



Quarterly Commentary – October 2014 Fasten Your Seatbelt ...Volatility Ahead

My Dear Client:

We all have experienced a bumpy ride whether by train, boat, plane, or our own car while smoothly driving along the interstate; only to pass through stretches of construction work. Global and domestic markets experienced quite a bit of seatbelt-fastening turbulence a.k.a. “volatility” in market terms during the third quarter. The up and down swings (and the amount of those swings) in equity markets on an intraday, day-to-day and month-to-month basis ramped up notably, provide shocks that had not been felt in any meaningful way since 2011. Stocks with the exception of small-cap stocks, pushed higher and fell lower throughout the third quarter while circling around all-time highs, as investors weighed the economic outlook for the remainder of the year, the timeline for rate hikes by the Federal Reserve and the geopolitical tensions. The recent market movements have been quite a change, after little volatility over the last few years including the decrease in market volatility during the second quarter. While it may seem like a lot, market volatility during this quarter was still significantly below volatility levels experienced in 2011 (during the height of the European debt crisis) or in 2008 during the financial crisis.

Market Drivers and Activity

There was a relatively wide disparity in performance across the various segments of the equity and fixed income markets in the third quarter. On balance during the quarter, the areas of the market that investors perceived as less risky (such as U.S. large-cap equity and U.S. Treasury securities) posted tempered gains while the areas of the market viewed as more risky (such as U.S. small-cap stocks and high-yield bonds) posted losses.



Geopolitical tensions and conflicts came more to the forefront during the quarter, which helped drive this performance disparity. In the third quarter, continuing instability in Ukraine (which was intensified by the downing of a civilian Malaysian airliner in July) and Israel's continuing aggressive incursion into the Gaza Strip weighed on markets. This time the epicenter of European economic uncertainty hailed from the northern region as Scottish citizens considered ending their 307 year union as part of the British Empire. Ultimately, the vote for Scottish independence was rejected by voters, thus soothing global investors wary of the multiple intended and unintended outcomes had Scotland re-established full sovereignty from the United Kingdom. Those who supported independence believed Scotland “would be richer” if it broke from the UK. They want Scotland to make its own decisions about how resources are controlled and money is invested. Rather than investing billions of pounds in nuclear weapons, for example, they could focus on things like childcare or programs to retain talent and encourage young Scots to stay. This type of rift will continue and may negatively impact investment decisions in the region.



However, politicians beyond the UK are not completely out of the woodworks yet with both the Catalonia & Basque regions in Spain, as well as the Veneto region (home to Venice) now embolden to each more forcefully call for succession. All of which is the last thing the European Union needs to deal with while daily balancing the sovereignty of nation state members with the coordinated efforts needed to stave off a EU wide Recession.

U.S. Equity Markets

During the third quarter, the broad U.S. equity market changed very little when looking at overall quarterly returns, as the Russell 3000® Index returned a flat 0.01%. Yet a deeper look tells quite a different and potentially important story. The large-cap focused S&P 500® Index gained 1.1% for the quarter, and the small-cap Russell 2000® Index declined 7.4%. Growth-oriented stocks handily outpaced their value-oriented brethren across all market capitalizations. Serving as a proxy for the equity market, within the S&P 500 Index we saw the Health Care and Information Technologies sectors posted the strongest gains and the Energy and Utilities sectors posted the biggest losses. Underscoring the theme that investors saw their growth holdings rising higher when compared to their value investments. Additionally, in August both Barclay's Plc and Leuthold Group LLC opined separately that while not calling an end to the bull market, investors should definitely temper earnings expectations and subsequently future advances for equity markets. We are now a couple quarters into a pattern that may constitute an important trend of divergence between large cap and small cap stocks regarding market leadership (Large Cap) and market laggard (Small Cap). Historically, this is typical of the last leg or ending of bull markets, however in the uncharted waters of global quantitative easing (money printing) by Central Banks "last legs" or presumed trends can last longer and end more abruptly than prior experiences would indicate.

While the mixed results in the U.S. equity market were somewhat skewed by the negative small-capitalization segment of the market, overseas equity markets were decidedly negative on all fronts during the quarter, particularly within non-U.S. developed equity markets, as measured by the MSCI EAFE Index (Europe, Australasia and Far East-net of taxes), which returned -5.9%. Emerging equity markets, as measured by the MSCI Emerging Markets Index (net of taxes), fared better than developed markets, returning -3.5%. Geopolitics weighed heavily on non-U.S. markets, tensions between Ukraine and Russia hit close to home, and investors were concerned about the potential impact of these tensions on an already weak European economy. The emergence of "Isis" adding to the fragility of Syria, Iraq, Turkey and the entire region created further reasons for pause and concern with talks of increase military action by the U.S. and allies growing louder throughout the quarter.

