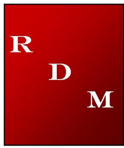

RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

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2014 FIRST QUARTER MARKET COMMENTARY

April 2014

EXECUTIVE SUMMARY

The First Quarter of 2014 brought a dose of reality to investors that had grown accustomed to the steady returns of 2013. After a year of record breaking highs, the S&P 500 took a breather to start the First Quarter, beginning with a 3.5% decline in January. As we wrote at the time, the pullback was a temporary and normal part of a bull market. Fortunately, equities rebounded somewhat in February and March: <u>the Dow finished the quarter down 0.7%, while the S&P 500 gained 1.3%</u>. Most importantly for our clients, <u>RDM's equity account composite outperformed both the Dow & S&P 500 with a 1.9% net return for the First Quarter</u>.

Several factors contributed to the markets' weakness to start 2014.

First, unusually harsh winter weather across the country distorted several closely watched economic indicators related to the labor market and manufacturing. The weather also likely played a part in weak earnings reports across many sectors. However, bad weather is not solely to blame for the disappointing economic climate in the First Quarter. We will be watching the Second Quarter earnings reports and economic indicators for further insight into just how much of an effect weather had on the economy.

Second, several emerging market nations experienced rapid currency depreciation amidst signs of economic weakness. This was, in part, exacerbated by the reduction of monetary stimulus by the U.S. Federal Reserve, thereby making safer U.S. treasury obligations more attractive to investors. A series of weak economic reports out of China also contributed to the emerging market currency crisis, as many emerging markets conduct a significant amount of business activity with China. China's slowdown remains an important economic indicator we will be closely monitoring in the Second Quarter.

Finally, we suspect that some of the weakness in January was due to simple profit taking. A market maxim (or myth) is that equity prices rise in January because investors re-enter the market in the new year after selling in December to harvest capital losses for tax season. This January we may have seen the reverse of the so-called "January effect." That is, investors sitting on large gains from 2013 did not want to incur additional taxable capital gains in December and, thus, waited until January to begin selling their winners. The volatility and downward trend among "momentum" stocks, as well as in the biotechnology sector, supports this theory.

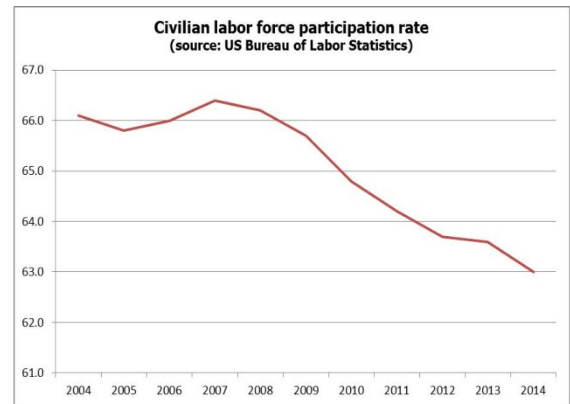
Looking ahead to the Second Quarter, we believe that geopolitical concerns will continue to dominate investor attention. Emerging markets remain unsettled and the Russia-Ukraine dispute threatens to disrupt the fragile European economic recovery. Nevertheless, we believe that the geopolitical concerns will eventually abate and investor attention will return to the positive economic and corporate underpinnings of the current bull market. We are sticking to our prediction that the economy should return to a 2.5 – 3% growth rate by the end of 2014 and that the equity markets will finish the year with high single digit returns. We do not foresee dramatic, market-wide gains like last year due to moderately high valuations and stagnant economic growth, but we believe there still are values particularly in the financial and commodity-driven sectors, as we explain below.

The Harsh Winter Weather Distorted Economic Data in the First Quarter

As many of our clients know firsthand, this winter has been particularly harsh! While winter weather impacts everyone's daily activities, it also "chills" business activity. Many businesses close shop on the worst snow days. Consumers also spend less due to higher home heating costs or because they do not want to leave their homes to shop. Manufacturing may suffer as transporting raw materials for production becomes difficult and demand for end products weakens. The labor market also suffers as businesses hire fewer employees due to these seasonal business impacts.

The upshot is that First Quarter economic activity appears to have been muted, in part, due to weather-related factors. For example, month-over-month retail sales in January dropped by an unexpectedly high 0.4%. The housing market saw surprisingly weak numbers, with declines in housing starts, building permits and existing home sales. Auto sales also stalled. All in all, some forecasters predict that weather-related factors may have caused up to a 0.5% drop in GDP during the First Quarter.

