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Quarterly Investment Report

October 2014

***SUMMARY**: The third quarter of 2014 witnessed some mixed market action in stocks: up for big, blue-chip stocks, down for smaller issues; modestly higher for the U.S. market, quite a bit lower in Europe and outside the U.S. generally. In similar fashion, the dollar was at the head of the pack during Q3 2014, appreciating more than 7.5% against a trade-weighted basket of major foreign currencies – which didn't help U.S. investments in foreign stocks and bonds. U.S. bonds were mixed in the third quarter as well: modest returns in Treasurys, flat results in corporates and losses in high yield. The U.S. economy ended Q3 in better shape than most of the world's economies.*

U.S. stocks had a mixed showing in the third quarter of 2014, with healthy gains in August sandwiched between generally small declines in July and September. The Dow and S&P 500 reached all-time highs in the third week of September, losing momentum as the quarter came to a close, but most stocks started to wobble earlier than that. On the first trading day of October, the Russell 2000 small-cap index dropped into correction territory, having fallen just over 10% from its July 3 all-time high. By contrast, while the Dow began the fourth quarter with a 240-point or 1.4% decline on October 1, it was still just 2.7% below its September all-time high; the S&P 500 (-3.2%) and NASDAQ (-3.8%) were also down only modestly from their September peaks. Small-cap stocks and other market sectors singled out by Fed Chairman Janet Yellen in July as having "stretched" valuations – social media and biotech – clearly displayed higher volatility in the third quarter.

To a greater or lesser degree, third-quarter market action appeared to reflect growing concerns about the economies of Europe, Japan and China, and whether they would provide support to an otherwise respectable U.S. expansion. Cyclical market sectors tended to retreat in the quarter, while health care and technology were favored. The energy stocks in the S&P 500 lost 9% in price during Q3, as crude oil prices fell more than 10% on fears on both sides of the supply-demand curve. Going forward, lower gasoline prices should fatten U.S. wallets and boost consumer confidence. Outside the U.S., stock prices were flat (Europe) to moderately higher (Japan) in local currency terms, but the dollar's close to 8% appreciation against both the euro and the yen produced sizable losses in U.S. dollar terms.

Sovereign Bond Markets

As was the case with U.S. investment-grade corporate bonds and high-yield securities, sovereign bonds sold off slightly in September, but not enough to offset the tightening of yield spreads for the quarter. Sovereign Greek debt was an exception, experiencing more than 65 basis points of rise in 10-year yields, on the order of what U.S. high yield did in the quarter. But other European yields generally fell a minimum of 25 basis points in Q3; indeed, yields on 10-year Italian debt dropped below U.S. Treasury rates for the first time ever, and Spain's sovereign bonds (2.14%) ended September 35 bps

Global Investment Returns In U.S. Dollars				
	Q3 2014		9 MONTHS 2014	
	Stocks	Agg. Bonds	Stocks	Agg. Bonds
U.S.	**0.8%**	**0.2%**	**7.7%**	**4.1%**
Canada	-4.5%	-3.8%	6.6%	-0.3%
Mexico	2.1%	-0.2%	3.3%	8.8%
Japan	**-2.3%**	**-7.1%**	**-1.6%**	**-2.1%**
Pacific ex Japan	-5.9%	N/A	1.1%	N/A
Australia	-7.9%	-5.1%	0.2%	2.9%
China	1.4%	0.7%	0.7%	6.6%
Hong Kong	-2.6%	-0.6%	1.9%	3.7%
Europe	**-7.0%**	**-5.4%**	**-1.9%**	**-0.3%**
France	-8.4%	-5.1%	-4.1%	-0.3%
Germany	-11.2%	-5.6%	-10.0%	-1.6%
Italy	-8.7%	-4.9%	4.5%	2.7%
Netherlands	-4.7%	-5.2%	-3.2%	-0.7%
Spain	-7.5%	-4.7%	3.9%	2.6%
Switzerland	-4.4%	-5.0%	2.2%	-1.3%
U.K.	-6.1%	-2.0%	-1.2%	4.2%
World	**-2.2%**	**-3.1%**	**3.9%**	**1.6%**
World ex U.S.	-5.7%	-5.4%	-0.7%	-0.1%

Sources: MSCI Stock & Barclays Bond Indexes @ 9/30/14.

below Treasurys (2.49%). Compare this to the nearly 350 basis-point premium rate over Treasurys that Spain was forced to pay less than 24 months ago. As with stocks, however, the modest local currency returns earned on European debt during the third quarter was more than offset by the euro's depreciation.

