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Market Outlook & Strategy

Third Quarter of 2014

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Executive Summary

- Global equity markets took a turn for the worse in Q3. The broad U.S. equity market was flat, but with big variations: Large company stocks posted positive returns, but small companies sharply underperformed. Even more disappointing was that high-dividend earning, high-quality stocks also posted negative returns.

- International developed equity market indices (two-thirds of which are Eurozone countries) also posted negative returns for the third quarter, as evidence mounted that the Eurozone's economic recovery was slowing and the dollar strengthening against the euro. Emerging markets also finished in negative territory in U.S. dollar terms.

- The bond markets were also largely flat or slightly negative in the third quarter. Only municipals performed relatively well, up by +0.5%. Finally, natural resources had another terrible quarter, declining by almost 12% in their worst quarterly returns since 2008.

- Recent market turbulence reminds us that markets are likely to be volatile over the next months as the Federal Reserve wrestles with when, and to what extent, to raise interest rates, and we all wrestle the ever-changing evaluations of growth prospects in the rest of the world.

- In this issue, we identify and discuss some key current investment themes and how we plan to position client portfolios for what lies ahead. In brief, our investment themes continue to favor the U.S. over the rest of the world, and still modestly favor equity over fixed income. We believe that it is time to rebalance portfolios back to their targets, as the days of outsized equity returns are likely behind us, and volatility is set to increase.

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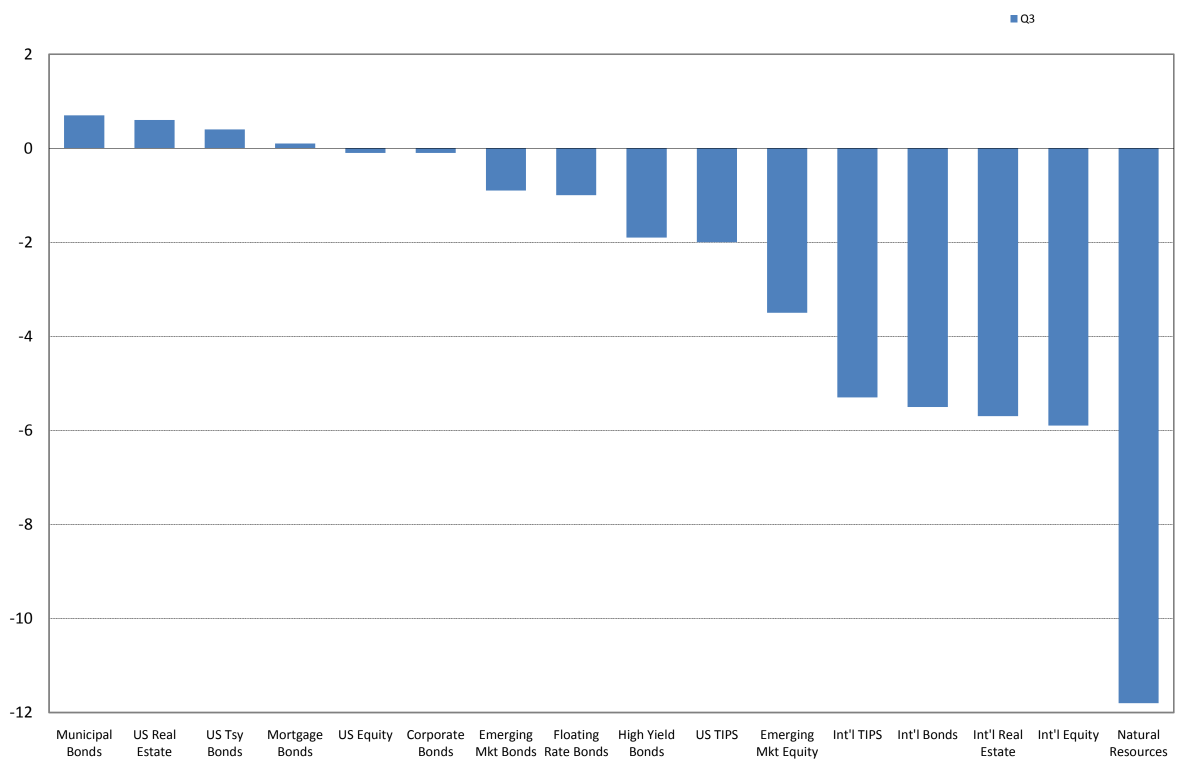
Markets in Review

