RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

2014 SECOND QUARTER MARKET COMMENTARY
July 2014

EXECUTIVE SUMMARY

Stocks continued their slow march higher in the Second Quarter of 2014 with the S&P 500, Dow and Russell Value index all posting moderate gains. ***The RDM Capital equity composite portfolio returned 5.66% for the 2nd quarter and 7.55% year-to-date after fees. This return surpassed all of the relevant benchmarks:***

	2nd Quarter	Year-to-date
RDM Capital *(net)*	**5.66%**	**7.55%**
S&P 500	4.69%	6.05%
Dow	2.24%	1.51%
Russell Value	4.51%	7.05%

As the equity bull market continues for a 6th year, underpriced stocks are increasingly hard to find. With volatility also low, there are limited opportunities to take advantage of temporarily undervalued stocks – the hallmark of our value strategy. We thus are only selectively adding to our equity positions, focusing mostly on energy, financial and materials/commodity-based stocks. At the same time, we are looking for opportunities to raise cash by trimming positions that have appreciated significantly.

While this has not been a buyer's market, we are not aggressively exiting our equity positions either, as we believe that the bull market still has a little time to run. In our view, the Fed's easy money policies, a slowly improving economic and corporate environment, decreasing unemployment, and increasing M&A activity lead to a moderately bullish picture for stocks over the next 18 months. We are closely watching for signs of the end of this bull market, such as unexpectedly higher inflation or a meaningful decline in employment, GDP or housing. There is also always the chance of a sudden geopolitical event that could upend the market. Indeed, the 2nd quarter saw the return of instability and possible military action in Iraq and Syria and increased tensions with Russia, all of which caught the market by surprise and led to minor pullbacks. But, at the halfway point of 2014, we do not anticipate the kind of economic or geopolitical shock that would abruptly end the bull market.

In summary, we believe the stock market will eke out further gains for the year (absent any unexpected events) and we reaffirm our prediction of high single digit gains in the S&P 500 by the end of the year.

I. U.S. Economic Data Points To A Continued Slow But Steady Economic Recovery

The economic figures from the 2nd quarter were mixed but on balance reflect a slowly growing economy driven by the Fed's easy money policies, low interest rates and recovering corporate profits. These catalysts have driven the market rally and look to continue to do so through next year.

The following is our take on the significant headlines from the U.S. economy in the 2nd quarter:

- *The **Federal Reserve** again confirmed that while it will reduce its bond buying program by $10 billion, to $35 billion a month, in July, it will support low interest rates for at least the next year.*

We've written much about the Fed's policies in prior commentary letters and will not belabor it here. Suffice it to say, fears last year that the Fed would cause a significant correction in the stock market by pulling back on its bond purchases appear to have been wrong in the short term, especially in light of the Fed's continued support for low interest rates. The Fed's easy money policies have created an environment where stocks still look more attractive than other investments despite a 5+ year bull market.

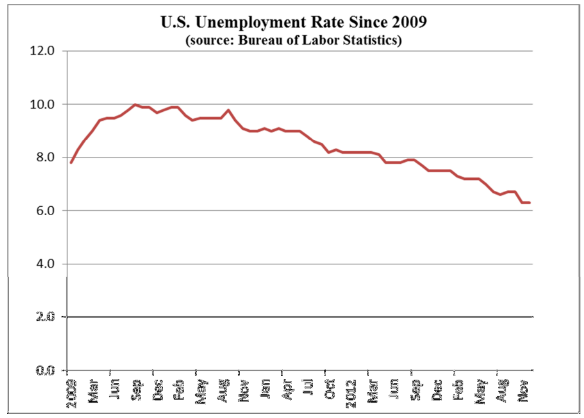
- *First quarter **corporate earnings** reported in the 2nd quarter for the S&P 500 companies were up 1.2%, with about 65% beating earnings expectations. Revenues were up 2.6% with about 50% of companies beating earnings estimates.*

Corporate earnings continue to drive the stock market, despite a challenging economic environment. Although revenues grew more than earnings as a percentage this quarter, we still see an environment where companies are growing earnings primarily by cutting costs to boost bottom line growth in lieu of stronger revenue (top line growth). As for sector performance, energy and utility stocks continued to lead the way. Financial services and basic materials stocks trailed other sectors, although these two sectors are still up moderately for the year. As noted above, we believe there are values in financials and basic materials/commodities in this growing economy, despite their relative underperformance this year.

