TAG ADVISORY SERVICES
TRUST ADVISORY GROUP, LTD. • A REGISTERED INVESTMENT ADVISOR

Monthly Investment Report

May 2014

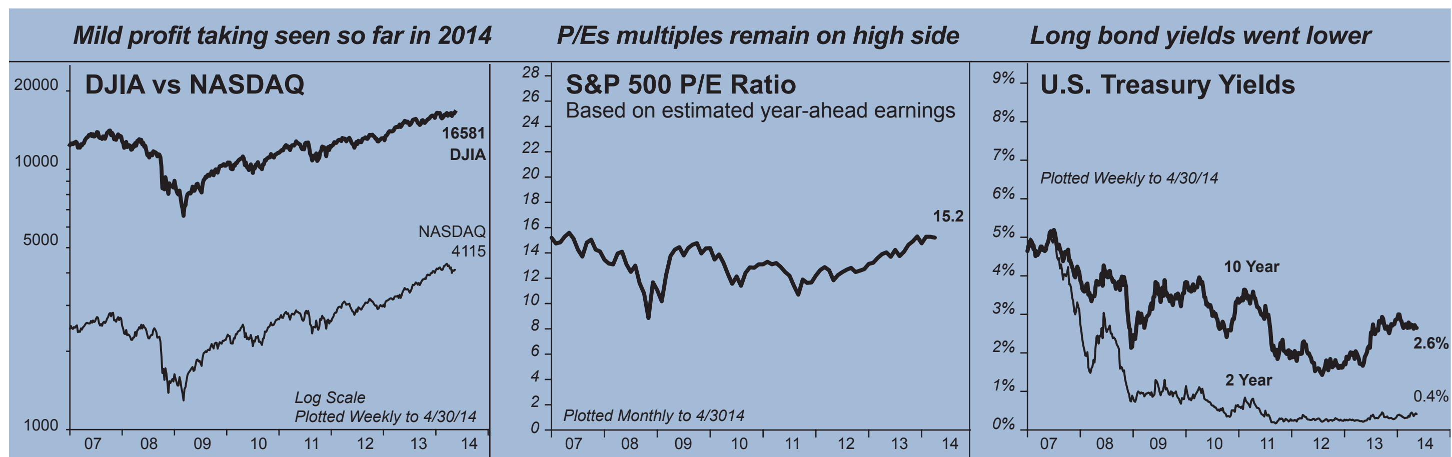
***SUMMARY:* Stock prices mostly edged modestly higher in April, although undercurrents of profit taking and stock/sector rotation were evident. The Dow and S&P 500 each returned a bit less than 1% in the month, while NASDAQ retreated 2% on selling in biotech and internet stocks. Bonds enjoyed another surprising 0.8% advance last month. With evidence of a firming U.S. economy, the lackluster returns from stocks and the better-than-expected showing by the bond market appear to derive from risk-averting portfolio moves engendered by uncertainties such as Ukraine and China. One third of the way through the second quarter, a strong rebound is under way in the U.S. economy.**

U.S. stocks continued their uneven advance in April, with the Dow Jones Industrial Average returning 0.9% and the S&P 500 up 0.7%, but NASDAQ dropping into negative territory for the year. The S&P 500 hit a record high in the first week of the second quarter and spent the rest of the month trying (unsuccessfully) to return to that high. Beneath the surface of April's seemingly boring stock market action, sector rotation was pronounced, with risk-averse investors taking profits in many of last year's winners. Sectors like technology, social media, consumer discretionary and health care – in other words, some of last year's high flyers – declined last month, while more mundane energy and utilities stocks moved to the front of the pack for the year with solid gains in April. The same profit taking dynamic was apparent in mid-cap and small-cap stocks, which lost, roughly speaking, 1.5%-3.0% last month; the S&P 600 SmallCaps, down 1.7% so far this year, is the laggard among the major stock market averages.

