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Monthly Investment Report

March 2014

SUMMARY: ***Stocks recovered most of their January losses during February, and two months into 2014 the S&P 500 has produced a 1.0% total return. Bonds also had positive returns last month, as Treasury yields were little changed and credit spreads narrowed. In dollar terms, foreign stocks performed more or less the same as U.S. stocks over the opening two months of the year – better in Europe, weaker in Japan, China and other emerging markets. After a strong second half of 2013, the U.S. economy slowed in December-February, in part as a result of severe winter weather.***

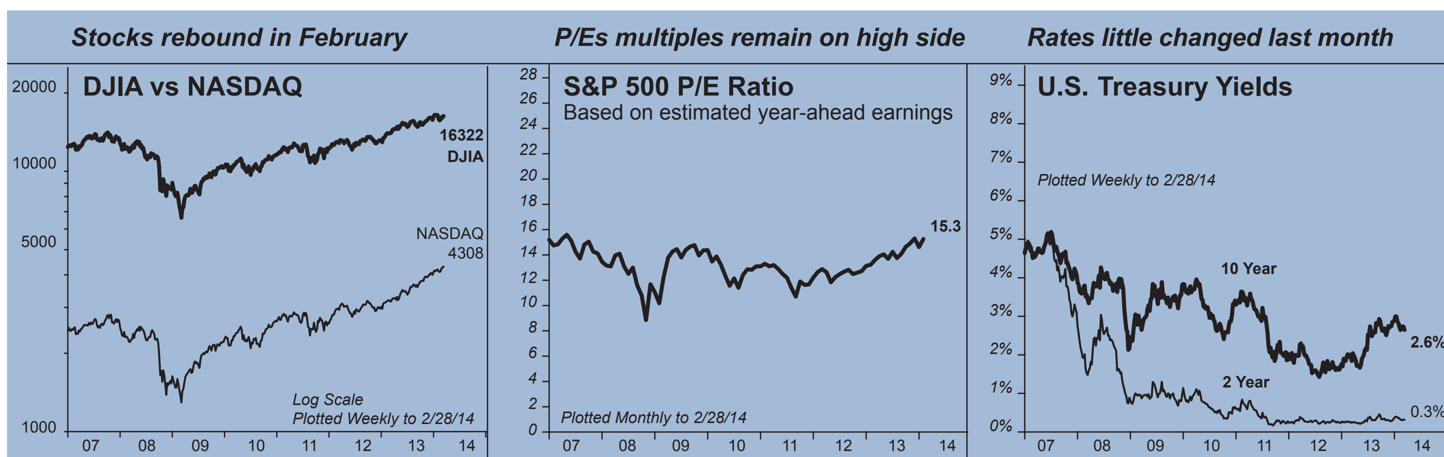
Most U.S. stocks made up for a poor January with healthy returns in February. From their lows on February 3, the major stock market indexes returned between 6.5% and 8% over the rest of February. Smaller-cap returns were generally as good or better. The S&P 500 ended the month at an all-time high, led by the health care and materials sectors. Stocks in these two sectors had the best gains last month and, along with technology and utilities, they are ahead for the year to date. Telecoms were the only S&P 500 sector with a negative return for February, due in part to AT&T's 4% decline. Google (+8%) and Facebook (+25%) made the biggest (index-point) contributions to the S&P 500's two-month return, while Apple (-6%) and GE (-9%) were the big detractors.

Foreign stocks lagged U.S. stocks slightly in local currency terms February, but stronger foreign currencies, particularly the euro, boosted their returns in U.S. dollars. The MSCI Developed World ex U.S. index returned 5.5% in U.S. dollars during the month, bringing its YTD return to 1.2% (vs 1.0% for the S&P 500). The MSCI Emerging Markets index returned 3.3% last month, but it remains down 3.4% for the YTD, with the BRICS markets (Brazil, Russia, India, China and South Africa) all still showing losses after two months, ranging from 0.5% for India to 12% for Russia.

For bonds, February's return was only about one-third of January's, but it was enough to stretch the Barclays U.S. Aggregate's total return to 2.0% since the end of 2013. In the first two months of 2014, with long Treasury yields down 25-40 basis points and credit spreads narrowing by 5 bps, the return to bonds has made up for their losses in all of 2013. The Barclays corporate bond aggregate YTD return is ahead of the high-yield aggregate's (+2.9% vs +2.7%), after trailing during 2013 (-1.5% vs +7.4%). Being long didn't help much in February – except in terms of carry – but the long end of the yield curve had the better returns over the two-month period by a wide margin. The new two-year Treasury floating rate note had a loss of 2 basis points during February.

Considering how much the stock market averages rose last year, equities have acquitted themselves quite well so far in 2014. Corporate earnings reports for the fourth quarter of 2013 have provided some support to stocks. With 488 of the S&P 500 constituents having reported, earnings are running 8% higher than in Q4 2012; sales, on the other hand, are running only about 1% higher. Both sales revenues and earnings represented positive surprises relative to analyst forecasts: 62% of firms had sales that beat (by an average of 1%); 74% of companies had better-than-expected earnings (by an average of 5%). Company guidance was overwhelmingly negative for Q4; in other words, for the most part, firms were beating lowered expectations.

Along with stock prices, the U.S. economy and Federal Reserve policy makers appear to have gotten the benefit of the doubt from Wall Street when it comes to the effects of bad



winter weather. Federal Reserve Chair Yellen, in weather-delayed testimony to the Senate in late February, said that bad weather might explain some of the softness seen recently in U.S. economic indicators. But Yellen added that the Fed doesn't know by how much growth was slowed. Barring evidence that the fundamental outlook has worsened, Yellen expects that the Fed "will likely reduce the pace of asset purchases in further measured steps [i.e., taper] at future meetings."

