EMERALD ASSET ADVISORS, LLC

Investment Strategists for **Successful Families**


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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.

# Third Quarter 2014 Economic Commentary and Market Outlook

Dear Valued Clients,

As we write this letter, global equity markets are going through the first significant correction since 2011. This has generated the expected sensational media headlines, since bad news sells better than good news. Besides the financial markets, there is the Ebola virus concern and numerous geopolitical issues, but none of these overrides a simple truth: the U.S. economy is doing better now than any time since the financial crisis of 2008-2009. The GDP (Gross Domestic Product) and the employment picture became considerably brighter. This is what over the long term drives the prices of financial and real assets: stocks, bonds, real estate and commodities alike. Improving economy is usually good for equity prices, but expectations for endless stock market gains without any interruptions were just too high.

Third quarter 2014 was nothing but easy from the asset management perspective. All major asset classes (stocks, commodities, real estate and the majority of bond categories) registered price declines in September, some of them quite severe. This trend accelerated towards the end of September and continues so far in October. Corrections are a part of investing landscape, a necessary element of the process, and should be treated as such. If anything, they may present us with an opportunity for timely portfolio rebalancing, as well as acquiring quality assets at a lesser cost. The investment committee at Emerald stays vigilant; we discuss global developments regularly, and are prepared to take action if needed.

Below you will find more detailed analysis of the equity, as well as the fixed income (bond) markets in the third quarter. We encourage you to call or write us with any questions or comments.

**Equity Market**

Geopolitical crisis and global growth uncertainty made for a rather turbulent third quarter. For the quarter ending September 30, 2014 there was fairly wide divergence among equity indices. In general, growth stocks out-performed value, large capitalization companies out-performed small and mid-cap companies, and domestic stocks bested international companies. Small and mid-cap stocks as well as global equities had negative returns for the quarter. Small capitalization companies and European equities suffered the biggest percentage losses, both down approximately 7% for the quarter.

While the S&P 500 hit a new all-time high on September 18th, it is instructive to note the declining breadth of this bull market, which is the fourth-longest in modern history and the fourth-biggest rise (200%) since it began in 2009. A detailed look under the hood tells a changing story. According to Bespoke Investment Group, as the major equity indexes (such as the Dow Industrial Average) were reaching new highs, the average S&P 500 stock was down 7.2% from its 52-week high. This dynamic speaks to the capitalization-weighted construction of the S&P 500 and the outsized impact of the largest companies such as Apple, which has risen to new highs. Note also that the average stock in the S&P 400 mid-cap index was down 11% from their highs (official correction territory). In addition, one-third of the stocks in the Russell 2000 small-cap index are down over 10% in 2014 and the average stock in the S&P 600 small cap index is down over 17%. After leading the market higher in the first half of 2014, the energy sector has been hard hit since mid-year. The average energy stock in the S&P 1500 (all three S&P indexes) is down over 20% on the year (the official bear market territory). Declining breadth in market leadership is not unexpected in the later stages of a bull market and the bull market can continue to run despite a narrowing of leadership. However, the fact that there are few leaders and more laggards is a growing sign of concern. Importantly, the fact that the few leaders are big enough to push the indexes up further hides potentially troubling indicators to investors who have fallen into a sense of complacency.

Since the end of the quarter the equity markets have continued to tumble in October, with the S&P 500 now down over 6% from the high reached in mid-September. Whether we get a full 10% pull-back in the major market indexes (which defines the correction) remains to be seen. However, irrespective of the size of the equity market drawdown, we believe the domestic economic recovery remains in place and the equity markets will continue to reflect improvement in the U.S. economy and will ultimately move further to the upside.

**Bond Market**

The bond market is expressing concern of its own as the Barclays Global Aggregate Index fell 3.1% for the third quarter. Contributing to the downturn of the index was a 5.4% drop in international government bonds and a 2% drop in both high yield and Treasury Inflation Protected Securities (TIPS). Long term U.S. Treasury securities and municipal bonds were the only strong performers in the third quarter. It is clear that multiple factors are weighing on bond market investor sentiment, including the timing of the first Federal Reserve (Fed) interest rate hike, the strength of the US dollar, stalled economic growth in Japan and the

Eurozone. Increasing concern over the rate of growth in China's economy only adds to global economic uncertainty, which weighs heavily on bond market participants.

While U.S. economic metrics have steadily improved, the tightening of spreads between short and long-term U.S. Treasuries reflects the bond market's uncertainty over the sustainability of U.S. economic growth. Yields on U.S. Treasuries with two to five-year maturities are at their highest level since 2011. At the same time, U.S. Treasury yields on bonds maturing in 10, 20, and 30 years remain well below their levels at the beginning of the year, in sharp contrast to expectations. The bond market reflects the expectation of rates to rise on the short end as the Fed's bond buying program concludes this month and probabilities increase for a Fed rate hike in 2015. However, the bond market is also telling us that long-term yields reflect uneven economic growth and that as the Fed pursues more "normalized" monetary policy, uneven growth may become more constrained. If more robust economic growth was expected, long-term rates would be increasing in line with short rates. An overlay to all of this is that long-term U.S. Treasury yields offer a very compelling value relative to the sovereign debt of all other developed countries, which argues for continued strength in the U.S. dollar. Of course, a stronger dollar makes U.S. exports more expensive, putting further pressure on domestic economic growth.

Not surprisingly, the skewed sense of risk in the equity market has found its way to the bond market. How does one make sense of 10-year bond yields of Ireland, Italy, and Spain being lower than comparable U.S. Treasuries? Even in the face of prospective huge quantitative easing in Euroland, this risk dynamic does not make sense. How about the fact that Ecuador, which defaulted on its debt in 2008, easily raised $2 billion of ten-year bonds? When the above is distilled down to a directional thesis we believe that equity markets will grow increasingly volatile, but will likely move higher as long as the domestic economy continues to improve. We also believe that the Fed holds strongly to the belief that they are better to error on the side of holding rates low for too long rather than raise rates too soon and risk stalling the economic recovery. Further, it is our expectation that the Fed will hold rates steady until the global economic picture gains greater clarity and its impact on the U.S. economy can be determined.

As for an actionable strategy, we believe that now, more than ever, portfolio diversification is of paramount importance. Prudent diversification, combined with a disciplined, long-term investment plan, has a potential to reduce volatility caused by negative factors, such as changing market sentiment or 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.

Regards,

The Emerald Team

Disclosure
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