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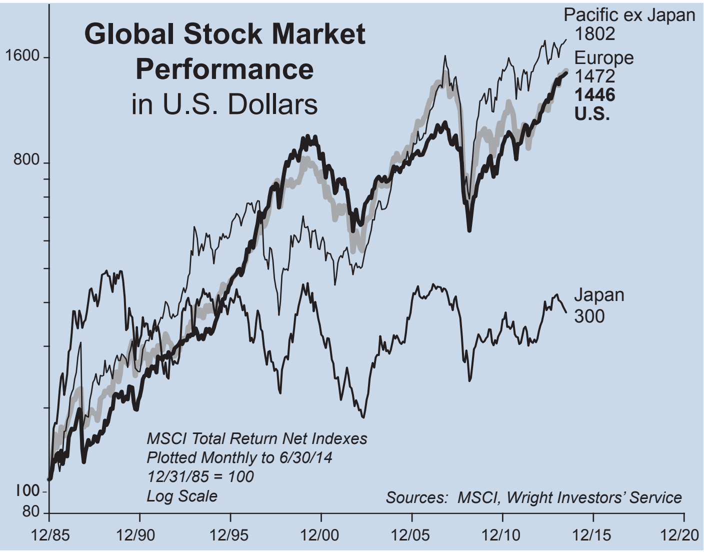
Quarterly Investment Report

July 2014

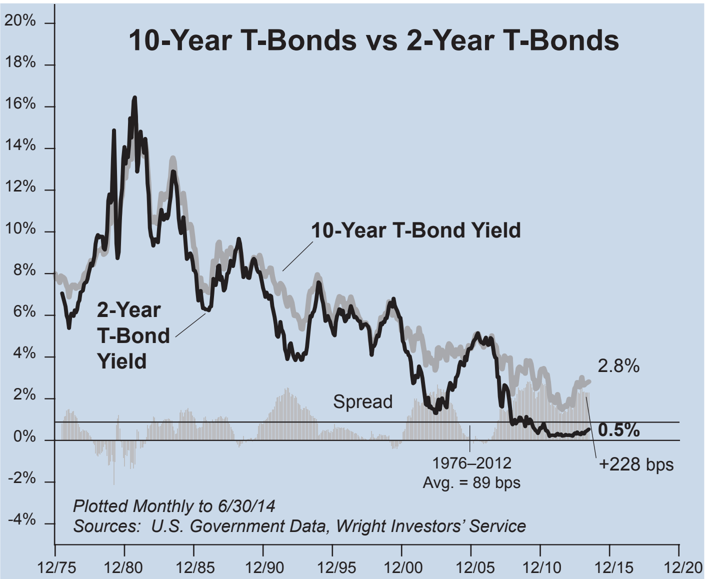
***SUMMARY:** The S&P 500 enjoyed a healthy, 5%+ rate of return in the second quarter of 2014, more than twice its not-quite 2% return in the first quarter. Outside the U.S., stock performance was mostly improved in Q2 relative to Q1's anemic returns or in the case of emerging markets outright losses. Bonds also put in a workmanlike performance for the quarter, staying ahead of inflation (and the Dow) for a second quarter in a row. Treasury bond yields fell roughly 20 basis points at the long end of the yield curve during Q2, while short rates inched up, resulting in some modest further flattening in the yield curve. U.S. economic growth has rebounded from the dismal first-quarter result, but there is not yet a strong basis for expecting sustainable growth closer to 3% than to the 2% growth seen in the 5 years since the 2008-09 recession*

Earlier this year, the long-avoided correction in U.S. stocks appeared to have arrived, but a solid second quarter had stock market averages at record levels as July began. As the third quarter begins, the major stock market averages are trading at all-time highs or, in the case of NASDAQ, at the highest level since 2000. The S&P 500, with a return of 5.2% for Q2, has now gone two years since its last price correction of 10% (9.9% in May-June 2012) and 2½ years since a 20% correction (19.4% in the summer of 2011). The bull market rally in stocks has powered the S&P 500 to a 190% price rise since its March 2009 low (157% for the Dow and 247% for NASDAQ). In June, expected stock market volatility, as implied in the price of S&P 500 index options, receded to the lowest levels since 2007. These low readings on VIX, sometimes referred to as a "fear gauge" and sometimes as a measure of complacency, prompted Fed Chair Janet Yellen to express concern about declining volatility at her mid-June press conference, where she highlighted some of the uncertainties extant around the globe that markets may be underestimating.

