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INSIGHTS

A Quarterly Newsletter Bringing you Financial Insights

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2014 Q2 INSIGHTS:
"$2.4 Trillion vs. $24 Billion"

RECAP: Capital markets posted another great quarter with decent gains spread across all asset classes. Global Equity again moved to a new all time high led by Emerging Markets and the U.S. with the domestic large cap index (S&P 500) moving to another all-time closing high of 1962.87 on June 20, 2014.

Even Fixed Income bounced back with the U.S. Aggregate Bond Index posting its best quarter since Q2 2012. To put the second quarter's gain into perspective, the actual advance (2.04%) was not only larger than the losses of 2013 in its entirety (-2.02%) but also moved an investment into bonds back to new all time highs. To repeat, the yesteryear "bond bubble" talk in which the media was determined to conclude that bonds would suffer a 'permanent impairment of capital' (i.e. a bubble) has simply not come to fruition even as rates have moved from 1.60% to 2.60% (due in large part to the very nature of bonds and the annual income component).

Although the mainstream financial media does a great job at effectively capturing the "hot" water cooler topics of the day (what investors "want" to hear), it does a terrible job at capturing the essence of what is moving capital markets (what investors "need" to hear). Case in point; hours of analysis were devoted to Q2's $24 billion of deals/valuations in Private Equity including Apple's $3 billion purchase of Beats Electronics, Uber's $18 billion valuation, and GoPro's $3 billion IPO that doubled within a matter of days. While these hot topics are interesting, they provide very little useful information for the average investor.

Furthermore, on the first Friday of every month the media focuses on the monthly jobs report. And in early April, headlines focused on the March jobs report that moved U.S. payrolls past pre-recession peaks, which we agree is a hot topic, but does little for investors. Rather, it was the news the day before (which received little fanfare) that would go on to move capital markets for the rest of the quarter. On April 3rd, the head of the European Central Bank (ECB) Mario Draghi prepped investors that officials were debating whether the ECB should engage in their own version of Quantitative Easing (QE) to fight the European deflation danger. Fearing that QE would push bond yields down, investors clamored for bonds, driving the 10-year German bond down 30 bps to yield less than 1.30%. Providing further proof of today's truly global capital markets, the buying spree spread worldwide. U.S. rates peaked for the quarter one day later at 2.80% and subsequently dropped for the ensuing 8 weeks eventually bottoming around 2.44%, finishing the quarter at 2.52%.

	Notable Sectors	Q2	TTM
Stocks	**Global Equity**	**5.04**	**22.95**
	U.S. Large Cap (S&P 500)	5.23	24.61
	U.S. Small Cap (Russell 2000)	2.05	23.64
	International Developed Markets	4.09	23.57
	International Emerging Markets	6.60	14.31
Bonds	**Global Bonds**	**2.47**	**7.39**
	U.S. Aggregate (High Quality)	2.04	4.37
	U.S. High Yield (Low Quality)	2.41	11.73
	International Aggregate	2.72	9.42
	Emerging Market Debt	4.49	10.19
Alts	Gold	2.98	8.03
	Commodities	0.08	8.21
	Master Limited Partnership	14.18	21.57
	Real Estate	7.00	13.38
Cash	Inflation	0.81	1.61
	Cash (3-month T-bills)	0.01	0.03

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The drop in interest rates not only drove returns in US & European bond markets but also drove returns across most capital markets. If global capital markets exceed $100 trillion, then Q2's gains added trillions to worldwide wealth–in stark contrast to the $24 billion that was the focus of the financial media.

On June 5th, Draghi finally unveiled historic measures to further drive the European recovery by effectively making interest rates negative. But by then, the bulk of the gains had been had. Global bond investors pushed interest rates down, thereby making stock dividends more attractive and thus the buying spread across asset classes. By the end of the quarter, interest-rate sensitive securities within each asset class outperformed–again mostly due to the April 3rd missed headline out of Europe.

EQUITY: Global Equity gained ground for the fourth consecutive quarter with a 5.04% gain. Leaders included Emerging Markets which led with a 6.60% gain, followed by the Developed Pacific Region (Japan, Australia, South Korea, Hong Kong, etc.) which bounced back after a tough first quarter with a 5.89% gain in Q2. Within the U.S., Large Cap stocks (S&P 500) gained ground for the 6th consecutive quarter ending with a 5.23% gain, besting Small Caps for the third quarter in a row, which posted a gain of 2.05%. Value and Growth stocks posted similar results but returns varied greatly between sectors. Of the ten S&P sectors, the Energy sector posted the best return with a 12.09% gain–due in large part to the tailwind of higher oil prices stemming from the turmoil in Iraq. Interest-rate sensitive Utilities followed with a 7.77% gain. However the fall in interest rates acted as a headwind to the Financial sector which lagged all sectors with a 2.30% gain.

FIXED INCOME: With the yield on the 10-Year Treasury falling from 2.72% to 2.51%, Bonds (Barclays Aggregate Bond) subsequently had their best quarter in two years with a 2.04% gain. The High Yield sector (i.e. Low Quality, Credit, or Spread) gained 2.41% and outperformed the Government sector (i.e. High Quality or Duration) for the 8th consecutive quarter. And in a mirror image of 2013 which saw rising rates act as a headwind to Emerging Market (EM) securities, the tailwind of falling interest rates in Q2 lifted EM Debt to a 4.49% quarterly gain leading all fixed income sectors.

ALTERNATIVE ASSETS: Just as the falling interest rates aided traditional interest rate-sensitive securities (Utilities, Bonds, Emerging Markets, etc.), the tailwind propped up higher yielding Alternative Assets as well including MLPs which not only outperformed Global Equity but all other sectors too by posting an eye-popping 14.18% quarterly gain. REITs also outperformed but gained "only" 7.00% in the quarter. Alternative Assets with little or no yield did not fare as well–Gold rose 2.98% and the commodity basket as a whole was essentially flat, gaining only 0.08%.

OUTLOOK: After a robust Q2, the S&P 500 is now up 7.14% for the year. And with a new high on July 1st, the S&P has now gone 1,002 days since its last 10% correction–the 5th longest streak on record. While a 10% correction can psychologically test long-term financial plans, it is wise to acknowledge that even an immediate correction would only take the index back to levels last seen in February (a mere 5 months ago!). And while we can guarantee that a 10% correction will come eventually, we cannot guarantee that it won't come from a level 10% higher than today. But as always, it is prudent to periodically revisit ones asset allocation as the moves over the last 18 months may have left some investors overexposed.

Sincerely,
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