Emerging Markets

Emerging market stocks gave back a good chunk of their first-half returns during the third quarter, leaving the sector just about 2% to the good for the first nine months of 2014. China's markets were on net positive in the third quarter, with a big gain in Shanghai mostly offset by declines in Hong Kong, where the Hang Seng index fell more than 7% in September. Geopolitical uncertainty was front-page news for virtually the entire third quarter, ranging from sanctions on Russia related to its trouble-making in Ukraine; to Scotland's independence referendum; to something similar in Spain (Catalonia); to the usual troubles in the Middle East; and, not least, to the Ebola pandemic developing in Africa. The MSCI Emerging Markets total return index was 2.4% in the black for the first nine months of 2014 in dollar terms.

The third-quarter action of the stock and credit markets was consistent with concerns that the global economies may continue to disappoint. In markets where economic growth is more in doubt or where inflation is trending lower, stocks tended to weaken most and credit spreads tended to widen, especially during September. Outside the United States, purchasing managers' surveys generally crept closer to neutral readings, where contraction is as likely as expansion. Just as worrying, inflation seemed to have turned into disinflation, with outright deflation not all that far off in some regions. For the most part, central banks are still dealing with recalcitrant consumers and businesses that are reticent about hiring or making new capital investments. In the U.S. and the U.K., where growth has been better, debates rage about how soon the Fed and the BOE will raise interest rates and by how much.

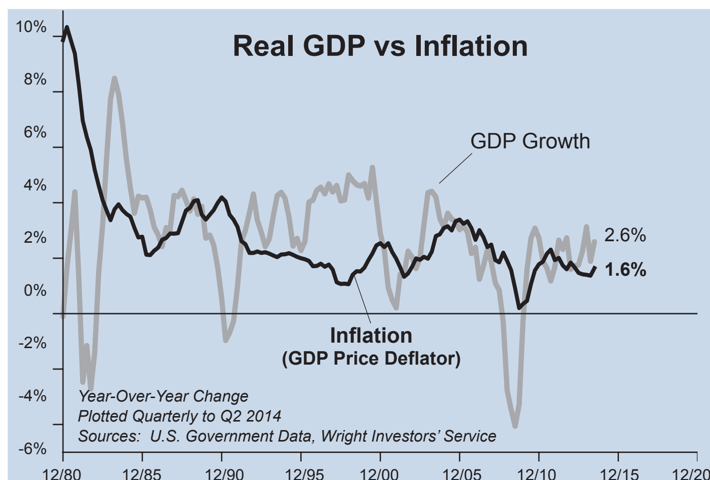
Global Economic Outlook

Global policy makers remain mostly on the side of growth, but in the U.S. and the U.K., where growth has been better, debates rage about how soon the Fed or the BOE will raise interest rates and by how much…

- **Following Japan's increase in the national sales tax from 5% to 8% on April 1, GDP fell like a brick, and full-year 2014 economic growth seems to be settling back into the 1%-1.5% range.** So much for Abenomics getting the two-decade economic slowdown turned around. Efforts to boost inflation – in part to spur spending – may be working in 2014, but economists are more cautious about 2015-16. The Bank of Japan can probably be expected to continue to its quantitative easing program of buying bonds, to be offset to some degree by fiscal policy efforts to trim the government's budget deficit from this year's problematic 7%-8% (of GDP).

- **Taken aback by the soft August report on employment conditions, investors were pleasantly surprised by September's report, which revised the August jobs totals higher and showed a quarter-million net new jobs added in September.** Still, some part of the 4.6% growth in U.S. GDP during Q2 represented only a technical rebound from the economy's dismal Q1 showing, and concerns remain about economic momentum stalling in 2015. The Fed will end its QE bond buying at the end of October and, depending on the course of GDP and inflation indicators, will start raising the fed funds rate sometime around mid-year 2015. As September's lower bond yields, falling inflation expectations and modestly higher interest rate volatility indicate, there is still room for debate about the starting point and magnitude of Fed rate hikes. The approaching midterm elections add another layer of uncertainty to the short- to intermediate-term interest rate outlook.

- **Three months after the European Central Bank cut interest rates in June, the ECB had yet to launch the "broad-based asset-purchase program" – read QE.** But to mollify the markets, it did announce limited details on two programs lasting at least two years to purchase asset-backed securities (beginning sometime during the fourth quarter of 2014) and covered bonds (starting in latter half of October). Designed to enhance the transmission of an (easier) monetary policy, these programs' ultimate aim is to boost euro area economies out of their stagnant state as Q4 2014 begins and keep what modest inflation there is from turning into outright deflation.