If stock market action during the first quarter of 2014 was about profit taking and sector rotation, the second quarter brought a reversal of many of those Q1 trends. The NASDAQ biotech composite, which fell more than 20% from its high in the first quarter to its low in the second, has gained back nearly three-quarters of its decline and at midyear sits 13% above its beginning-of-the-year level. Yield-rich utilities stocks, easily the leading market sector in the S&P 500 during Q1, were second only to energy stocks (which returned 12.1%) in Q2, returning 7.8%, which stretched the S&P utilities' first-half return to 18.7%. Like energy stocks, consumer discretionary stocks were laggards in Q1; unlike energy, they remained near the back of the pack in Q2 (3.5%), ahead of only financials (2.3%).



MSCI Total Return Net Indexes
Plotted Monthly to 6/30/14
12/31/85 = 100
Log Scale
Sources: MSCI, Wright Investors' Service



Plotted Monthly to 6/30/14
Sources: U.S. Government Data, Wright Investors' Service

Social media and internet stocks also experienced a 20% or so correction in 2014's first half, from which the NASDAQ internet composite has rebounded enough to get back to flat for the first half. Among the erstwhile high flying IPOs of recent years, many in social media, there were big winners in the first half (e.g., Facebook, +23%) and big losers (Twitter, -36%). While still off their highs, other high flyers such as Tesla (+60%) and Netflix (+20%) enjoyed great first-half returns. GoPro, the camera maker that went public in the final week of June, was up 69% within days of its IPO and 93% by July 1.

Global Investment Returns
In U.S. Dollars

	Q2 2014		LAST 12 MONTHS	
	Stocks	Agg. Bonds	Stocks	Agg. Bonds
U.S.	**5.1%**	**2.0%**	**6.8%**	**3.9%**
Canada	9.9%	5.2%	11.6%	3.7%
Mexico	6.6%	4.8%	1.3%	9.0%
Japan	**6.7%**	**2.4%**	**0.7%**	**5.4%**
Pacific ex Japan	4.3%	N/A	7.4%	N/A
Australia	2.8%	4.3%	8.9%	8.5%
China	5.5%	3.5%	-0.7%	5.8%
Hong Kong	8.3%	2.3%	4.6%	4.3%
Europe	**3.3%**	**2.1%**	**5.5%**	**5.4%**
France	1.7%	2.3%	4.7%	5.0%
Germany	1.6%	1.5%	1.3%	4.2%
Italy	-0.1%	2.8%	14.5%	7.9%
Netherlands	0.5%	2.0%	1.6%	4.8%
Spain	7.2%	2.4%	12.3%	7.7%
Switzerland	2.1%	1.4%	6.9%	3.9%
U.K.	6.1%	3.5%	5.2%	6.4%
World	**4.9%**	**2.5%**	**6.2%**	**4.9%**
World ex U.S.	4.6%	2.7%	5.4%	5.6%

Sources: MSCI Stock & Barclays Bond Indexes @ 6/30/14.

Developments in Iraq were no doubt part of the story in the rise in prices of energy commodities in April-June. Crude oil prices increased 4% for the second quarter and 7% over the first half, while unleaded gasoline was up 6% in Q2 after a 4% rise in Q1. Gold (+3%) and silver (+6%) extended their first-quarter gains and were up 9%-10% in the first half. The price of copper, which serves as a proxy for global economic activity, rose 5% in Q2, after an 11% decline in Q1. Corn and wheat suffered big Q2 declines, enough to more or less offset their outsized Q1 gains and leave prices near four-year lows.