- *The third estimate of **U.S. GDP for the 1st quarter 2014** now shows a contraction of -2.9%.*

The GDP decline is eye-opening: for context, this is the largest decline in GDP since the depth of the Great Recession. The 16 other times that GDP has declined by more than -2.9% the economy has either been in or on the verge of a recession. However, the interim data points for the 2nd quarter – e.g., employment, consumer confidence, service-sector activity – continue to suggest that the 1st quarter contraction was an anomaly and that bad winter weather, rather than an overall slowdown in the economy, was the primary cause of the GDP surprise slowdown. Most importantly, the market, as a forward-looking mechanism, is concerned with future GDP growth, not revised estimates of prior GDP. Consensus estimates are that GDP grew at over 3% during the 2nd quarter and the final GDP number for the year will be between 2%-2.5% – lower than the historical 3% GDP growth rate, but not reason for panic. However, until wages rise, consumer consumption will stay relatively low and it will be difficult for the economy to return to +3% GDP growth soon.

- *The* ***U.S. unemployment rate*** *remained at 6.3% in the 2nd quarter; the U.S. now has recovered all of the 8.7 million jobs lost during the recession.*



It is easy to see the employment numbers as proof the U.S. labor market is back to pre-recession strength (*see chart*). Yet, there is a pervasive feeling that the U.S. job market remains in a recession – over half of Americans still believe we're in one! The reasons? Stagnant wage growth and a U.S. labor force participation rate that remains under 63%, a four decade low. With each passing month, it becomes increasingly clear that there are fundamental problems with the U.S. labor market. Specifically, employers have little incentive to hire, having now streamlined their businesses during the recession and as technology continues to replace workers. Wage growth is also stagnant because many of the newly created jobs are part-time or lower paying jobs. Studies showing wage growth steadily trailing economic growth over the past few years, and actually the past several decades, suggest this dynamic is unlikely to change soon. As we've stated before, the fundamental shift in the makeup of the labor force and wage growth favors a significant allocation to investments – owning capital – rather than the traditional reliance on wages to grow net worth.

- ***Inflation*** *rose 2.1% year-over-year in May and 0.4% from April.*

Inflation is well below the historical median of 3%, but the 2nd quarter inflation numbers were the first rumblings of inflation we've had in some time. Steadily increasing, moderate inflation can be a positive for stocks over time, as it usually corresponds with a growing economy. However, if inflation spikes unexpectedly, it can be a negative over the short term as prices rise faster than companies can raise earnings and increase dividends. Consumers also are pressured if inflation rises higher than wage growth, which is a further negative for the market. We've noted before that we do not see any signs of significant, short term inflation, considering the subpar wage and GDP growth. Nevertheless, with the Fed in year 5 of its historic easy money policies, we believe higher inflation is inevitable further down the road. We thus are beginning to allocate towards equities that will benefit from inflation over our 3 - 5 year outlook, in particular commodity-based stocks and financials.

- *Increased* ***merger activity*** *reflects higher business confidence.*

As we've discussed in recent market commentaries, businesses have stockpiled cash since the financial crisis. This is partially due to conservative financial management after the Great Recession. Low interest rates have also led to increased corporate borrowing. Since businesses have unfortunately not re-invested their cash in hiring new employees, investors have waited patiently for businesses to otherwise deploy the cash stockpile through dividends, stock buybacks or strategic corporate mergers. In the first half of 2014, we have seen a return to the level of merger activity not seen since the financial crisis. Currently, M&A activity is running at more than a $3 trillion pace for 2014, which would be the most money spent on corporate deal-making since the financial crisis.

Rising confidence in the economic recovery is clearly the main catalyst behind the current rise in M&A activity. Additional reasons for the spike in M&A are: 1) the low interest rate environment, which makes corporate borrowing to finance deals cheaper, and 2) record highs in the equity markets, which makes deals financed with stock of the acquirer cheaper. Due to this second point, increased M&A activity often coincides with the peak of a bull market – i.e. an acquirer is most likely to pursue a merger with a stock transaction when its stock is expensive, which means M&A activity may be at its height during market peaks or bubbles. However, due to the significant slowdown in M&A activity after the financial crisis and the relatively sluggish economy that persists today, we believe that there is still much pent up capital for M&A activity before it reaches its peak over the next 2 - 3 years.

