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Monthly Investment Report

June 2014

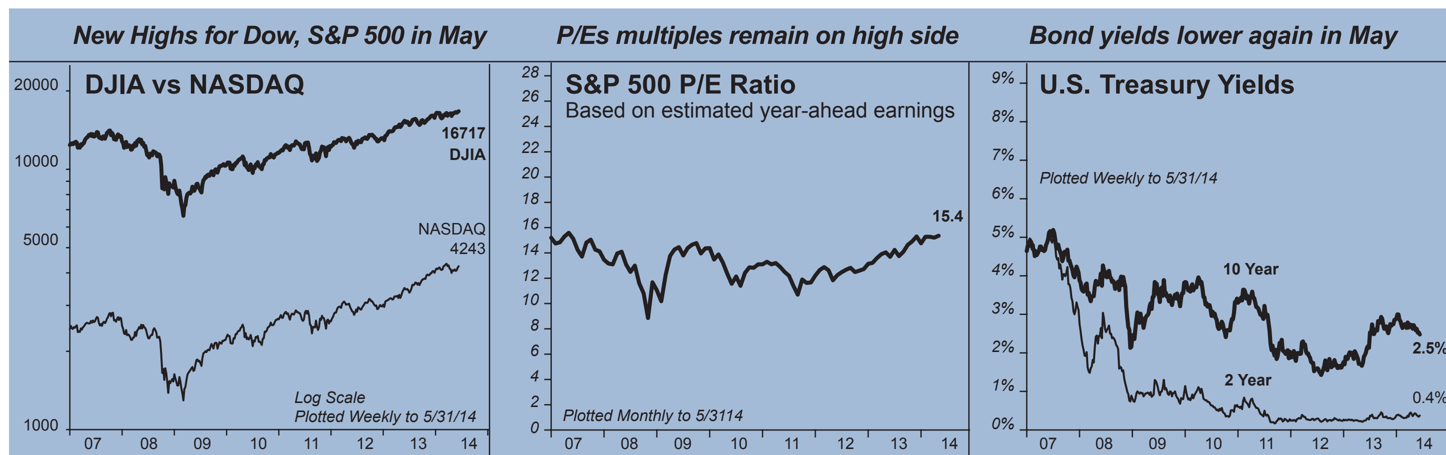
***SUMMARY*: The saw-tooth stock market action of the first four months of 2014 continued to the upside in May, with the major market averages returning from 1.2% (Dow) to 3.3% (NASDAQ) for the month. Bonds also had positive returns, as Treasury yields moved to 12-month lows near month end. Foreign stock and bond returns were mildly positive in May, with emerging markets experiencing their most impressive move in many months. Global economic performance can only be described as spotty, with hoped-for acceleration still largely undelivered. U.S. economic activity, while improving, continues to come up short of its potential.**

U.S. stocks continued to climb the proverbial wall of worry, posting modest returns for the month of May. The S&P 500 ended May at an all-time high of 1924, where it was up 2.1% (price only) for the month (2.3% including dividends). The Dow Jones Industrials (+0.8%/+1.2%) had a shallower rise for the month, while NASDAQ (+3.1%/+3.3%) regained some of the momentum lost in the March-April profit-taking. Smaller-cap stocks lagged in May's rebound. The U.S. economic backdrop has improved, with Q2 GDP growth heading toward a strong (3%-4%) rebound from Q1's surprising 1% GDP decline, which most observers write off to the worst winter weather in years. Also noteworthy in May's stock market action was the relatively light level of trading volume and the lowest stock price market volatility since before the 2007-09 financial crisis. To be sure, some of the sector rotation trends that occurred in the first four months of the year were undone in May, as investors appear to have concluded that earlier profit taking in some biotech, internet and social media stocks had been overdone. The utilities sector, the leading market sector in the S&P 500 universe this year, was the only one to register a decline in May.

European stocks continued to perform okay last month, and Asian stock markets enjoyed a nice bounce. The MSCI Developed World ex U.S. index returned 1.5% in U.S. dollars in May, roughly matching April's return. Year to date, developed markets outside the U.S. boast a 3.9% return, roughly one percentage point behind the S&P 500's 5.0% return, but ahead of most other U.S. stock market averages. For the most part, stocks in the U.K. and the rest of Europe had slight gains in the latest month, while Asian markets vaulted ahead, thanks in part to India's 8% rise on the convincing election victory of the BJP party's Narendra Modi as prime minister. Japan, China, Hong Kong and Korea all had improved showings in May.

Surprisingly, bonds continued to run neck and neck with stocks in the 2014 total return derby. While short Treasury yields were not much changed in May, long-term yields fell by 13 (30-year T-bonds) to 17 basis points (10-year T-notes). Higher bond prices swelled the Barclays U.S. Aggregate's total return to 3.9% for the first five months of 2014 after May's 1.1% return. That is behind the S&P 500 but ahead of most other stock market indexes. As former Federal Reserve Chairman Alan Greenspan famously put it some nine years ago, falling long-term interest rates are somewhat of a "conundrum." The most logical causes of this year's lower yields: rising risk aversion at a time of uncertainty in Ukraine; concerns that there was something more troubling and more lasting than just bad winter weather behind the first quarter's 1% decline in real U.S. GDP; and a declining supply of Treasury and mortgage bonds as the U.S. budget deficit shrinks and housing activity remains weak.

The first week of June saw U.S. Treasury yields back up about 20 basis points to 2.60% for the 10-year Treasury. The twice-revised ISM report on U.S. manufacturing in May, once



it was correctly nailed down, showed healthy growth in production and in new orders. Auto sales soared to an eight-year high 16.8 million annual rate in May. Later in the week, the Labor Department reports on employment conditions for May, and a good report would go a long way to restoring the markets' faith in the U.S. economy's ability to move up from the 2¼% annual rate of growth averaged over the five years since the great recession to the 3%+ growth rates seen in the second half of 2013 and, most likely, in the second quarter of 2014.