Foreign Markets

Developed stock markets outside the U.S. failed to perform as well as U.S. stocks again in the second quarter, but emerging markets did – for only the second time in the past six quarters. The MSCI Emerging Markets Index returned 6.6% in the second quarter in U.S. dollar terms, with good gains in India and Russia, which each returned more than 10%, and a smaller contribution from China, which struggled to produce a 3.5% return for the quarter. The MSCI Developed World ex U.S. Index returned 4.6% in Q2 in terms of U.S. dollars, modestly behind the S&P 500's 5.2% total return. Returns in Europe lagged U.S. returns in local currency terms, and the euro depreciated 0.6% vis-à-vis the dollar. Spain once again had better-than-average returns, while German, French, Italian and U.K. markets lagged as it became clear that Europe's economic recovery has sputtered. Tokyo saw a nice rebound in Q2 from the poor Q1 results and is nominally ahead for the first half. Outside of Japan, the developed markets of the Pacific had a solid second-quarter return.

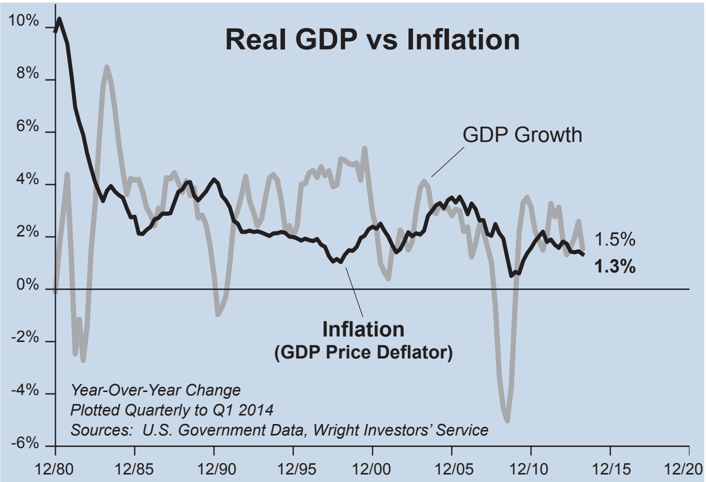
Global bonds generally performed well again in the second quarter, aided by lower rates and further declines in spreads against Treasurys. Long-term Treasury bond yields fell about 20 basis points in the second quarter, due partly to disappointing economic trends and partly to the safe-haven trade precipitated by the ongoing geopolitical drama in places like Iraq and Ukraine. Much as they did in the first quarter, credit spreads narrowed in the second. High-yield bonds and the sovereign debt of the nations of Europe had strong Q2 showings. The yield to worst on the Barclays corporate high-yield composite fell to 4.9% from 5.2% during the second quarter; similarly, German 10-year bund yields fell roughly 30 bps and Spain (-55), Italy (-45) and Greek rates (-60) fell even more. The Federal Reserve reduced its bond buying rate at each of the two second-quarter Federal Open Market Committee meetings, remaining on course to end quantitative easing (QE) by the fourth quarter of 2014. We remain of the opinion that the Fed will keep short-term interest rates low through mid-2015 and possibly longer if the expected ramp-up in economic growth fails to materialize.

Rising stock prices and the ongoing narrowing in credit spreads fly in the face of concerns that the economies of the U.S., Japan, China and Europe may continue to disappoint. The U.S.'s dismal Q1 GDP growth (+0.1% in the advance estimate, -1.0% in the preliminary estimate and -2.9% in the final estimate) caused a cascade of estimate revisions for 2014. Soft consumer spending in April and May call into question the Fed's forecasts of 3%-ish growth for 2015-16. June's record level of auto sales and healthy rate of job creation suggest that momentum is building for a stronger second half.

Global policy makers are still mostly on the side of growth, going pedal-to-the-metal in monetary accommodation, mixed here and there with some modest fiscal austerity...

