

Second Quarter 2014 Market Outlook

Cetera Financial Group

200 North Sepulveda Blvd., Suite 1300, El Segundo, CA 90245



3020 Old Ranch Parkway #100, Seal Beach, CA 90740
Phone: (866) 8-ASKHOW, Phone: (562) 546-6021, Fax: (562) 596-6024
E-Mail: Askhow@ErmanRetirementAdvisory.com
www.ErmanRetirementAdvisory.com

©2013 Cetera Advisor Networks LLC 12-013 12/12

SECOND QUARTER 2014 MARKET OUTLOOK

Diverging Paths

It is natural for American investors to focus mainly on the U.S. economy and U.S. asset classes. This has long made sense because the U.S. is the world's largest national economy, the dollar is the world's major reserve currency, and Americans consume mostly in dollars. To be sure, U.S. investors have become much more inclined to invest internationally over the past twenty years, but always with awareness that it is economic and market developments at home that are likely to have the largest impact on their wealth. That is likely to be true over time for most dollar-based investors, but today, in our view, it is events abroad that pose the greatest risks to the returns investors can hope to achieve on both their domestic and international assets.

The most obvious risk today is geopolitical: the crisis in the Ukraine. After demonstrations in February led to the fall of President Yanukovich and the appointment of a new government pledged to closer ties with the West, Russian forces occupied the Crimean peninsula. Crimea has an ethnically Russian majority population and is home to the Russian Black Sea fleet. Crimea had been transferred to Ukraine in 1954, however, and has been subject to Ukrainian law. On March 16 a majority of voters in Crimea voted to join Russia; the Ukrainian parliament has stated the referendum is unconstitutional.

The main concern, of course, is that the crisis could escalate into a full-blown military conflict, including a Russian incursion bent on suppressing the Ukrainian Revolution. But even if there is no further military action, the conflict could have serious political and economic consequences. The White House has said that it will "impose a cost" on Russia. So far this has meant only freezing the U.S.-held assets of a Russian bank and of individuals identified as responsible for undermining democracy in Ukraine and cancelling the visas of Russian officials. But both the United States and the European Union are considering further sanctions, and Russia has vowed to retaliate. An economic war of this kind could be disruptive and costly to all involved. The United States does relatively little trade with Russia, but Europe is a major market for Russia's exports of natural gas, accounting for a fifth of its total export earnings. Germany, meanwhile, supplies about 12% of Russia's imports. Russia's oligarchs, meanwhile, own investment firms, basketball teams, gas stations, mines, and steel mills in the United States and soccer clubs, industrial companies, and country estates in Europe. A freezing of their assets would be painful to their owners and send a powerful message to Moscow. But it would also raise questions about whether capital mobility, a hallmark of the international financial system in recent decades, would be subject to political tests in the future.

In the past, the reaction of asset markets to geopolitical events has varied directly with the severity and duration of the event. The stock market sold off and remained below its pre-event level for months, for example, after events such as the attack on Pearl Harbor or the 1940 invasion of France. In contrast, the stock market has tended to recover from terrorist events that had fewer casualties, such as airline bombings, in a matter of days (see Exhibit 1). In the case of the Ukraine conflict, we will not know until after the fact whether it was the beginning of a protracted confrontation with vast spillover effects or whether it ended without an escalation. If it is the latter, the market's attention will soon shift to other matters, such as the global economy, earnings, and monetary policy actions.

SECOND QUARTER 2014 MARKET OUTLOOK

Exhibit 1: Reaction of the Dow Jones Industrial Average to attacks

<u>Event</u>	<u>Date</u>	<u>Event-day return*</u>	<u>Days to rebound**</u>
Invasion of France	May 5, 1940	-4.9%	795
Pearl Harbor attack	December 7, 1941	-2.8%	232
N. Korea attacks S. Korea	June 25, 1950	-4.8%	57
Pan Am bombing	December 21, 1988	-0.1%	3
Iraq invades Kuwait	August 2, 1990	-1.4%	134
World Trade Center bombing	February 26, 1993	-0.1%	1
Oklahoma City bombing	April 19, 1995	0.5%	1
Embassy bombing in Kenya	August 7, 1998	0.2%	1
9/11 terrorist attacks	September 11, 2001	-7.1%	40

*Abnormal return on Dow-Jones Industrial Average (DJIA)