U.S. Fixed Income Markets

The U.S. fixed income market, as measured by the Barclays U.S. Aggregate Bond Index, posted a more modest gain in the third quarter, rising 0.2%. The quarter's modest return still added to an already strong bond market for 2014, as the Barclays U.S. Aggregate Bond Index has returned more than 4% year-to-date (as of September 30), and the 10-year Treasury bond yield had declined to 2.52% at the end of the



Financial Management Strategies, LLC • 1330 Smith Ave. Suite 7 • Baltimore, MD 21209

410-779-1276

www.fmsadvisors.com



quarter from more than 3% to start 2014. While the third-quarter results for the broad U.S. fixed income market were tepid, the drivers were anything but consistent throughout the quarter. The Barclays U.S. Aggregate Bond Index was negative in July and September, but returned a solid 1.1% in August to help maintain the quarter's overall results. The fixed income markets also experienced two notable trend changes during the quarter. Lower credit quality and longer duration have been the strongest drivers throughout the year, including July and August, as investor demand for yield pushed prices up in these areas. These trends reversed sharply in September. Bonds with the lowest credit ratings of the investment-grade index and U.S. bonds with maturity of 10 or more years were among the weakest performers, posting losses. The trend changes coincide with sector performance during the third quarter. Looking deeper, two interesting items surfaced. First, that thru September the best performing of all asset classes was U.S Treasury STRIPS (separate trading of registered interest and principal securities) i.e. these bonds are sold at big discount to their future face value- like the bonds your grandparents use to buy. Next, that U.S. Treasuries outperformed the corporate and securitized sectors during the quarter. Treasuries exhibited the stability for which they are known as investors sought "safety" in a period of unrest.

Global Economy

The key theme in the global economy will be monetary policy divergence. The European Central Bank along with Japan continuing easy money policy and the Federal Reserve (perhaps a few others too) tightening money policy by gradually normalizing interest rates and ending the various iterations of quantitative easing. While the Federal Reserve's quantitative easing program (bond buying) is scheduled to conclude during the fourth quarter, expectations for when the federal funds rate will raise in 2015 is an open debate. The Federal Reserve has been comfortable holding the federal funds rate near zero, even after more than a half-decade of economic expansion, is because stated U.S. inflation expectations have been restrained. Further, recent drops in oil prices from \$104 per barrel in April to mid - \$80 range has considerably reduced prices at the pump in the U.S and moderate increases in food prices too. The combination of slowing global demand, increased U.S oil production, dissension in supply levels within OPEC & non-OPEC states, and other factors (like less car utilization in the U.S) all contribute to declining oil prices. Dr. Yellen, as Board Chair continues to indicate the path of the U.S. labor market will strongly influence the timing and pace of the Federal Reserve's normalization of the federal funds rate, thus the easy monetary policies that have supported economic expansion will continue while waning in scope. The divergence in monetary policy seems to be a perfect backdrop for a **strong U.S dollar**.



In Closing

Shifting from a zero-interest rate era, market volatility is likely to continue, if not increase, in the coming quarters. The divergence in performance across asset classes and styles during the third quarter serves as a reminder that my chief priority continues to be assisting you with sound planning by maintaining disciplined asset allocation decisions, and focus on

Financial Management Strategies, LLC • 1330 Smith Ave. Suite 7 • Baltimore, MD 21209

410-779-1276

www.fmsadvisors.com



your long-term investment goals. I continue to believe that opportunistic investments in some private investments including secured direct lending, rebalancing to asset allocation targets, being mindful of expenses, and continuing to maintaining fixed income and cash (always good when markets transition) within a diversified investment approach consistent with your risk tolerance level trends is the most successful path toward navigating market swoons and screening out the short-term “noise”.

The year is passing quickly and the fall season is upon us. I look forward, as always, to working with you toward your financial goals. If you have any concerns, questions, or general thoughts about your portfolio or any other matter, please never hesitate to contact me.

Appreciatively,

Walid L. Petiri

[Market Commentary](#)

[Market Watch](#)

[Monthly Foresight](#)

[Connect with Me on LinkedIn!](#)

Sources: Barclays Capital, MSCI Barra, Russell Investments, Standard & Poors, Reuters, Federal Reserve Board Leuthold Group LLC and Barclays Plc. NASDAQ, S&P 500, MSCI, and Russell 3000 are unmanaged indexes.

Financial Management Strategies, LLC • 1330 Smith Ave. Suite 7 • Baltimore, MD 21209

410-779-1276

www.fmsadvisors.com