



Market Commentary July 2014

Introduction

Following the rocky markets of the first quarter, volatility took some time off this spring to enjoy the nice weather and, perhaps, catch a few World Cup games. This market “melt up” has appeared calm with every asset class across fixed income and equity posting solid gains for the quarter yet plenty has happened under the surface. Investors brushed off a terrible first quarter GDP number of -2.9% as a weather related fluke but have been paying attention to rising inflation and a rapidly improving job market for signs of when the Fed will begin to raise rates. Geopolitical risks like tensions in Iraq and the conflict between Russia and Ukraine shook the market at times but were not enough to cause a correction. Like Americas’ relationship with soccer, investors have been treating this rally with intrigue but may not invested in it completely. With an apparent sharp rebound in fundamentals like the labor market and manufacturing following the winter vortex, the US economy (unlike the US soccer team) may have a few rounds left. An easy Fed and rising corporate profits support our optimistic outlook but we are concerned about the still reluctant consumer, the impact of midterm elections, and the economy’s ability to hit the forecasted 3.5% GDP growth rate in the second quarter.

Domestic Equities

Despite the worst GDP print since the first quarter of 2009, domestic equities continued to reach record highs, with the S&P 500 hitting 25 new highs this year. As of June 30th, the S&P 500 was up 7.1% YTD and 5.2% for the quarter. Investors continue to buy into this equity rally, with equity mutual funds bringing in \$10 billion in net inflows, putting us on pace for the largest net inflows in almost a decade. The positive momentum within domestic equities has been supported by strong economic data. The ISM Manufacturing Index, which measures the factory sentiment around the country, has been in expansion territory for thirteen consecutive months and non-farm payrolls have risen by over 200,000 for five months straight, the longest stretch since before the tech bubble. Value stocks again outperformed growth stocks but, as growth stocks have become less expensive and more attractive to investors, we expect this trend to reverse. We also saw small cap stocks underperform in the second quarter, up 2.05% (Russell 2000) vs. large-cap stocks up 5.12% (Russell 1000) and mid-cap stocks up 4.97% (Russell Mid-Cap). All eyes are now on second quarter corporate earnings, but with the continued easing of the Federal Reserve and positive U.S. economic data coming out, we expect equities to finish the year at a higher level, albeit with some volatility along the way.

International Equities

After a lackluster first quarter, International Developed Equities were up 4.34% (MSCI EAFE) over the quarter due to a rally in Japanese equities and further easing by the European Central Bank (ECB). After investors fled Japan in the first quarter due to fears that Prime Minister Abe would not enact another round of easing, a strong first quarter GDP, rising consumer spending and business investment led Japan to outperform the EAFE, up 6.7% (MSCI Japan) for the quarter. Unlike Prime Minister Abe, the ECB President, Mario Draghi, took the unprecedented step of authorizing negative interest rates on bank deposits to combat deflation and spur economic growth. The effectiveness of charging banks to hold deposits is still unknown, as are the potential side effects. Much maligned Greece has even posted its first budget surplus this year after a decade of deficits but the UK and Germany, longstanding drivers of growth for Europe, have posted weaker data, hinting at even further ECB easing to come. Attractive valuations coupled with the increasing exports to the US, Europe and Japan have helped Emerging Markets post their best quarter since September 2012, up 6.71% (MSCI Emerging Markets). We continue to see value within Emerging Markets as many transition from export driven economies to consumer based economies similar to developed nations. Despite underperforming Emerging Markets, Frontier Markets continued their consistent rally, posting a gain of 2.16% over the quarter (MSCI Frontier 100). We believe there is opportunity within Frontier Markets due to the greater economic growth potential of these countries and their lower correlation to other asset classes.

Fixed Income

Following a strong first quarter, bond prices increased as rates declined in April and May before rebounding slightly in June. The benchmark 10 year Treasury yield unexpectedly declined from 2.72% to 2.53% due to the exceptionally weak first quarter GDP and the expectation that the Fed will keep rates at zero until 2015 at the earliest. The Barclays Aggregate Index rose 2.02% and all major fixed income classes posted positive returns. A 10 year Treasury rate of 2.5% is low by historical standards but is still higher than other countries. By comparison, the French 10 year bond yields only 1.7% and considering the recent European debt crisis you would expect a higher yield for the implied higher risk. Additionally investors continue to invest in higher yielding fixed income asset classes despite their higher risk in this low yield environment. We continue to keep our duration (interest rate risk) low, in part because we believe there’s a possibility the Fed will raise rates sooner than the market expects. The effects of the taper are still

unknown because, while the Fed is now buying half the dollar amount of Treasuries than they were last year, the reduction in the deficit means that they are still buying the same percentage of Treasuries issued. That percentage will finally decrease in the third quarter which, combined with higher GDP and an uptick in inflation, should result in a slow but steady climb in interest rates through the end of the year.

Alternatives

Alternatives serve two primary purposes in a portfolio. The first is to provide diversification and downside protection to the equity exposure without relying on fixed income and the second is to generate alpha, or excess returns, regardless of equity market performance. Two of our alternatives allocations, market neutral strategies and managed futures, are primarily diversifiers while the third, master limited partnerships (MLPs), has an additional alpha generation goal. Market neutral strategies, represented by the Credit Suisse Long/Short Liquid Index, were up 3.43%, posting their 6th consecutive quarterly gain. The Credit Suisse Managed Futures Liquid Index was up 0.67%, lagging the S&P but posting a positive return following the dismal first quarter. MLPs were the star in the second quarter with the Alerian MLP Index up 12.58%. US domestic crude oil production now tops 8 million barrels a day, a level not seen since the 1980s, and the production is occurring in untapped areas which require a massive infrastructure investment. This, along with the US government decision in June to allow limited crude exports, creates opportunities for MLPs that produce and transport crude oil and natural gas.

Real Estate

Residential real estate, which faltered after the 2013 spike in interest rates and the Polar Vortex of 2014, has begun to stage a bit of a comeback. Better weather for house hunting and construction combined with stable mortgage rates and an improving job market has resulted in new housing starts surpassing a 1 million annualized rate. This is higher than we have seen but still short of the 1.5 million rate considered normal. Housing price increases moderated to a 10.82% annual rate, but the slower rate of increase may be a positive to homebuyers as affordability improves, and the first time homebuyer is reentering the market. Despite these positives, real risks to the housing outlook include high debt levels among younger demographics limiting potential buyers and the likelihood of higher mortgage rates returning in the not so distant future.

Conclusion

The current bull market is now the fourth longest in US history and there are rising concerns on how much longer it can continue. We are keeping watch on inflation, rising geopolitical tensions and the impact of Fed decisions on the market. Most importantly the equity rally has made stocks somewhat expensive as their valuations have increased. However, with an estimated \$10 trillion on the sidelines in cash that could be invested in equities and no sign of a recession on the horizon based on the economic data, we're looking to see corporate profits continue to rise to support higher stock prices in the future.

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