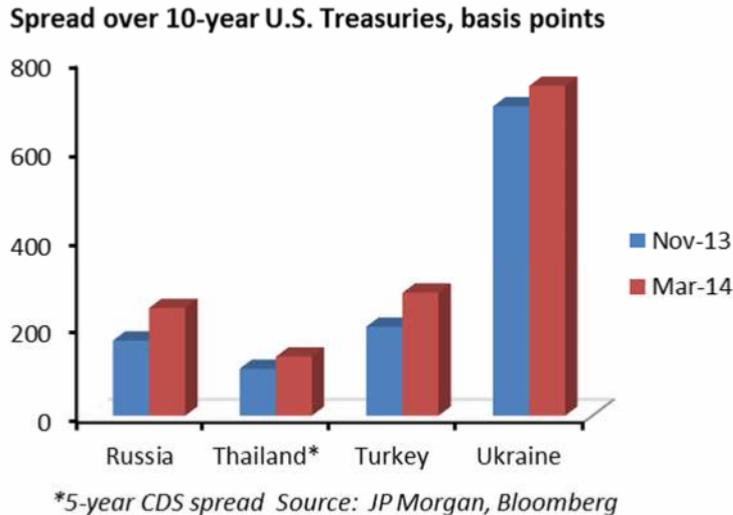
**Number of trading days for the DJIA to return to pre-attack level

Source: A.H. Chen and T.F. Siems, "The effects of terrorism on global capital markets," *European Journal of Political Economy*, Vol. 20 (2004)

The immediate effect of the Ukraine conflict has been a sell off among some — but not all — risk assets. The MSCI Emerging Markets Index has fallen by 6.6% percent since November 21 of last year, when President Yanukovich of Ukraine announced the abandonment of a trade agreement with the European Union, arguably the beginning of the crisis. Spreads over U.S. Treasuries on Ukrainian and Russian bonds have risen, as have yields on bonds in other countries in which there is a political crisis such as Turkey and Thailand (Exhibit 2). Gold — often viewed as a safe haven in a time of crisis — rose almost 10% from the start of the Ukrainian revolution to March 14, though it has given up about half of those gains since.

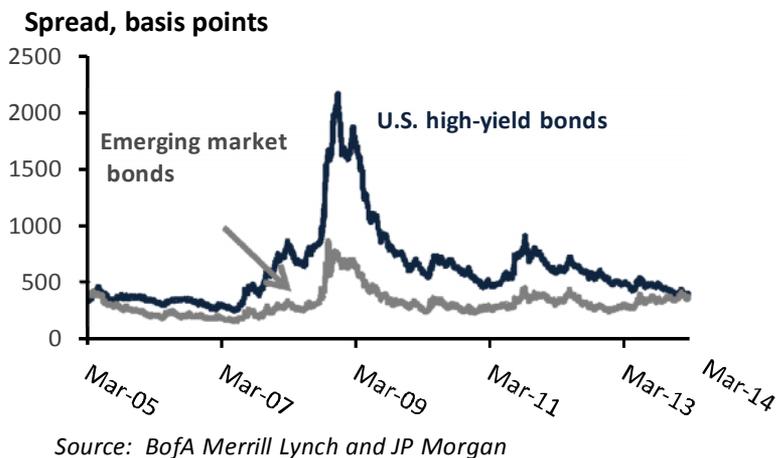
SECOND QUARTER 2014 MARKET OUTLOOK

Exhibit 2: Risk premia on emerging market bonds have widened



Had the rise in risk premia demanded by the markets been a result of the Ukraine crisis alone, this might have little implications for investment strategy. All parties to the conflict have strong incentives to avoid military hostilities or an economic war, and if the crisis subsides the value of the affected risk assets will rise. But differences in yield across risk assets suggest there is more going on than a political crisis. While yield spreads have been rising in the emerging markets, they have been falling in the U.S. high yield bond market, suggesting that investors' concerns about risk do not extend to domestic spread product. This is the opposite of what happened in the 2008-09 financial crisis and recession, when investors shunned risk in the U.S. market (Exhibit 3).

Exhibit 3: Risk perceptions are rising in the emerging markets but falling in the U.S. high-yield market