Global equity markets took a turn for the worse in Q3 (Figure 1). The broad U.S. equity market was flat, but with big variations. For example, large company stocks posted positive returns (the S&P index was up +1.13%), but with small companies sharply underperformed (the Russell 2000 index fell by -7.36%). This was one of the widest performance gaps between small and large company stocks in years. Even more disappointing was that high-dividend earning, high-quality stocks also posted negative returns.

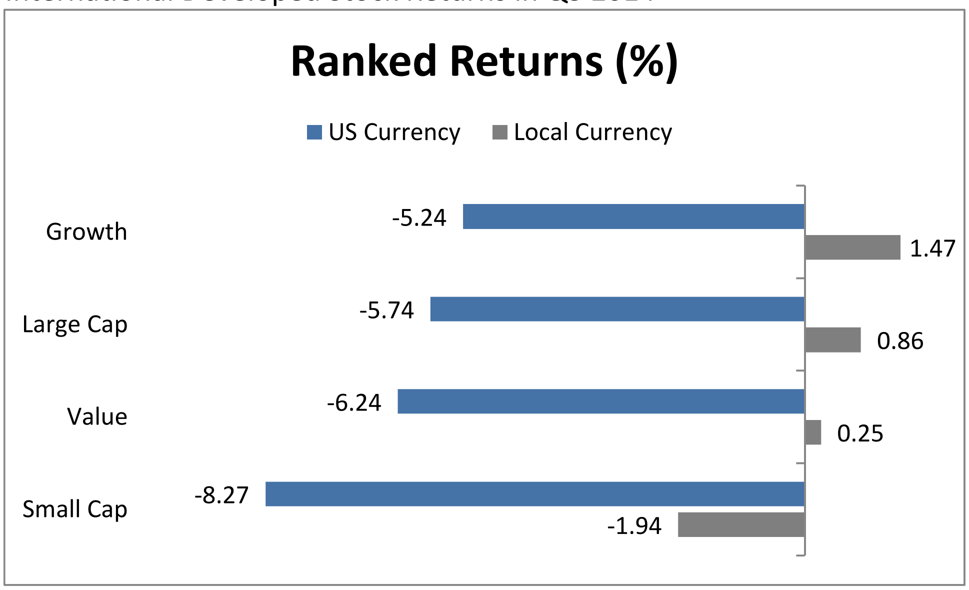
Figure 1: Asset Class Performance in Q3 2014 (percentage points)



International developed equity market indices (two-thirds of which are Eurozone countries) also posted negative returns for the third quarter as evidence mounted that the Eurozone's economic recovery was slowing. The performance weakness was concentrated in July after news of accounting irregularities at the parent company of Portuguese bank Espirito Santo. Worries over the volatile situation in Ukraine and the potential impact of sanctions on Russia also weighed on Eurozone returns.

However, it was the strengthening dollar that did most of the damage as shown in figure 2. Indeed, in local currency terms, international developed company stocks posted returns very similar to those in the U.S. Returns in Europe, in particular, got a boost in September when the European Central Bank took steps to try and boost the economy, cutting interest rates to +0.05%, reducing the deposit rate to -0.2%, and announcing a program to buy asset-backed securities. However, many analysts derided the move as too small to make much of a difference.

Figure 2: International Developed Stock Returns in Q3 2014



Source: MSCI 2014

Finally, emerging markets also finished in negative territory in U.S. dollar terms in the third quarter. Emerging Asia was the best-performing region, and Latin America was relatively weak. Russia had a terrible quarter, suffering a 14.2% decline in the ruble due to the escalation in tensions in the Ukraine and the worldwide decline in energy prices.