- Arguably the most aggressive fiscal action recently was Japan's increase on April 1 in the national sales tax from 5% to 8%, which put second-quarter GDP growth into negative territory. Street estimates put the Q2 GDP change at around -4%, which would offset a good part of the anticipatory 6.7% rate of GDP growth in Q1, ahead of the tax hike. Japan is desperate to spur growth and fight deflation, but it also has a budget deficit that may top 7% of GDP again this year. Quantitative easing appears to have succeeded in boosting inflation above 2% this year, but most forecasters expect prices to trend back toward being flat in 2015.

- U.S. GDP is rebounding from the depressed first quarter (-2.9%). Fiscal drag is starting to lessen; the government sector added 54,000 jobs in the first half of 2014, the most since 2010. The Fed is winding down its bond buying, and its balance sheet is likely to stop expanding by the fourth quarter. Still, absent a surge in inflation, the Fed is likely to keep short-term rates near zero for another 12 months or longer.



Year-Over-Year Change
Plotted Quarterly to Q1 2014
Sources: U.S. Government Data, Wright Investors' Service

Comparative Bond Returns
Total Investment Return for a Ten-Year Treasury Bond*

If Bond Yields at End of Period Are:	1.0%	1.6%	2.0%	2.5%	3.0%	3.6%	4.0%
Next 12 Months – Annual Rate of Total Return:	15.4%	10.9%	6.6%	2.5%	-1.4%	-5.1%	-8.7%
Next 2 Years – Annual Rate of Total Return:	8.0%	6.1%	4.3%	2.5%	0.8%	-0.9%	-2.5%
Next 3 Years – Annual Rate of Total Return:	5.7%	4.6%	3.6%	2.5%	1.5%	0.6%	-0.4%

*: Estimated returns for a hypothetical 10-year 2.5% Treasury bond due June 2024 under various interest rate scenarios at 6/30/14. Source: *WIS*

- Disappointed with the Eurozone's economic progress and concerned about deflation, in June the European Central Bank cut interest rates, launched a low-rate lending program to stimulate "lending to the real economy" and said it is prepared to undertake a "broad-based asset-purchase program" – read QE – if needed. While it appears that a fall back into recession will be averted, economic statistics are not yet encouraging on either the growth or deflation side.

- China's economic indicators have turned higher; the country's official manufacturing purchasing managers' index rose to 51 in June, the highest level in six months. A competing index from HSBC rose from 49.4 to 50.7, putting it in expansion territory (i.e., 50+). Consensus forecasts for GDP growth over the next several quarters tend to be unnaturally precise – 7.4%, 7.3%, 7.4%, 7.3%, 7.25%, 7.2% – and chances are good that some surprises, positive and/or negative, lie ahead. We would look for a shift in the consistently laggard performance of the Shanghai Composite as a leading indicator for this important economy.

- World GDP was a disappointing 2.2% in 2012 and 2.1% in 2013, and as a result of the U.S.'s weak first quarter, an underwhelming 2.7% is the consensus forecast for 2014. Global growth closer to 3% is Wall Street's projection for 2015 and 2016; should world GDP fall short of expectations, expect prolonged easy money from the central banks.

Inflation

From a low of 1.1% in the year to February, the U.S. inflation rate nearly doubled by the middle of the year. The 12-month change in the consumer price index was 2.1% in May, and the core inflation rate hit 2.0% for the first time in over a year. Another measure of underlying price pressures, the median CPI calculated by the Federal Reserve Bank of Cleveland, is up 2.3% over the latest 12 months, highest since the end of the recession in 2009. Wage rates have firmed, and with productivity declining, even unit labor costs may soon be at worrisome levels. The Fed has been attempting to boost inflation to the 2% level or even, temporarily, higher. Now that the CPI is at or approaching those levels, investors may start paying more attention to rising prices and anticipating the arrival of tighter policies from the Fed. Higher inflation is not now a global issue, except in the sense that Japan has for the moment succeeded in breaking the hold of its terrible deflation pressures. In Europe, June's actions by the ECB were as much about reversing deflation trends as about boosting economic growth.