II. Ukraine and Iraqi Conflicts Worry Investors

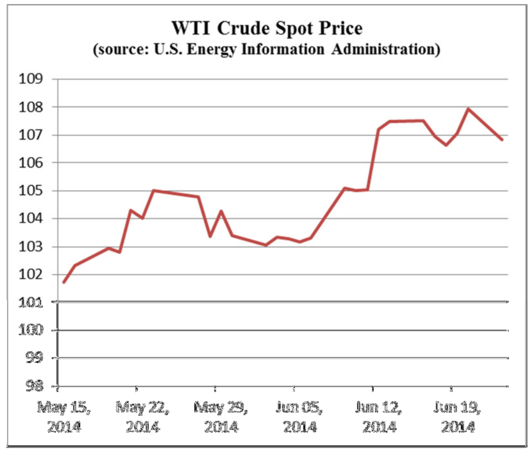
The Second Quarter 2014 saw one geopolitical concern abate somewhat while a new crisis emerged. Heading into the Second Quarter, the Russia-Ukraine conflict was at the forefront of investor concerns. Russia had lined the Ukrainian border with troops as Vladimir Putin appeared determined to annex Ukrainian territory and advance Russian interests in the region. In recent weeks, however, the conflict has dissipated some as the U.S. led economic sanctions appear to have incentivized Putin enough to play a less active role in the fighting in Eastern Ukraine between pro-Russian separatists and Ukrainian nationalists. Currently, however, Ukrainian military forces have launched an offensive against the pro-Russian separatists after a tenuous cease fire did not result in a peace deal.

Markets were initially skittish over the developments in Ukraine, due to the important role that Russia plays in the global economy. Russia produced over 10 million barrels of oil per day in 2012, just behind Saudi Arabia and the U.S. in total production. It is also the second largest producer of dry natural gas in the world. An extended conflict involving Russia could cause Brent crude oil and natural gas prices to spike overseas, which would hurt the fragile European economic recovery. While the Ukrainian conflict has abated some over the course of the Second Quarter, we will continue to watch further developments in Ukraine with an eye on their effect on oil prices and European economic conditions. A prolonged crisis and related economic sanctions would surely be a negative for the equity markets abroad, but would also dampen investor sentiment at home as the outlook for global economic growth would darken.

Meanwhile, dominating recent geopolitical headlines is the escalating conflict in Iraq between Sunni and Shiite loyalists, which also has significant implications for the price of oil, and relatedly, the equity markets. In June, Sunni extremists expanded their assault from Syria and launched a coordinated blitz attack through northern Iraq, toppling several major Iraqi cities on the way to Baghdad where they have faced strong resistance from government-backed Shiite troops and Iranian supporters.

The crisis in Iraq is significant to U.S. investors for a couple of reasons. First, the withdrawal of U.S. troops from Iraq created an opportunity for Al Qaeda-backed fighters to overwhelm an outmatched Iraqi military. The Obama administration has indicated that U.S. troops will not be deployed to Iraq to counter the insurgency, however military options remain on the table, such as airstrikes and other support for the Iraqi military. The level of U.S. involvement in Iraq will certainly influence the markets' reaction to events there. As long as the U.S. remains passively involved, the markets will likely not overreact to daily developments. However, should the U.S. take a more active role, including sending more troops to the region, the fear of a protracted military campaign will likely weigh on the markets.

Second, Iraq now plays a more prominent role in Middle East oil production than during the Saddam Hussein era. In the aftermath of the Iraq War, Iraq has become a significant player in the energy business. Iraq is now the second largest oil producer in OPEC, despite the country not reaching its full production potential due to ongoing political disputes and infrastructure delays. Iraq contains the fifth most proven crude oil reserves in the world and exports over 2 million barrels of oil per day, the majority of which is exported to the U.S. and Asia. An extended conflict in Iraq, as in the Ukraine, would have important ramifications for oil prices and the global economy. While most of Iraq's oil producing region is to the south of Baghdad, away from the current fighting, the potential for a prolonged conflict and political upheaval has already led to oil price increases. In June, the price of WTI crude oil in the U.S. rose from approximately $101 per barrel in May to more than $106 per barrel in part due to the threat of a disruption in oil production in Iraq (*see chart*). A prolonged disruption in oil production would likely cause European Brent crude oil prices to rise more significantly than U.S. WTI, which could help U.S. refiners profit from the higher spread between WTI and Brent crude oil. We will continue to watch the situation in Iraq as it develops, particularly with respect to the conflict's impact on oil production.



Ultimately, brief geopolitical conflicts that flare up and subside in a matter of months do not impact our clients' long term investment goals. Therefore, we do not make significant investment decisions based on them. We are far more concerned with longer term political instability or military actions in economically sensitive regions, such as Russia and the Middle East. Thus, we will carefully watch developments in Ukraine and Iraq for any signs that those conflicts may persist or worsen and negatively impact long term global economic growth or the energy industry.