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%	-5.2%	-8.7%
Next 2 Years – Annual Rate of Total Return:						
8.0%	6.1%	4.3%	2.5%	0.8%	-0.9%	-2.6%
Next 3 Years – Annual Rate of Total Return:						
5.6%	4.6%	3.5%	2.5%	1.5%	0.5%	-0.5%

*: Estimated returns for a hypothetical 10-year 2.5% Treasury bond due September 2024 under various interest rate scenarios at 9/30/14. Source: *WIS*

- **For an economy that supposedly grew at a 7.5% annual rate in 2014's second quarter, China's economic indicators have been amazingly close to registering neutral or contractionary signals for months.** Purchasing managers' survey readings for September, for example, showed declines relative to August readings to levels not significantly different from neutral (or breakeven between expansion and contraction). One of the few leading indicators pointing to better growth ahead has been stock prices; the Shanghai Composite rose roughly 15% during Q3, way better than most global markets. Since 2009, virtually every stock market rally in China has ended badly, and so might the current one. The IMF cut its 2015 GDP growth forecast for China to 7.1% – below China's official growth target of 7.5%. PIMCO went a bit further, trimming estimated growth to 6.5%.

- **World GDP has been stuck close to a disappointing 2% growth rate since 2011, and only modest improvement to 2.5% is likely in 2014, according to the latest Bloomberg monthly survey of economists.** That is down from the 2.7% growth forecast three months ago. Out in 2015-16, economists are holding out hope for global GDP growth close to 3% per annum. Going forward, we would not be surprised to find private and official forecasters lowering their global growth targets.

Inflation

After nearly doubling, from a low of 1.1% in the year to this past February to 2.1% in the year to May, the U.S. inflation rate fell back to 1.7% in the 12 months ended August. Likewise, the core inflation rate (ex food and energy) hit 2.0% in May only to subside to a 1.7% rate though August. So-called breakeven inflation rates – the inflation rates implicit in the Treasury bond market and expressed as the difference between nominal Treasury yields and TIPS yields – have sent a reassuring message to inflation hawks. While not necessarily any better as inflation indicators than economists' forecasts, breakeven inflation rates have taken a dramatic turn lower in recent weeks. Indeed, the 10- and 30-year breakeven inflation rates hit their lowest levels in nearly three years: 1.94% for the 10-year and 2.10% for the 30-year. As noted three months ago, higher inflation is not a global issue; in fact, vanishing inflation is more the concern in Europe.

Corporate Profits

The corporate earnings story for the second quarter of 2014 was pretty much the same story seen in Q1: earnings beat expectations, but revenue growth remained lackluster. Second-quarter earnings for the S&P 500 increased 9%-10% over year-earlier levels, beating Street forecasts by roughly 5%. S&P 500 sales grew by a more pedestrian 4% year over year, 1% to 2% ahead of market expectations. The latter sales surprise was the best in some time, but it is hard to get too excited about 4% sales growth. Health care was the only one of the S&P 500's 10 market sectors to post double-digit percentage growth in sales (12% y-o-y). The Commerce Department's estimate of U.S. corporate profits from current production for the second quarter had profits increasing 8% over first-quarter profits.

Consensus forecasts are for another healthy increase in profits for the just-ended third quarter of 2014. Earnings reporting season for Q3 2014 gets under way over the next week. The Street is projecting a 5% or so increase in earnings, which is quite respectable given that Q3 2013 profit margins were at 45-year highs. For the fourth quarter, faster earnings growth is expected, in part because the comparison with Q4 2013 earnings is easier. If the pattern of recent quarters holds, though, Q4 earnings estimates will be progressively reduced as the fourth quarter unfolds. Nevertheless, given the 3% or so real growth in U.S. GDP that appears to be the most likely case for the second half of 2014, corporate profits continue to look like the best aspect of what has thus far been an otherwise economic expansion. As we noted last quarter, corporations possess a great deal of operating leverage, and now that sales growth finally appears to be bending higher, corporate profits stand to follow suit. Looking out over the next five years, Wright continues to believe that growth in corporate profits and dividends will be close to the 5%-6% long-term average.

Historical and Prospective Returns from Equities and Bonds

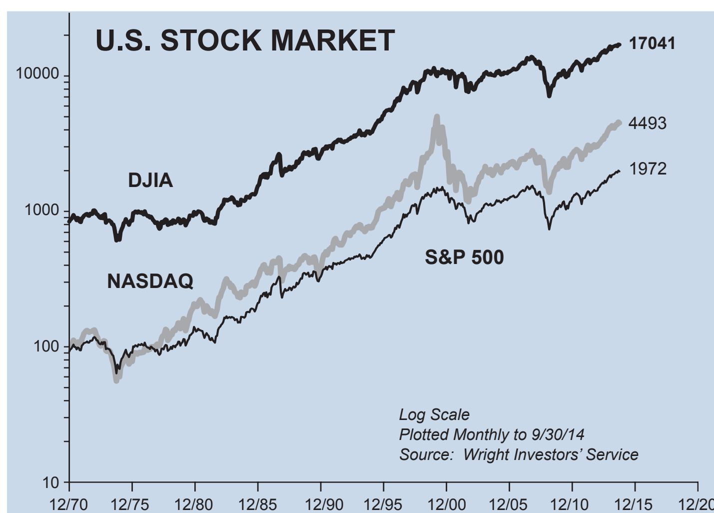
Annual Rates of Return S&P 500 (09/30/14)	1950-2013	1950s	1960s	1970s	1980s	1990s	2000s	2008	2009	2010	2011	2012	2013	2014*	Projection Next 5 Yrs
Dividend Income	3.6%	5.1%	3.3%	4.3%	4.5%	2.5%	1.7%	1.5%	3.0%	2.3%	2.1%	2.2%	2.8%	1.6%	2.1%
+ Earnings Growth	6.0%	3.9%	5.5%	9.9%	4.4%	7.7%	2.0%	-24.7%	-2.6%	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%	8.3%	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%	4.1%	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%	4.2%	3.5%