The U.S. economy did not end the fourth quarter of 2013 as strongly as the Commerce Department's advance estimate indicated. Based on more complete information – notably smaller contributions from the export sector and from inventory building – Commerce revised down its estimate of Q4 real GDP growth to 2.4% from the 3.2% rate estimated one month earlier. Consumer spending on goods was more modest than estimated earlier, possibly the result of a weather-related drop in traffic at auto dealerships.

On the positive side, business investment in equipment and intellectual property during the fourth quarter was better than in the advance estimate by 0.4%. The Q4 contribution to GDP growth from equipment and intellectual property investment was the best in over three years. Before we conclude that business investment, the missing link in the economic expansion for much of the past four years, is about to provide a sustained boost to economic growth, though, we need to see more evidence in durable goods shipments, new orders and even hiring. Orders for non-defense capital goods ex aircraft, a proxy for business capital spending, rose 1.7% in January, but over the past 12 months there has not been much progress.

Final sales, i.e., GDP less the volatile change in business inventories, increased at a 2.4% annual rate during the second half of 2014. That is modestly better than the 1.9% averaged in the 4½ years since the recession. It may also be a better gauge of the underlying potential for economic growth than GDP, which grew at an inventory-inflated 3.3% annual rate in the final six months of 2013. With business still reticent in hiring and capital investment, and consumers still concerned about their debt burdens, 2%-2.5% may be the new normal growth rate for the U.S. economy, at least in the intermediate term. In the near term, i.e., in Q1 2014, GDP growth looks as if it will be at the low end of that 2%-2.5% range, perhaps lower if spring doesn't arrive soon. Longer term, breaking out of this sub-par range on a sustained basis will require greater investment and an improvement in productivity growth.

Total Investment Returns — 2/28/2014

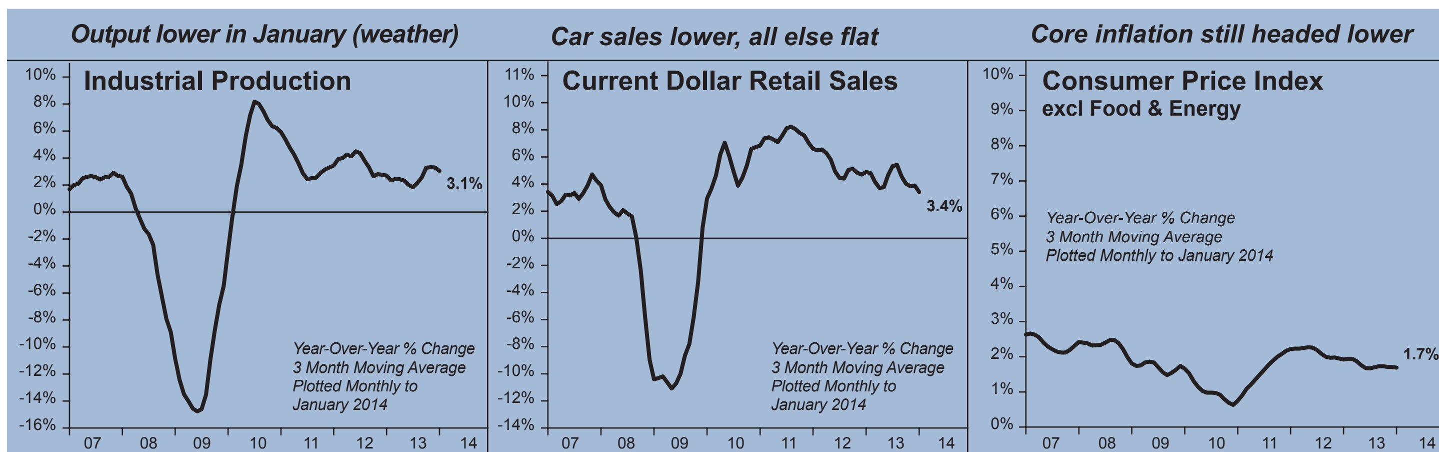
	February	Last 12 Mos.
Dow Jones Industrial Average	4.3%	19.0%
Nasdaq Composite	5.1%	38.1%
S&P 500 Composite	4.6%	25.4%
S&P MidCap 400	4.9%	26.6%
S&P SmallCap 600	4.5%	32.3%
MSCI World ($)	5.0%	21.7%
MSCI World ex U.S. ($)	5.5%	17.9%
Barclays Capital U.S. Aggregate Bond Composite	0.5%	0.2%
90-Day Treasury Bills	0.0%	0.1%
Consumer Price Index (NSA)*	***0.4%***	***1.6%***

* Month and 12 months ended January 2014.

INVESTMENT OUTLOOK

The 6% price correction in the S&P 500 over the first one month and one day of 2014 matched the largest correction in stocks in 16 months. Said correction was dispensed with expeditiously, as the S&P 500 rebounded to an all-time high on February 28. Our guess is that we may not be so lucky as to be done with market corrections for the year. On the other hand, we do not foresee a correction of bear market proportions this year. We hasten to add that exogenous events, such as Russia's incursion into Ukraine's Crimea, can always make hash of "best-laid plans." With this caveat, we believe that economic growth will pick up after a weather-socked first quarter; that corporate earnings growth will approach double-digit rates by the fourth quarter; and that bond yields will rise, but only moderately. If we are correct, conditions should be in place for a respectable, in-line-with-history, 10% or so return from stocks in 2014, with more months like February than like January.

March 5, 2014



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