past performance does not indicate future results.

About Emerald

Emerald Asset Advisors, LLC is a Registered Investment Advisor (RIA) founded in 1998. For more information, please visit our website.
Visit our Web site »