The bond markets were also largely flat or slightly negative in the third quarter. The standard benchmark for the U.S. market—the Barclays U.S Aggregate Bond Index—was up only +0.17%, with higher-yielding bond segments posting modestly negative returns. Only municipals performed relatively well (up by +0.5%). Finally, natural resources had another terrible quarter, declining by almost 12% in their worst quarterly returns since 2008.

Investment Themes for Turbulent Times

Anyone who has picked up a newspaper in the last month could not have escaped noticing the wild ride investors have had in global stock markets recently. Unfortunately, we are likely to be in for more volatility over the next months as the Federal Reserve wrestles with when and to what extent to raise interest rates, and we all wrestle with the ever-changing evaluations of growth prospects in the rest of the world. As such, it seems reasonable to focus on how to best position portfolios for these turbulent times. As a start, here are some key investment themes we see currently.

Theme No. 1: Lower Interest Rates for Longer

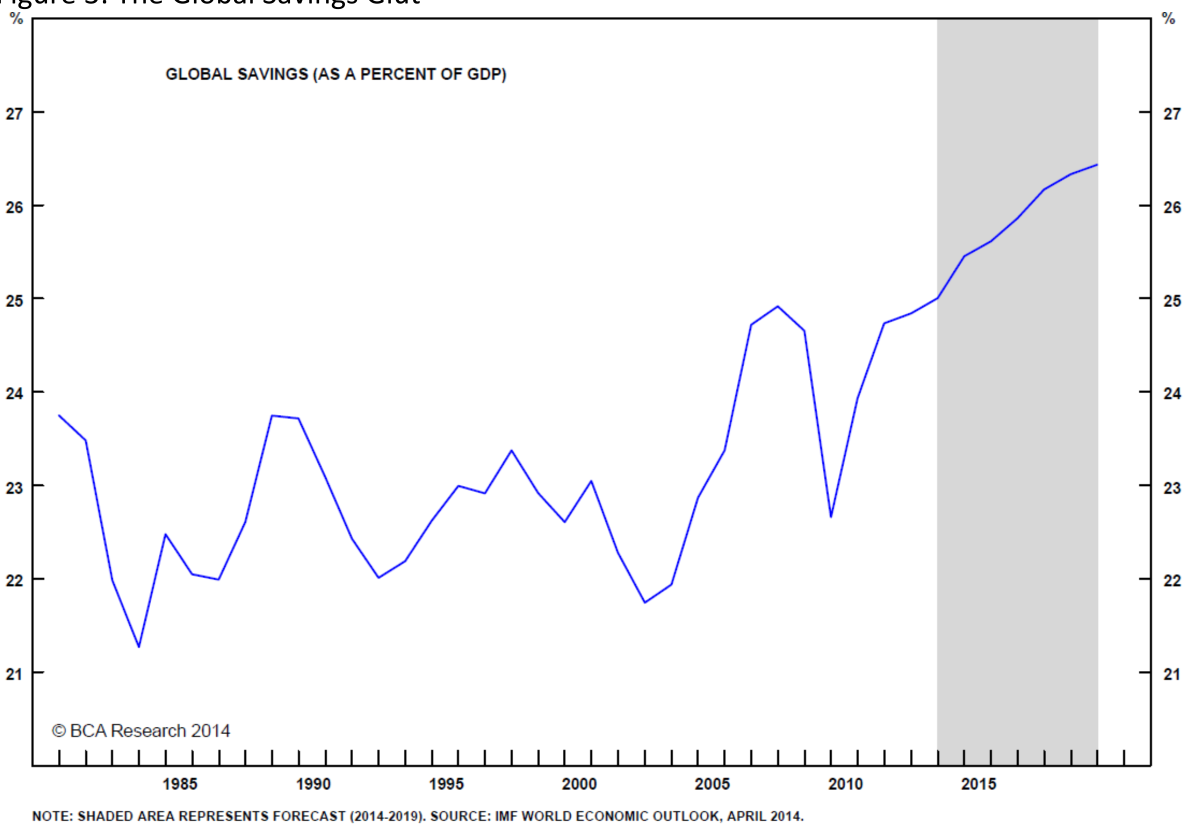
When thinking about interest rate trends, it is helpful to remember why the Federal Reserve has been engineering low rates. The key reasons have been to induce households to pull forward more consumption, and to entice firms to invest in projects with lower expected returns (because they could not earn acceptable returns by just holding onto their money). Put differently, the Fed has been trying to increase aggregate demand to eliminate the demand shortfall that emerged after the financial crisis when households and companies embarked on a deleveraging cycle (i.e., a period of reducing their debts).