SECOND QUARTER 2014 MARKET OUTLOOK

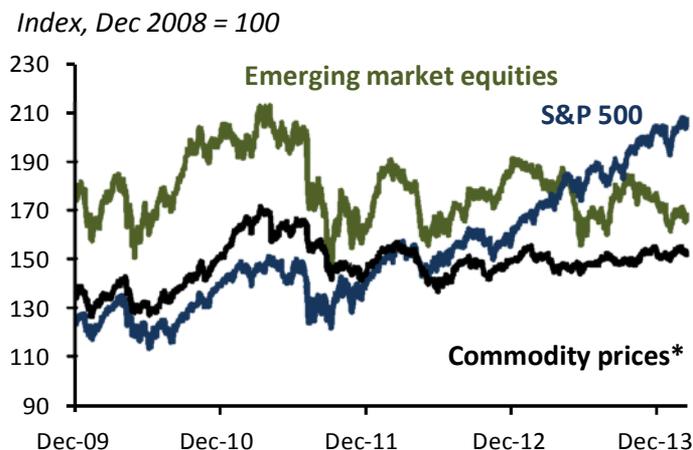
The market has been wary of emerging markets for over a year. First, the emerging markets have been affected across the board by tepid growth in the developed world, including the recent recession in Europe. China's development model has relied heavily on a strong export performance, and its export growth has slowed. Meanwhile, policymakers in China are walking a fine line between trying to cool off credit-fueled overheating in real estate markets and avoiding bankruptcies, especially in China's shadow banking system. The result has been a moderation of GDP growth in China, from over 10% in 2000-12 to 7.2% in 2013-14, according to JPMorgan forecasts. This may seem only like a modest deceleration, but it has been enough to lead to a reduction in China's demand for imports of commodities from other emerging markets — notably Argentina, Brazil, and Chile — whose economies have in turn slowed.

Second, the capital that was once flowing into the emerging markets as if from a fire hose has reversed course. Flows into emerging market debt and equity funds peaked at about \$38 billion per month in January of last year, but remained positive until June, when comments from Federal Reserve officials suggested that the central bank would begin tapering its \$85 billion per month in bond purchases. The prospect of higher interest rates in the United States was enough to induce mutual fund investors to begin bringing their money home, and emerging market funds have had outflows in every month since then. Some countries, such as Brazil, have raised interest rates in an effort to stem the outflows; others such as Chile have cut rates to stimulate their economies. The combination of slow growth among their trading partners and the reversal of capital inflows points to slower GDP growth in most emerging economies this year than in the recent past. It is mainly the expectations of slower growth, and the risks it can bring in its train, that are behind the underperformance of the emerging markets in recent months, in our view.

A brighter outlook in the developed world.

While economic activity is slowing in the emerging markets, it is proceeding apace in the developed world. This goes far in explaining the divergent paths that equity markets in the emerging and developed worlds have taken recently, in our view. Since mid-2012 both the MSCI Emerging Markets Index and commodity prices have been essentially trendless, while the S&P 500 has taken off. (Exhibit 4).

Exhibit 4. The S&P 500 has parted company with the emerging markets and commodity prices



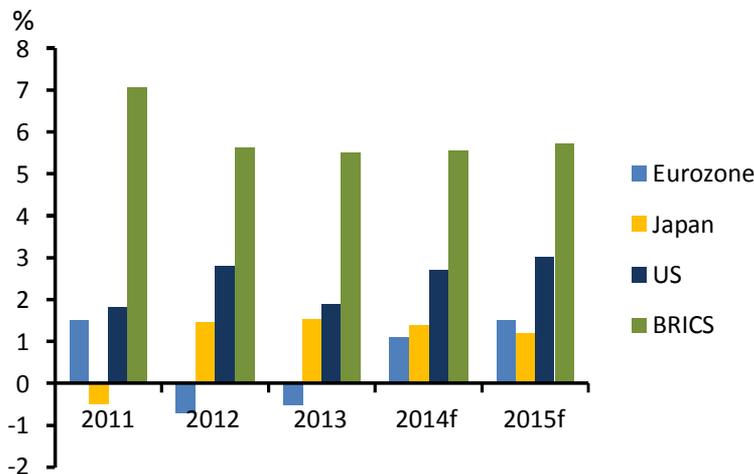
Source: Bloomberg, CRB, MSCI, and S&P

*50% CRB Raw Materials index and 50% Brent crude oil price

SECOND QUARTER 2014 MARKET OUTLOOK

Following an unusually harsh winter in the United States, economists have reduced their 2014 GDP forecasts. Still, the consensus sees growth accelerating from last year's below 2% rate to 2.7% this year and 3% in 2015. These rates are not fast enough to bring unemployment down as fast as in past recoveries, but are above the Congressional Budget Office's new 2.2% estimate of the U.S. economy's potential GDP growth rate — the maximum rate at which the economy can grow without raising inflationary pressures. If the economy manages to continue to grow at an above-trend 2.5% rate, the CBO estimates that the gap between actual and potential GDP, which has been large since the 2008-09 recession, will be eliminated by 2017. Europe, meanwhile, is coming out of what has turned out to be a fairly mild recession. The consensus sees real GDP growth of only 1.1% in 2014 in the eurozone, however, and not much higher than that in 2015 as that region struggles to work itself out of a large debt overhang and comes to terms with a rapidly aging population. The consensus expects Japan, which faces similar challenges, also to grow at below 2% during 2014-15.