Since the end of 2013, the two-year to 10-year portion of the Treasury yield curve has flattened by more than 50 basis points. The 10- to 30-year end of the curve has come in another 10 bps. Compression of credit spreads slowed to a crawl in May, and option-adjusted spreads on high-yield bonds widen a bit for the month. There may be room for further narrowing in credit spreads, in Wright's view, but probably not too much.

By most accounts, Federal Reserve officials continue to be satisfied with the outlook for U.S. economic growth and inflation. The Fed looks to be on course to ending its bond buying program by 2014's fourth quarter. At its mid-June policy meeting, we expect the Fed to reduce the rate of monthly bond purchases to $35 billion from the $85 billion-a-month buy rate of 2013. After this tapering is completed, the fed funds rate – the overnight interbank lending rate that the Fed employs to effect policy – is unlikely to be increased until the second half of 2014, provided of course that prospects for employment and inflation meet up to Fed projections. One caveat: concerned about low levels of stock and bond market volatility (rather, the high degree of investor complacency built into stock and bond prices), Fed officials may accelerate their rate hike plans. As always, markets will no doubt try to get out ahead of the Fed in factoring higher interest rates into securities prices.

U.S. firms generally beat Wall Street's expectations for earnings in the first quarter of 2014. Once again, positive earnings surprises were achieved through margin improvement, as revenue growth continued to just meet Street forecasts for 2%-3% year-on-year growth. If nominal GDP growth does ramp up going forward, as we think possible, then sales growth should also improve, and Wall Street forecasts of 10% profit growth for 2014-16 will no longer seem so much of a reach.

Total Investment Returns — 5/31/2014

	May	Last 12 Mos.
Dow Jones Industrial Average	1.2%	13.3%
Nasdaq Composite	3.3%	24.3%
S&P 500 Composite	2.3%	20.4%
S&P MidCap 400	1.8%	18.0%
S&P SmallCap 600	0.3%	19.7%
MSCI World ($)	2.0%	18.9%
MSCI World ex U.S. ($)	1.5%	17.5%
Barclays Capital U.S. Aggregate Bond Composite	1.1%	2.7%
90-Day Treasury Bills	0.0%	0.1%
Consumer Price Index (NSA)*	***0.3%***	***2.0%***

* Month and 12 months ended April 2014.

INVESTMENT OUTLOOK

Bargain hunters managed to overpower profit takers in May's stock market action, propelling the DJIA and S&P 500 to all-time highs as the month was ending. The middle of 2014 is symbolic in that the U.S. economic expansion begins its sixth year in July, and in the postwar period year six is about when expansions start to wane. True, that has not been the case with the three most recent expansions, which have lasted 7.5 years, 12 years and 6 years. Further, the saving grace of the current slow expansion may be that it has not created the sort of excesses that typically bring expansions to an end. Perhaps as noteworthy is the 6¼-year old bull market in stocks, which has now gone almost 30 months without a 10% correction in the S&P 500, also unusual historically speaking. The market's recent profit taking in some of last year's high flying stocks and apparent rotation to a new group of favorites have the potential to extend the 2009-14 bull market. Favorable monetary policy has been a factor in the stock market's long run, so one should not rule out the possibility that the Federal Reserve is getting anxious about the low volatility (read complacency) that has recently been manifest in stock market pricing.

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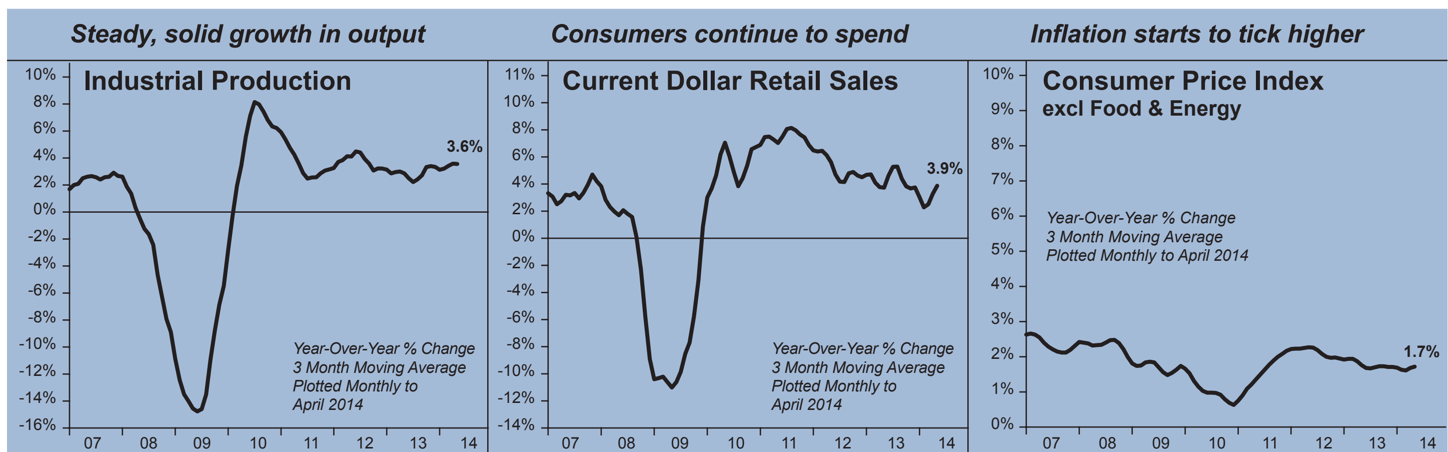

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