The consensus view is that the Fed has helped to increase aggregate demand but that monetary actions alone are insufficient to stimulate sufficient demand to permit normal levels of output. Indeed, despite rock bottom interest rates, both the U.S. and Europe are still operating way below any estimate of their potential made before the onset of the financial crisis.

The lack of sufficient aggregate demand is leading to a global savings glut (see figure 3, next page). The savings glut is even bigger today than when former Fed Chair Ben Bernanke first coined the term; and indeed, it is likely to increase further as more emerging markets begin their own deleveraging process. This glut of savings has to go somewhere. Typically, it has found its way to assets such as long-term Treasuries -- increasing their demand and lowering their yield. (Remember, an increase in demand for bonds lowers their yield and increases their price.)

There are several other factors operating to reduce natural interest rates, including rising inequality since wealthier families spend less of their current income than do poorer families. Population aging across much of the developed world is also putting downward pressure on interest rates, as older folks tend to want more bonds in their portfolios.

Figure 3: The Global Savings Glut



Source: BCA Research

Finally, what is happening in Europe also matters as investors look at relative value. Rock-bottom interest rates in Europe (see Figure 4) make U.S. bonds look cheap and thus increase their demand (and lower their interest rates). It's a global market.

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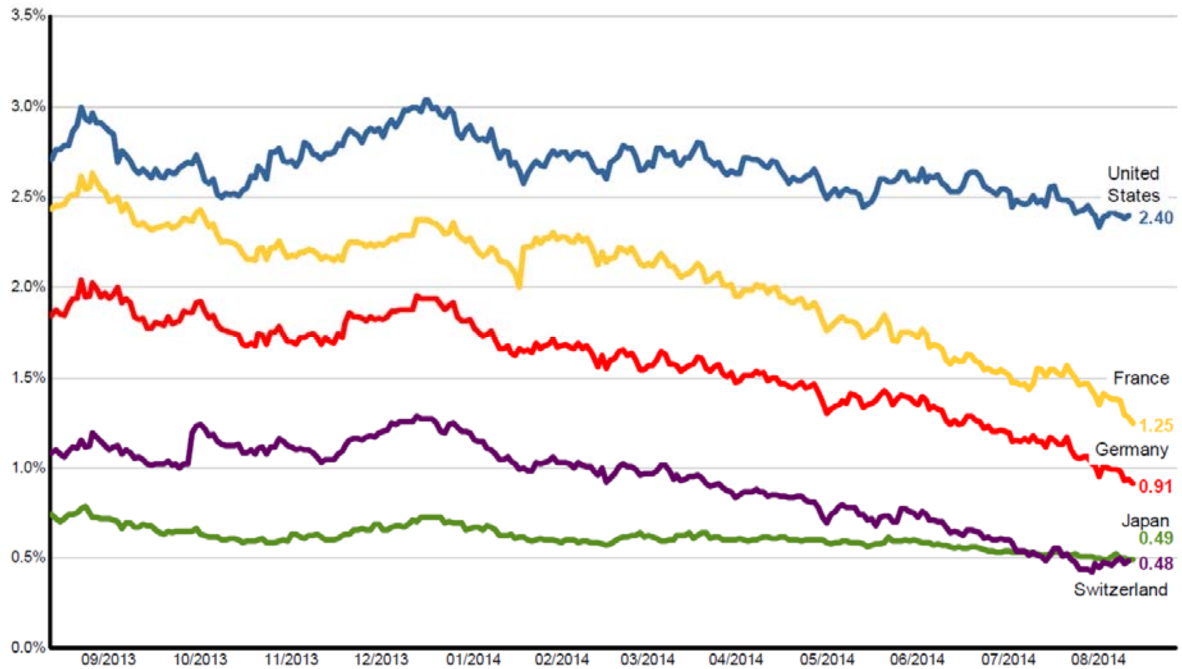
Figure 4: Sovereign Bonds – 10-year yield (as of 8/26/14)