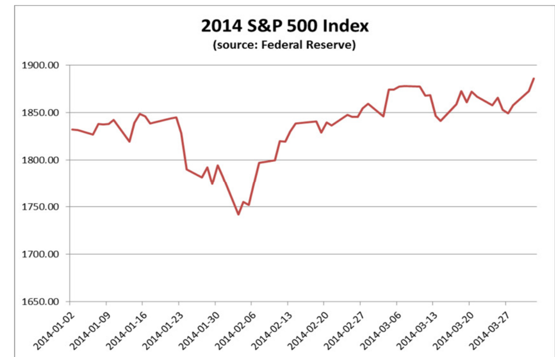
While the weather likely had an impact on the economy during the First Quarter, the fundamental economic picture seems to have weakened slightly irrespective of the weather. Much of this non-weather related weakness was illustrated by the disappointing retail holiday season, which takes place partially online and is thus less affected by weather. Higher mortgage rates and low inventory also are largely to blame for a weaker housing market. The unemployment rate remains stubbornly high at 6.7%, with approximately 7 million additional Americans currently under-employed in part-time jobs. Finally, the labor participation rate, i.e. the percentage of Americans working or looking for work, is at a 35-year low of 63% (*see chart*). (Once an individual stops looking for work, they are no longer counted as "unemployed"; therefore, both the unemployment rate and participation rate decline, but not for positive economic reasons.)



The extent to which the weaker U.S. economy in the First Quarter was weather-related or due to fundamental factors will be clarified over the course of the Second Quarter. With the Federal Reserve continuing to taper its asset purchase program (or quantitative easing) due to purported economic improvement, many observers (the Fed included) will be watching economic indicators closely over the coming months for a better indication of the true course of the economy. While the weather's ultimate impact can be debated, we believe that economic weakness in the First Quarter was largely a product of a theme that has underscored the economic recovery of the past few years: a consistently sluggish economy growing at best only 2 – 3% annually thanks to weak business spending and hiring and an uncertain fiscal and regulatory climate.

Equity Markets Rebounded from January's Pullback but We Will Keep an Eye on Geopolitical Turmoil in the Second Quarter

Given the high bar set by the 30% return on the S&P 500 in 2013, it is no surprise that the equity markets got off to a slow start in 2014. In January, the S&P 500 declined 3.5% amid weaker economic data, Fed tapering and concerns related to emerging markets currencies (*see chart*). Overall, the markets in the First Quarter were choppy. As we explained in our blog post in January, we believe that the equity markets were due for a pullback after 2013. The primary stimulus for the pullback was depreciation of emerging markets currencies caused by political instability, the after-effects of the Fed's tapering of its quantitative easing asset purchases, and profit taking. However, pullbacks of 3 – 5% are a normal and healthy component of any bull market and after the emerging markets worries subsided, equities rebounded with the S&P 500 climbing 1.3% for the quarter.



Due to strong 2013 returns, stocks currently trade at a forward P/E multiple of approximately 15, higher than the average forward P/E multiple of approximately 13. As we highlighted in our end of the year market commentary back in January, we expect valuations to moderate somewhat in 2014 from their levels reached in 2013, in part due to the reduced role that the Fed will play in supporting the financial system. We also believe that geopolitical concerns such as America's ongoing dispute with Russia over Ukraine and the Crimean territory will continue to make headlines in the Second Quarter and therefore dampen some enthusiasm in the markets.

Despite these worries, we expect a high single-digit return on the equity markets this year. We expect corporate earnings to grow at the 11% rate projected at the start of 2014 and companies to continue to return cash to shareholders through increased buyback and dividends. The Fed's policies, while relatively ineffective at stimulating real economic growth, will continue to inject confidence into the markets by serving as a "put" against downside risk. Perhaps most importantly, we do not foresee any imminent fiscal crisis that could cause a significant correction.

That being said, investors should not expect the across-the-board gains witnessed last year and thus sector and company selection is even more important. In the First Quarter, we increased allocations for our clients' equity portfolios slightly towards the financial and commodity-sensitive sectors, as we believe these sectors will be winners over the long term.

Financial Sector: The stress tests performed by the Fed in March demonstrate that the banking sector is as strong as it has been in years. Many of the world's largest banks, such as JPMorgan Chase, Wells Fargo and Bank of America, continue to build their capital cushions to satisfy regulatory standards and mitigate the impact of a severe economic crisis. They also have been slowly allowed to return capital to investors in the form of dividends and stock buybacks – a process that will continue to add value to equities in this sector in the future. Finally, valuation multiples in the financial sector lag the broader equity market; when combined with rising cash returns to shareholders, the sector looks attractive from a valuation and yield perspective.

Commodity-Driven Sectors: We also positively view investments in commodity-sensitive sectors, such as basic materials and energy, through mining companies, oil and gas producers and chemicals manufacturers. In the short term, these investments may be volatile or out of favor. However, we believe that the tremendous amount of liquidity injected into the financial system by the Fed, as well as foreign central banks, will eventually lead to inflationary impacts over the next several years. Accompanied by global economic growth that we predict will pick up over the same time frame, companies in these sectors will tend to benefit from higher commodity prices, thanks to inflation, and increased demand for their products, thanks to resurgent economic activity. Furthermore, if the current dispute with Russia intensifies, prices for commodities ranging from potash to natural gas likely will rise, potentially benefiting Western companies with earnings that are sensitive to commodity prices.

We also continue to maintain a significant allocation to stocks with high dividends yields, consistent with our overall equity strategy. High dividend paying stocks were among the top performers in the First Quarter and played a large role in the outperformance of RDM's equity account composite.

In sum, we continue to be slightly bullish on the equity markets for the rest of the year, but recognize that success will come (even more than usual) from patience and careful investment selection.

As always, all comments are welcome.

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