Corporate Profits

Corporate earnings surpassed our projections in the first quarter of 2014, although revenue growth continues at sluggish rates. Second-quarter earnings reporting season gets under way soon, and the Wall Street consensus forecast is for S&P 500 earnings per share to rise 6% for Q2 2014, followed by gains averaging more than 10% in the second half. While Wright believes that the Street may be rushing things in looking for double-digit percentage gains in earnings as early as the third quarter, it does appear that corporate profits are on track toward that 10% growth plane. Corporations possess a great deal of operating leverage, and when better sales growth finally does materialize, this should produce a powerful boost to corporate profitability. S&P 500 dividends have increased at double-digit rates in 13 of the past 14 quarters, and they grew by 14% in the first half of 2014.

Dow 17000

During the first week of July, seven months after hitting 16000 for the first time ever, the Dow Jones Industrial Average broke through the 17000 level. At that level, the Dow approximates the nominal dollar value of U.S. gross domestic product, which totaled $17 trillion in the first quarter of 2014. For much of the past 50 years, the nominal value of U.S. GDP has served as a very rough gauge to the attractiveness of stock market valuations. This is not the only measure of stock market value currently suggesting the need for caution. Absent the prop that the easy money policies of the Federal Reserve provide, stock prices would be hard pressed to maintain the remarkable momentum they have shown since September 2011. Today's low interest rate environment

Historical and Prospective Returns from Equities and Bonds

Annual Rates of Return S&P 500 (06/30/14)	1950- 2013	1950s	1960s	1970s	1980s	1990s	2000s	2008	2009	2010	2011	2012	2013	2014*	Projection Next 5 Yrs
Dividend Income	3.6%	5.1%	3.3%	4.3%	4.5%	2.5%	1.7%	1.5%	3.0%	2.3%	2.1%	2.2%	2.8%	1.0%	2.1%
+ Earnings Growth	6.0%	3.9%	5.5%	9.9%	4.4%	7.7%	2.0%	-24.7%	-2.6%	37.8%	14.5%	6.0%	5.7%	NA	5.5%
+ Change in P/E Ratio	1.5%	10.4%	-1.0%	-8.3%	8.6%	8.0%	-4.7%	-13.8%	26.1%	-25.0%	-14.5%	7.8%	23.9%	NA	-0.6%
= Total Return	11.1%	19.4%	7.8%	5.9%	17.5%	18.2%	-1.0%	-37.0%	26.5%	15.1%	2.1%	16.0%	32.4%	7.1%	7.0%
– Agg. Bond Return	6.2%	1.0%	3.0%	6.6%	12.3%	7.7%	6.3%	5.2%	5.9%	6.5%	7.8%	4.2%	-2.0%	3.9%	3.5%
= Equity Risk Premium	4.9%	18.4%	4.8%	-0.7%	5.2%	10.5%	-7.3%	-42.2%	20.6%	8.6%	-5.7%	11.8%	34.4%	3.2%	3.5%

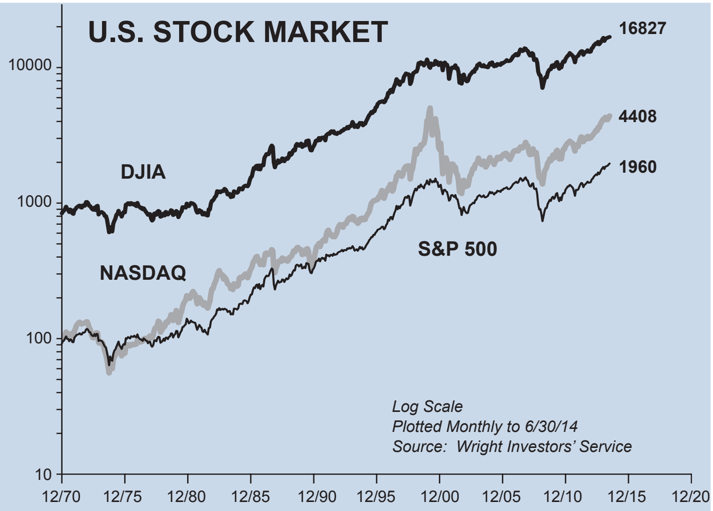
Source: Wright Investors' Service; e: *WIS* estimate; *: Unannualized rates for six months to 6/30/2014; NA: Not available.

generally supports today's higher price/earnings multiples. But last week's strong June employment report and recent higher inflation readings will no doubt give rise to speculation that the Fed may raise interest rates sooner than investors have been assuming.