Source: FactSet

While the above factors increase the demand for bonds, there are also factors decreasing their supply. First and foremost, is the declining budgetary deficit in the U.S. As I indicated in a recent blog post, the U.S. budget deficit has declined from 9% of GDP to under 3% currently, and the deficit as a percentage of GDP is not projected to increase again until after 2018. Hence, the Treasury doesn't need to issue so many bonds.

Finally, in our report last quarter we discussed the variety of reasons why the world is in a period of slower economic growth and why this slowdown is projected to persist. This in and of itself acts as a damper on interest rates, as in theory, the real return on investment capital (i.e., the real interest rate) should be somewhat related to economic growth. In a fast-growing economy, a dollar put to work should be expected to earn a higher rate of interest than in a slower-growing economy.

In summary, the fair value of a 10-year Treasury yield (nominal) may only be in the 2.5% range, not the 3.8% range the Fed is actually assuming. This is not to say that 10-year rates may not rise above that level for a time but that the average over the next business cycle may not be much more than that. Today, the 10-year Treasury yield is hovering around 2.2%.

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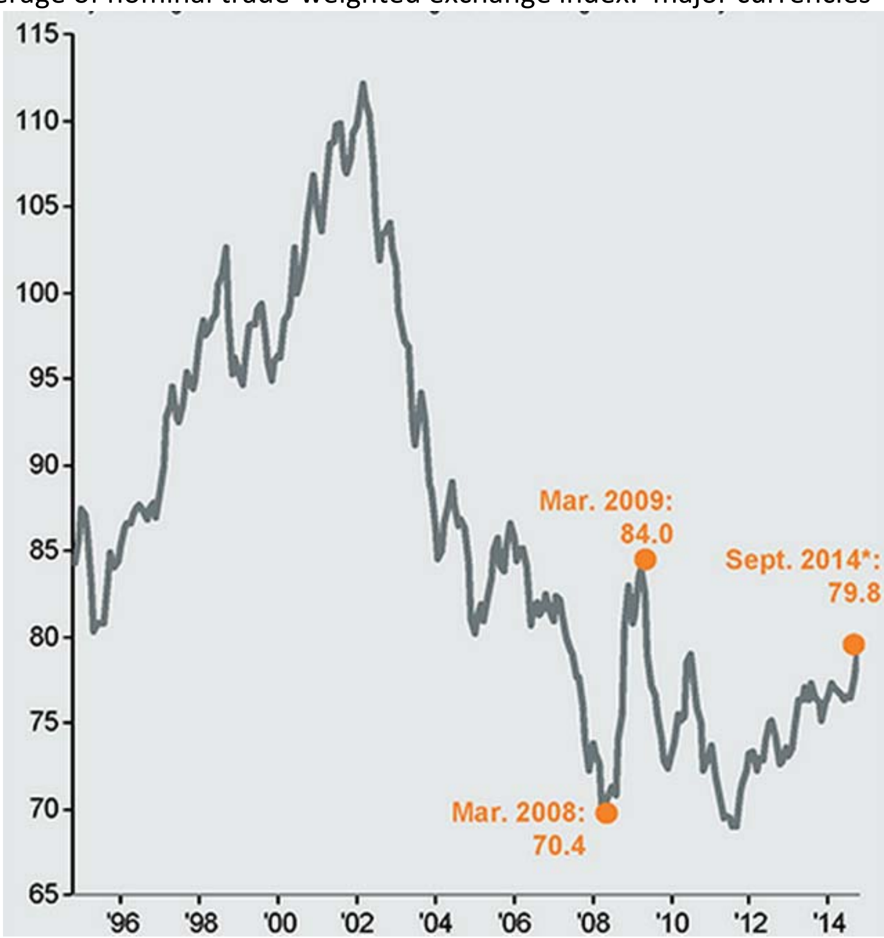
Theme No. 2: Strengthening Dollar

As pointed out earlier in this report, the U.S. dollar appreciated by almost 7% against the euro during the quarter, something that had been widely predicted but did not happen until now. While the many drivers of the foreign exchange markets are often conflicting, several of them are now positive for the dollar.

