



## Quarterly Commentary – July 2014 Beware Investor Complacency in an Ever Rising Market

My Dear Client:

In many ways, the second quarter followed the pattern of the first quarter. Second quarter saw markets stay resilient and trended higher, despite uneven U.S. economic growth data, geopolitical unrest- now from both Ukraine/Russia & Israeli/Gaza fighting, the lingering effects of an epic harsh winter, and once more slowdown news from China. Still this deja' vu moment ended with the S&P 500® and many other indexes reaching a series of record level highs, while interest rates generally declined during the quarter. This surprise led to generally positive returns in the U.S fixed income market. Unlike the first quarter of the year, the broad emerging equity markets participated in the gains, momentarily reversing their recent trend of quarterly declines.

### Global Equity Markets



Global equity markets continue to be supported by the unprecedented aggressive accommodative monetary policies of the world's major central banks, which continue to inject liquidity in some form into the financial system in an effort to keep sluggish economies expanding. This past quarter while the Federal Reserve continued to reduce its quantitative easing experiment, the largest monetary stimulus actions were taken by the European Central Bank

(ECB) which is the central bank and monetary policy administrator of the Eurozone. As it made an all-out attempt to spur growth in the Eurozone and prevent deflation (i.e., falling prices). In June, the ECB instituted negative interest rates for banks that deposit funds with the ECB, a historic measure never before implemented by a central bank. In addition, the ECB cut other interest rates to a record low level and pledged to take more action if needed. This announcement was generally well received by equity markets, and U.S. stocks rallied to fresh record-highs after this announcement. As I have discussed in both previous writings as well as during direct conversation, the actions of Central Banks now nearly six years after the financial crisis should be viewed by prudent investors with reflect pause if not alarm...for it is clear that markets are indeed being artificially directed. While this can be argued as necessary at a crisis inflection it is very difficult to justify its perpetuation or in the case of the ECB (and Japan) upping the ante. Unless one will assert that the need for continuing these types of monetary actions implies the true equilibrium level for financial markets is at Recession levels or worse.



In what may be seen in hindsight as “a quite before the storm” moment accompanying the increasing returns of equity markets was a noticeable drop in market volatility. Raising the specter that investors are once again showing very short historical memories, being overly complacent and ultimately taking on far more risk than is warranted. The S&P 500 Index closed out the quarter having gone 51 sessions in a row without closing up or down more than 1%, the longest such stretch since 1995. This resulted in the lowest level of market volatility, as measured by the CBOE Volatility Index (VIX), since 2007. Ironically, the significant decrease in volatility created additional angst for many investors, as they finished the quarter contemplating whether the renewed calm in the markets was the result of a stable economic backdrop or a reflection of investor complacency, a historic precursor of a market bubble. While the market is still at a zenith a handful of seasoned investors like Jeremy Grantham, Carl Icahn, and Axel Merk have begun to caution investors that monetary policy induced markets are likely fully if not over valued and the level of current complacency should make all buyers purchase with caution.

In the second quarter, the broad U.S. equity market (as measured by the Russell 3000® Index) advanced 4.9% and the S&P 500 Index advanced 5.2%. Large-capitalization stocks fared better than mid- and small-cap stocks. On a style basis, with the exception of large-cap, value-oriented stocks outpaced their growth-oriented counterparts across the market capitalization spectrum (based on the suite of Russell indices). All 10 economic sectors of the S&P 500 Index all had positive returns during the second quarter. The Energy and Utilities sectors were the two best-performing sectors, while the Financials and Consumer Discretionary sectors had the lowest returns during the quarter. Along with the lack of volatility at this time we should note the growing performance spread between Large Cap Growth Stocks and Small Cap Growth Stocks- a gap that year to date is **roughly 800 basis points (8%)**. A disparity of this magnitude at best is a signal that the Bull Market is fully into its 2<sup>nd</sup> stage (perhaps latter) as market leadership is passed off from smaller nimble firms to larger scaled enterprises... Or in some school of thoughts this is another breadcrumb on the trail to a significant correction or two. As always time will tell.



Similar to U.S. equity markets, non-U.S. equity markets exhibited a rise in the second quarter of 2014. Non-U.S. developed markets, as measured by the MSCI EAFE (Europe, Australasia and Far East) Index (net of taxes), returned 4.1% while emerging markets, as measured by the MSCI Emerging Markets (EM) Index (net of taxes), returned 6.6% during the period. Country-by-country, equity market performance varied across the spectrum from positive to negative. Equity market performance in the emerging markets presented a degree of reversion to the mean,



as some of the strongest performers of the first quarter retracted during the second quarter. For example, the first quarter's strongest-performing emerging market nations, Greece and Indonesia, were among the second quarter's weakest markets. On the other hand, Russia, which had likely been negatively affected by the turmoil in Ukraine during the first three months of 2014, bounced back during the second quarter with double-digit gains. This performance is in spite of the fact that the troubles in Eastern Europe remain ongoing, although they have subsided somewhat.

### **U.S. Fixed Income Market**

U.S. fixed income market returns were above average as well during the second quarter, as the Barclays U.S. Aggregate Bond Index posted a quarterly return of 2.0%. The quarter's return added to an already unexpectedly strong bond market year-to-date. The broad U.S. bond market (as measured by the Barclays U.S. Aggregate Bond Index) is up nearly 4% year-to-date, despite a relatively flat June. The drivers of the U.S. fixed income market largely remained intact throughout the first two quarters of 2014, with fixed income investors pushing up the prices of higher yielding securities. Similar to last quarter, long-term duration fixed income securities generally outperformed short- and intermediate-term duration fixed income securities during the second quarter. Interest rates generally declined during the second quarter. The majority of these movements occurred during April and May. Interest rates were generally unchanged or slightly positive during June. This shift could indicate investors are rethinking their position in these assets, particularly in light of the eventual end to quantitative easing and rising geopolitical issues.



Although we have been a rising tide environment of the broad market gains, it is important to remember that risk (and market sell-offs) often happen swiftly and without warning. The Federal Reserve's (Fed) monetary policies, including any actual or perceived changes in those policies, have been and are likely to continue to be, a focal point of investors and impact markets. While the Fed's

monetary policies have remained accommodative and stated inflation has remained relatively tame, as the economy begins to strengthen and inflation increases, the Fed's change in policies will lead to the eventual normalization of interest rates from their historically low levels. U.S. consumers will note the spike in pork and beef prices this year (10 and 8 percent respectively) as well as the increase in produce this summer (roughly 6%). The return of inflation in the coming quarters along with a more fully-valued equity market, combined with ongoing turbulence around Israel and extending from Russia, could very quickly bring market volatility back in to the picture in a hurry. Sometimes short-term "noise" becomes a long-term crash.



While, remaining focused on the “big picture” will always help you better navigate through any market dips and swoons, let us not overlook the health of the trees as we admire the beauty of the forest.

### **In Closing**

Inclusive of my obvious concerns about the markets both equity and fixed income there are ample investment opportunities that persist. The landscape as a result of Basel III and other similar higher capital requirements placed on banks continues to make mid-market & small business lending, both senior & senior secured as very favorable investments. Additionally, mezzanine investing (where loans can be converted to equity), other credit (debt) strategies and oh yes, energy infrastructure –from pipelines to the containers, trucks and railcars that carry natural gas, liquid natural gas and old fashion oil- appear to be in the early stage of a multi-year uptrend. I wish you a sunny healthy, happy and festive remaining summer season.

As always, I enjoy working with you toward the achievement of your financial goals and do not hesitate to contact me with thoughts or questions should they arise before our coming meeting.

Appreciatively,

**Walid L. Petiri**

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