The current bull market began its run following two secular bear markets that each shrunk stock prices by 50% or more. There is nothing in today's market quite like the bubbles that were experienced in 2000 (dot.com stocks) and 2007 (home prices). Price corrections earlier this year brought valuations in biotech, social media and small-cap stocks, areas where one could make a case of overvaluation, down to more reasonable levels. These sectors may require further correction, but on the evidence so far, one can hope that renewed selling will be localized.

Market Valuations

As the second half of 2014 began, the S&P 500 was priced at 18 times trailing 12 month earnings, high by historical standards, but a far cry from peak P/E's near 25 at the market top of 2000. Unlike 2007, when stock prices looked reasonable but subprime mortgages were about to crater, today's business climate is on an improving trend. Further, on a forward basis, the stock market multiple is in the 16-17 range, a fair approximation of stock value in an era of limited competition from fixed-income securities. But fundamentals are looking better, and some of the more extreme market valuations have begun to correct. An example of this is the way consumer discretionary stocks, last year's leading sector, and utilities, one of last year's weakest sectors, have swapped places in the first half of 2014: yield-rich utilities returned nearly 19% in 2014's first half, compared with less than 1% for yield-poor consumer discretionary stocks. Such internal market dynamics may be enough to avert a broader sell-off and extend the bull market through this, its sixth year.



Log Scale
Plotted Monthly to 6/30/14
Source: Wright Investors' Service

The U.S. Economy 2012–2015

		% Change In			End of Period Rates	
		Real GDP*	PCE Core Deflator*	Profits from Operations#	90-Day T-Bills	10-Year T-Bonds
2012	Q1	3.7%	2.2%	9%	0.1%	2.2%
	Q2	1.2%	1.8%	7%	0.1%	1.6%
	Q3	2.8%	1.4%	1%	0.1%	1.6%
	Q4	0.1%	1.3%	7%	0.0%	1.8%
2013	Q1	1.1%	1.4%	4%	0.0%	1.9%
	Q2	2.5%	0.6%	6%	0.0%	2.5%
	Q3	4.1%	1.4%	6%	0.0%	2.6%
	Q4	2.6%	1.3%	9%	0.0%	3.0%
2014	Q1	-2.9%	1.2%	5%	0.0%	2.7%
	Q2 e	3.3%	1.5%	5%	0.0%	2.5%
	Q3 e	3.0%	2.0%	7%	0.1%	2.9%
	Q4 e	2.8%	2.1%	7%	0.1%	3.0%
2015	Q1 e	2.8%	2.1%	9%	0.2%	3.1%
	Q2 e	2.7%	2.0%	9%	0.2%	3.2%
	Q3 e	2.7%	2.0%	8%	0.3%	3.4%
	Q4 e	2.6%	2.0%	8%	0.4%	3.5%

e: WIS estimate @ 6/30/14; *: Annual rates; #: Year-over-year chg. in S&P 500 e.p.s. Sources: U.S. Government data, Wright Investors' Service.

Investment Outlook

The strong June employment report released on July 3 was a welcome sign that the second-quarter economy will be as good as the first quarter was bad. We are mildly skeptical that U.S. GDP growth will reach and sustain the 3% rate that the Federal Reserve projects for 2015. Nonetheless, we expect a better business backdrop ahead, one that should improve the odds of increasing corporate earnings and higher stock prices during the second half of 2014. Stock returns were mixed in the first half: above average for the S&P 500 (7%) and NASDAQ (6%) but below average for the DJIA (3%). Bonds have put in two better-than-expected quarters in a row, but we doubt that the second half will produce equally good returns, as gradually rising interest rates are expected. The lower volatility that bonds bring to a portfolio warrants their playing an important role in balanced portfolios, in Wright's view.

July 2014

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