First, by many measures, the U.S. dollar is still undervalued. For a simple valuation metric, one can look at the U.S. Federal Reserve real broad trade-weighted measure, which was 14% below its long-run average at the end of September (figure 5).

Figure 5: U.S. Dollar Index
Monthly average of nominal trade-weighted exchange index: major currencies



Source: BEA, Federal Reserve, FactSet, J.P. Morgan Asset Management

Second, domestic oil and gas production has surged, and import volumes have declined 30% since the mid-2000s. Consequently, the U.S. trade deficit as a share of GDP has narrowed from 6.3% at the end of 2005 to a much lower 2.3% by the end of the second quarter this year.

Third, growth in the U.S. is outpacing that of many other countries. As global investors want to invest where growth is higher, this naturally puts upward pressure on the exchange rate of the faster-growing economy.

Will the dollar soar as it did in the second half of the 1990s? No. I believe the bull market in the dollar will be gradual, reflecting the slower pace of economic expansion in the U.S. as well as the fact that interest rates are near zero in Europe and Japan. Moreover, Europe is running a large current account surplus, which is not expected to slow until the European Union's leaders take real measures to increase internal demand.

Investment Theme No. 3: Continued Low Inflation

Some analysts worry that we are rapidly approaching full employment in the U.S., given the decline in labor force participation rates as baby boomers retire. As such, continued accommodative policy by the Federal Reserve to further increase employment may soon produce wage-induced inflation (and likely quite a jolt to the stock market).

However, there are more than a few forces keeping inflation in check. First and foremost is rapidly declining oil prices. Second, a strengthening dollar makes imports cheaper in U.S. dollar terms. Third, low interest rates reduce the cost of mortgage payments. Finally, as Europe and Japan are fighting deflation, there is zero chance of importing inflation from other parts of the world.

Investment Theme No 4: Continued U.S. Expansion

As I have written recently, I am confident that the domestic recovery will continue and that stocks are not overvalued. I recognize that valuations are generally looking less compelling, but I still believe the recovery will help companies to deliver further earnings growth and maintain profit margins in the near-term.

Indeed, most macroeconomic indicators suggest that private sector activity is actually strengthening in the U.S. Also, consumer income growth is improving. Meanwhile, I don't see that the strengthening U.S. dollar is going to choke off growth. While the overseas earnings of U.S. companies will be hurt, they are also benefiting from the decline in energy prices and continued low interest rates.

This is not to say all is well. On the negative side, prolonged stagnation in Europe and Japan and sub-trend growth in the U.S. and China suggest that the global economy is still very much plagued by the serious problem of over-saving and under-spending. The dramatic fall in global bond yields this year is an unambiguous call for more government action to stimulate business activity, but such actions seem to be hard to come by.

Artemis Strategy

What is Artemis doing in response to these trends?