Source: Wright Investors' Service; *: Unannualized rates for nine months to 9/30/2014; NA: Not available; Projections for next five years are *WIS* estimates.

Dow 17000 and S&P 500 2000

The Dow Jones Industrial Average and S&P 500 broke through some historical milestones during the third quarter of 2014. For no good reason, such round-number levels have in the past presented at least temporary obstacles to stock market appreciation. Such has been the case again in 2014, with the Dow trading sideways for much of the year. Of course, real value resides in fundamental considerations such as corporate earnings growth and interest rates, the latter of which go a long way toward determining the earnings yield at which to capitalize earnings. Price/earnings multiples, while above average, are nowhere near the exorbitant levels of 2000. Yet, Fed Chairman Janet Yellen has expressed some concerns about valuations in some sectors, and the IMF warned in its October update to the *World Economic Outlook* that markets may be "underpricing risk." Fed Vice Chairman Stanley Fischer has been appointed to head a new financial stability committee to assess (avert) the development of asset-price bubbles. Good luck with that.

As the fourth quarter of 2014 began, the S&P 500 was priced at 17-18 times trailing 12 month earnings. That represents roughly a 10% P/E premium over the market's average P/E multiple since 1980. Considering the limited competition to stocks from today's fixed-income securities – at historically meager yields – such a premium is hardly prohibitive, in Wright's view. Corporate fundamentals have improved and, as noted three months ago, some of the more extreme market valuations have begun to correct, e.g., in small-cap, biotech and internet stocks. While we do not rule out an old-style market correction, sector rotation and the market's internal dynamics may be enough to avert a broader sell-off.



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	2.2%	2.1%	9%	0.1%	2.2%
	Q2	1.6%	1.9%	7%	0.1%	1.6%
	Q3	2.5%	1.2%	1%	0.1%	1.6%
	Q4	0.1%	1.4%	7%	0.0%	1.8%
2013	Q1	2.7%	1.4%	4%	0.0%	1.9%
	Q2	1.8%	1.0%	6%	0.0%	2.5%
	Q3	4.5%	1.4%	6%	0.0%	2.6%
	Q4	3.5%	1.3%	9%	0.0%	3.0%
2014	Q1	-2.1%	1.2%	5%	0.0%	2.7%
	Q2	4.6%	2.0%	10%	0.0%	2.5%
	Q3 e	3.3%	2.1%	7%	0.0%	2.5%
	Q4 e	2.8%	2.0%	6%	0.1%	2.6%
2015	Q1 e	2.8%	2.1%	8%	0.2%	2.8%
	Q2 e	2.8%	2.0%	6%	0.2%	3.0%
	Q3 e	2.7%	2.0%	6%	0.4%	3.2%
	Q4 e	2.8%	2.0%	6%	0.6%	3.5%

e: WIS estimate @ 9/30/14; *: Annual rates; #: Year-over-year chg. in S&P 500 e.p.s. Sources: U.S. Government data, Wright Investors' Service.

Investment Outlook

Midterm election years such as 2014 have typically been the weakest in the four-year presidential election-year cycle. Through nine months, this year has proceeded along those lines, with better-than-average returns for the S&P 500 and NASDAQ, but sub-par returns for the DJIA and losses in small-cap stocks. Still, it has been three years since the last correction of 10% or more in the major market averages. Easy monetary policy has supported higher stock prices, but the Fed is set to end the expansion of its balance sheet later this month. And sometime around the middle of 2015, the Fed is expected to begin raising interest rates.

At its last go-round, Federal Reserve governors and bank presidents trimmed their projections for 2015 GDP growth from 3.1% to 2.8%. Nonetheless, we expect a better business backdrop ahead, if not 3% GDP growth rates. Such a backdrop boosts the odds of increasing corporate earnings and higher stock prices. Bonds have put in three better-than-expected quarters in a row, but we are skeptical about there being a fourth, as gradually rising interest rates are expected.

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