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INSIGHTS

A Quarterly Newsletter Bringing you Financial Insights

1st Quarter 2014
Volume 7, Issue 1

2014 Q1 INSIGHTS:
"Something Old, Something New..."

RECAP: The end result of Q1 was rather boring. After global equity markets gained more than 20% in 2013, stocks started off 2014 with rather meager gains of 1.08%. But the increased volatility intra-quarter was anything but dull. Investors world-wide had plenty of news to digest. And as a cold winter turns to spring, a wedding theme seems appropriate to characterize recent events.

Something Old: Putin wiped off the *old* World War II/Cold War-era playbook by invading a neighboring sovereign country. Markets negatively reacted as investors witnessed a real-life game of Risk when Russia successfully annexed Crimea away from Ukraine. But perhaps most importantly, Russian capital markets sold off hard, which may have persuaded Putin to back off from any further aggression—and the ensuing relative calm allowed markets to rebound. It's still too early to write the history books, but perhaps in this era of intertwined global capital markets, Russia's financial losses (including their currency) may have preempted further military action in a way that was more efficient than NATO's tanks and guns of yesteryear.

Something New: Markets enjoyed a small bout of volatility when *new* Fed Chair Janet Yellen took the podium for the first time after her first Fed meeting. Her off-the-cuff statement that interest rates might rise as soon as mid-2015 spooked markets as the short timeframe was earlier than many market pundits had envisioned. Her comments were quickly softened in the days after—thus easing tensions once again and allowing markets to rebound.

Something Borrowed: China reclaimed headlines in January when the second largest economy in the world posted weaker economic growth. Adding fuel to the fire, China signaled a greater willingness to subject *borrowers* to true market discipline by letting a local bond default. While common in capitalistic economies, in centrally planned China there has been a market perception of implicit government support of local companies. While this move towards free market capitalism is an encouraging step in the long run, the default unnerved local EM bond markets in the short run.

	Notable Sectors	Q1	TTM
Stocks	**Global Equity**	**1.08**	**16.55**
	U.S. Large Cap (S&P 500)	1.81	21.86
	U.S. Small Cap (Russell 2000)	1.12	24.90
	International Equity	0.66	17.56
	Emerging Markets Equity	-0.43	-1.43
Bonds	**Global Bonds**	**2.40**	**1.88**
	U.S. Aggregate (High Quality)	1.84	-0.10
	U.S. High Yield (Low Quality)	2.98	7.54
	International Aggregate	2.79	3.24
	Emerging Market Debt	2.82	0.04
Other	Gold	6.78	-19.55
	Oil	3.21	4.47
	Inflation	0.56	0.68

Something ~~Blue~~ Blew: Normally investors analyze economic data points like earnings, interest rates, inflation and unemployment. But when Old Man Winter *blew* his way into the record books this quarter, investors were forced to analyze the effects of "the Polar Vortex." The change in normal

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weather patterns put the eastern United States under a deep freeze which was so severe that it clouded and negatively impacted major national economic data. Weaker economic data stateside, coupled with weakening data points from China, prompted the S&P 500 to pull back 6% in late January into early February (In fact, February's start was the second worst on record). Investors, however, ultimately hypothesized that the snow would melt, Russian tensions would thaw, China's credit markets would not freeze, and Yellen would not throw ice water on the tepid recovery. U.S. markets subsequently moved to new all-time highs for the 5th consecutive quarter.

EQUITY: Global Equity gained ground for the third consecutive quarter with a 1.08% gain. Leaders included International Small Caps which led with a 4.86% gain followed by Europe's 2.14% gain for the quarter. Laggards included the Pacific Region (Japan, Korea, Australia, Hong Kong, Singapore, etc.), which lost 2.41% in the first three months of the year. Within the U.S., Large Cap Stocks (S&P 500) gained ground for the 5th consecutive quarter ending with a 1.81% return, besting Small Caps for the second quarter in a row (+1.12%). Gains were skewed towards the "cheaper" areas of the market as Value (+2.92%) outpaced Growth (+1.07%), reversing a two quarter streak. The outperformance of Value over Growth was not surprising as Utilities (a stalwart of Value indices) led all sectors (+10.09%) while Consumer Discretionary (a typical holding of Growth indices) lagged the market by posting losses (-2.80%).

FIXED INCOME: Bonds (Barclays Aggregate Bond) had their best quarter in almost two years with a 1.84% gain. Although Credit/Spread (High Yield) outperformed Quality/Duration (Treasuries) for the 7th consecutive quarter, gains in the bond market were widespread as both defensive and aggressive sectors performed well. Treasuries gained 2.63% and High Yield returned 2.98% in the quarter, both of which benefitted from a 30 basis point drop in Ten-Year Treasury yields, which finished the quarter at 2.72%.

ALTERNATIVE ASSETS: Along with Treasury Bonds and Utility stocks, REITS benefitted from a drop in interest rates and gained 9.98% in the quarter. Commodities were a mixed bag. Gold bounced 6.78% after a brutal 2013 but Copper lost 9.70% after rumors of Chinese bankruptcies surfaced.

OUTLOOK: Our outlook from 2013q4 is still largely intact: "In the long run, more meaningful data for stocks and bonds are whether global GDP growth (and corresponding jobs creation) will live up to current projections. Expectations are high as investors have priced into stocks the first globally synchronous growth in GDP since the onset of the financial crisis six years ago. Unlike prior years, it is now critical that economies live up to these expectations now that equity valuations are elevated. With price-multiples now near fair value, investors have lost the valuation tailwind. But if the global economy can transition to real "growth" then the bull-run can continue a good while longer." And to reiterate a common message dating from last summer, equity investors should continue to look abroad for "double whammy" equities—stocks that have higher earnings growth potential but are valued more attractively than those found in the U.S.

Sincerely,
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Chief Investment Officer

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