Considering that Russian/Ukrainian uncertainties escalated during the month, European stocks performed surprisingly well in April; Japan and China continued to lag. The MSCI Developed World ex U.S. index returned 1.6% in U.S. dollars last month, roughly twice the return on U.S. stocks, bringing its YTD return to 2.3% and closing the gap with the S&P 500's 2.6% return. Stocks in the U.K. rose 4.5% in April; returns in the rest of Europe averaged 1.6%. Asian markets were mixed: Japan and China lost 2.6% and 2.3%, stretching their year-to-date declines to 8%; MSCI's Pacific ex Japan index posted a 2.3% return for April in U.S. dollar terms. On average, emerging markets had a small positive return for the month and a small negative return for 2014's first four months.

Bonds continued to surprise on the upside in April, bringing the Barclays U.S. Aggregate's total return to 2.7% for the first four months of 2014. If stock market action has been increasingly about rotation to lower risk and greater value this year, this rising risk aversion has also been evident in the higher bond returns seen so far in 2014. In the first four months of 2014, long Treasury yields have fallen 35-50 basis points, while the two-year Treasury yield has ticked up a few bps, resulting in a flattening yield curve, particularly in the two-year to 10-year portion of the Treasury yield curve. Longer bonds performed better than shorter in April, and credit spreads continued to compress. History suggests that there is further room for even narrower spreads, although the near-record low absolute yields, especially on high yield securities, gives one pause.

Federal Reserve officials appear to be sufficiently satisfied with the U.S. economy to stay the course on policy. Effective May 1, the Fed is half way to getting out of the bond-buying business, reducing its purchases of Treasurys and mortgage-backed bonds to the $45 billion a month rate, down from $85 billion a month throughout 2013. The plan, by all indications, is to taper quantitative easing to the vanishing point by sometime



in the fourth quarter – in the Fed's own words, reducing "the pace of asset purchases in further measured steps." The Fed has also suggested that it will be some time after tapering is done and unemployment and inflation reach threshold levels before consideration is given to raising interest rates. We suspect that the fed funds rate – the overnight interbank lending rate that the Fed employs to effect policy – will not be increased until the second half of 2014 at the earliest. Of course, that doesn't mean the markets won't begin to anticipate higher interest rates somewhat ahead of the Fed's schedule.

The U.S. economy slowed to stall speed in the first quarter of 2014, with real GDP increasing a scant 0.1%, but the return of more seasonable weather is speeding up economic growth. Most data reports for March showed significant improvement – e.g., auto sales were at a more than six-year high for the month – and early reports for April show continuing growth in economic activity. The April employment numbers, while not without shortcomings, did boast the biggest increase in net new jobs in two years. April was also the third month in a row in which job creation exceeded 200,000. The civilian employment rate fell from 6.7% in March to 6.3% in April – although not entirely for good reasons. Seniors and discouraged job seekers continue to exit the labor force at an unsatisfactorily high rate, with the labor participation rate dropping back to a 36-year low last month. What's more, wage rates are running less than 2% above year-earlier levels on average, not exactly what one would expect if employment conditions were approaching more normal levels.

By and large, corporate earnings are meeting Wall Street's admittedly reduced expectations for the first quarter of 2014. With almost 400 of its constituent companies having reported, S&P 500 earnings are running 4%-5% ahead of 2013 levels, roughly 6% ahead of analyst estimates. Sales growth, in contrast, is just 2%, in line with Street estimates. It will take some doing for the S&P 500 companies to reach analyst targets for all of 2014, currently in the neighborhood of 9% growth, despite some slippage in those targets over the first four months of the year. Profit margins are likely to rebound from their weather-constrained first-quarter levels, but after that firms will finally need to see better top-line growth if bottom-line results are to get to levels satisfactory to investors.