Exhibit 5. Recent GDP growth and consensus forecasts



Source: Bloomberg

The risks to the consensus forecasts are that economists are being too sanguine about the prospects for growth in Europe. Core inflation has been falling in the Eurozone since 2011 and is now running at about a 1% rate — well below the European Central Bank's 2% inflation target. The risk is that the Eurozone's disinflation (a falling inflation rate) will turn into deflation (falling prices). Deflation can wreak havoc on an economy because it means rising real debt burdens for consumers and governments and a rising threat of bankruptcies. Double-dip recessions are rare, however, and the ECB still has room to ease monetary policy further, so a deflationary spiral is unlikely, in our view. Japan's policy of quantitative easing and driving the yen down, meanwhile, seems to be working. After falling during 2009-12, consumer prices edged up last year, and the consensus expects mild (below 1%) inflation in 2014-15.

SECOND QUARTER 2014 MARKET OUTLOOK

Investment implications.

So far, stock and bond markets in the United States seem to be discounting the possibility that the crisis in Ukraine will widen. As of March 20, the S&P500 has risen 3.7% since the first demonstrations occurred in Kiev on December 1 and is at a slightly higher level than before Russian troops entered Crimea in late February. After dipping for a few days in late February and early March, 10-year U.S. Treasury yields are back to pre-crisis levels. Still, the downside risk to the Ukraine crisis widening cannot be ruled out. This would argue for reducing exposure to assets such as emerging market equities and debt likely to be caught in the downdraft of any further risk-shunning move in the markets. We are not inclined to make short-term market timing recommendations, but a lower exposure to the emerging markets makes broader sense in the context of the slow growth and capital outflows that appear in store for those markets. With still attractive valuations and growth prospects picking up in international developed nations, especially in Europe, we would opportunistically further allocate to this asset class.

As tapering continues, we believe the US dollar will likely rise further, and a move on the short end of the curve may possibly occur sooner than previously estimated. In this environment, emerging market nations may experience inflation as their production input costs rise, possibly forcing their central banks to raise interest rates and leading to slower economic growth. On the other hand, developed nations, who do not import as much raw materials in their production process, would not be impacted nearly as much. Also, they would likely benefit as their exports become more attractive to the U.S.

Outside of the aforementioned change, we would not alter some of our existing recommendations, which include:

(1) *Favor spread product in the United States* such as corporate bonds — a better place to accept risk for a potential return than emerging market debt, in our view;

(2) *Maintain a substantial exposure to equities*, and favor developed-country equities which are trading at attractive valuations after years of sub-par economic growth; and

(3) *Stay diversified, using alternative assets*. Market risks change over time. Not long ago, political paralysis in the United States seemed to be the main risk. That has been supplanted by geopolitical risk, tepid growth in the developing world, and (since last summer) the risk of a faster-than-expected normalization of monetary policy in the United States. The arguments for diversification, however, remain unchanged.

Prepared by: Brian Gendreau, Market Strategist
Cetera Financial Group

This information compiled by Cetera Financial Group is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. The information has been selected to objectively convey the key drivers and catalysts standing behind current market direction and sentiment.

No independent analysis has been performed and the material should not be construed as investment advice. Investment decisions should not be based on this material since the information contained here is a singular news update, and prudent investment decisions require the analysis of a much broader collection of facts and context. All economic and performance information is historical and not indicative of future results. Investors cannot invest directly in indices. This is not an offer, recommendation or solicitation of an offer to buy or sell any security and investment in any security covered in this material may not be advisable or suitable. Please consult your financial professional for more information.

While diversification may help reduce volatility and risk, it does not guarantee future performance. Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards.

Affiliates and subsidiaries and/or officers and employees of Cetera Financial Group or Cetera Advisor Networks LLC may from time to time acquire, hold or sell a position in the securities mentioned herein.



3020 Old Ranch Parkway #100, Seal Beach, CA 90740
Phone: (866) 8-ASKHOW, Phone: (562)546-602, Fax: (562) 596-6024
E-Mail: Askhow@ErmanRetirementAdvisory.com
www.ErmanRetirementAdvisory.com

Registered Representative offering securities through Cetera Advisor Networks LLC (doing insurance business in CA as CFGAN Insurance Agency), Member FINRA/SIPC. Cetera Advisor Networks LLC and Erman Retirement Advisory are not affiliated companies.