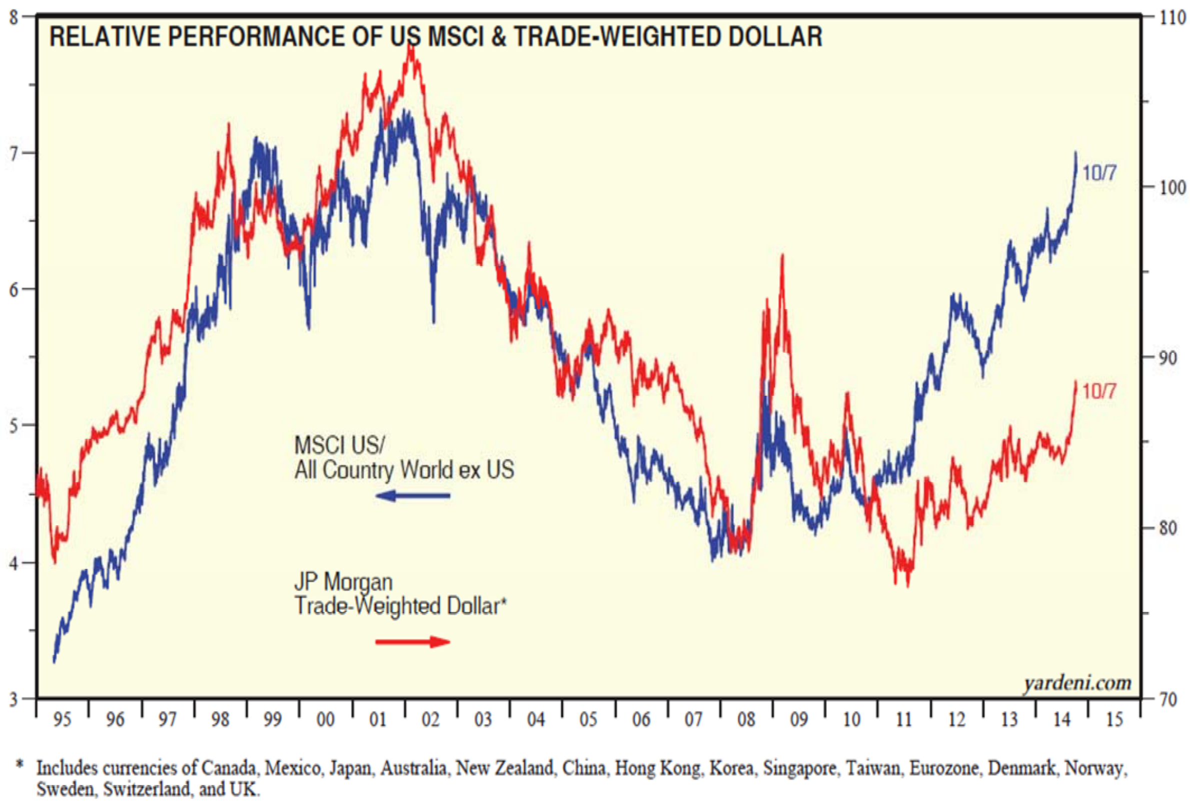
We reduced our exposure to Europe in August, just after the onset of the Ukrainian crisis. As you may recall, nearly all client portfolios had targeted exposure to Germany because we had felt that Germany was the safest way to reenter Europe when we started rebuilding our European position a couple of years ago. This strategy performed very nicely, but the Ukrainian crisis was a big red flag, and so we sold off Germany in all portfolios, thereby taking our overweight European exposure back down to neutral in favor of U.S. equities (risky portfolios) or municipal income (more conservative portfolios). This was the only change we made to our portfolios during the quarter.

Going forward, our investment themes continue to favor the U.S. over the rest of the world, and still modestly favor equity over fixed income. Some worry that the strengthening dollar might be bad for U.S. stocks because overseas earnings could decline. Overall, however, dollar strength is historically correlated with U.S. stocks outperforming the rest-of-world (Figure 6). I therefore plan to further increase our tilt toward the U.S. (large companies) at the expense of the rest of the world.

Our themes also suggest that it is time to rebalance portfolios back to their targets, as the days of outsized equity returns appear to be behind us (see last quarter's report for a detailed discussion), and we are likely to experience a fair bit of volatility in the next months.

For most client portfolios, this will mean reducing equity exposure and increasing fixed income. Our favored fixed income sector is the municipal bond sector. State and local government finances have improved nicely since the crisis, and the asset class is one of the least volatile even in the worst of times (largely because municipal bonds are mostly held by retail investors who do not trade in and out frequently). They are also attractively valued relative to both Treasuries and corporate bonds. We are currently researching high-yield municipals as a potentially attractive complement.

Figure 6: U.S. Stocks Outperform on $US Dollar Strength



Source: Yardeni Research, Inc.

Finally, we have also selected a new manager for emerging market bonds and will be making this change in the context of our end-year tax-loss harvesting exercise.