Total Investment Returns — 4/30/2014

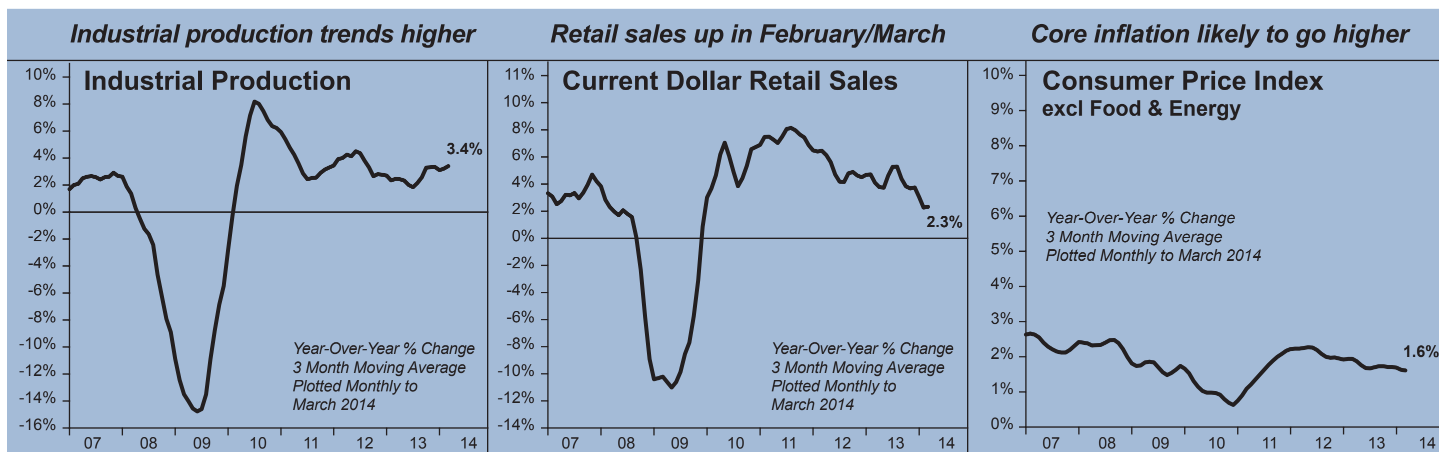
	April	Last 12 Mos.
Dow Jones Industrial Average	0.9%	14.4%
Nasdaq Composite	-2.0%	25.2%
S&P 500 Composite	0.7%	20.4%
S&P MidCap 400	-1.6%	18.6%
S&P SmallCap 600	-2.8%	24.6%
MSCI World ($)	1.0%	16.6%
MSCI World ex U.S. ($)	1.6%	13.1%
Barclays Capital U.S. Aggregate Bond Composite	0.8%	-0.3%
90-Day Treasury Bills	0.0%	0.1%
Consumer Price Index (NSA)*	***0.6%***	***1.5%***

* Month and 12 months ended April 2014.

INVESTMENT OUTLOOK

The U.S. stock market has been engaged in a tug of war so far in 2014, pitting profit takers on one side against bargain hunters looking to buy the dips on the other. So far it has been a pretty even battle. Should any of the uncertainties facing the market today – chaos in Ukraine, a hard landing in the Chinese economy or a reversal in Europe's fragile economic recovery, to mention three – breaks the wrong way, then be prepared for a stock price correction greater than the 6% or so corrections (mini-corrections really) seen in 2013-14. In fact, it has been almost two years since the last 10% correction in the S&P 500, a longer hiatus than usual. The market's recent rotation to a new group of favorites may turn out to be a good thing for the prolongation of the 2009-14 bull market, but it will not get far, in our view, unless the economy starts to deliver on the improved growth that has been hinted at recently in the leading economic indicators. Since the end of the great recession in June 2009, GDP has averaged only 2.2% real growth and less than 4% nominal growth. The potential is there for faster U.S. growth and improved corporate profitability, which, if realized, should provide the constructive backdrop for stocks and gradually rising interest rates.

May 2014



Copyright © 2014 by Wright Investors' Service, Inc., 440 Wheelers Farms Road, Milford, CT 06461. All Rights Reserved. Except for quotations by established news media, no part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without prior written permission. Statements and opinions in this publication are based on sources of information believed to be accurate and reliable, but Wright Investors' Service makes no representations or guarantees as to the accuracy or completeness thereof.