<u>Outlook for August, 2014: “Cross Currents…”</u>

While US equity markets appear to be taking a ***breather*** (pausing for breath as it were after a cumulative doubling over the past five or so years), stronger US data coupled with lower interest rates continue to confound many market participants so far this year. Oft repeated mantras like “sell in May and go away” as well as “mid-term election gyrations” have not come true this year. It goes without saying that predicting markets has gotten tougher, but we soldier on, believing that fundamentals will eventually win the day.

The non-farm payroll report for July confirmed yet again that the economic engine is chugging along at a ***slow, steady pace.*** The U.S. economy added ***209k jobs in July***, slightly trailing expectations of 230k and below June’s revised gain of 298k. Average hourly earnings were up 2% year-over-year, in line with the average pace over the past 4 years, but still well below the 2.5-3.5% yearly gains prior to the Great Recession.

The ***unemployment rate*** ticked up slightly from 6.1% to 6.2% in July, primarily due to an increase in the size of the labor force (+329k). During 2014 alone, an average of 28k people per month are re-entering the workforce as job prospects appear to be improving. The “broadest” measure of underemployment, the ***U-6 measure***, worsened slightly to 12.2% (from 12.1% in June). The labor force participation rate edged up one-tenth to 62.9%, down from 63.4% a year ago.

The ***private sector*** was responsible for an increase of 198k jobs during July, taking the monthly gain over the past year to an average of 192k jobs per month. Virtually all the sectors (including the beleaguered Government sector) ended up posting gains in July, with Professional and Business Services (+47k) and Trade, Transportation and Utilities (+39k) being the top two sectors. Information (+2k) and Other Services (+7k) brought up the rear. The Average Work Week stayed anchored at 34.5 hours (the same as last four months) – suggesting that the ***labor market is healing, albeit at a slow pace***.

While ***wages increases have stayed quiescent*** for quite some time, there was some indication in July that the tide might finally be turning. According to the Bureau of Labor Statistics’ ***Employment Cost Index***, which tracks changes in employers’ labor costs, the second quarter saw a 0.7% (quarter on quarter) increase on a seasonally adjust4.5ed basis. The wages component, which makes up roughly 70% of the index, was up 0.6% (also q/q), the fastest rate of increase in nearly six years. Likewise, the PCE price index, which is a theoretically more robust inflation gauge, rose +1.6% on an annualized basis, marking an acceleration from a 1% pace a year ago.

GDP figures released by the Bureau of Economic Analyses of the Department of Commerce confirmed that the U.S. economy ***rebounded strongly*** in the second quarter as growth accelerated at a 4.0% clip (seasonally adjusted annual rate). This was a marked improvement from first quarter’s -2.1% (saar) contraction as a result of the brutal winter. From 2Q2013 to 2Q2014, the economy grew by 2.4%, which is slightly better than the average 2.3% annual growth since the beginning of the recovery.

The Federal Open Market Committee of the Federal Reserve have been surprised at how fast the unemployment rate has fallen this year. In their December 2013 forecasts, the Fed expected the unemployment rate to reach 6.0% in late 2015. It is currently 6.2%. The general consensus on Wall Street is that interest rates will rise sooner than expected. But ***Janet Yellen*** quelled such fears by reminding everyone during her testimony in Congress that the Fed has been fooled before by ***"false dawns".***

Our fear is that the Fed's policies will be kept in place for much longer than is warranted, and thus, ***create major imbalances***, sowing the seeds for the next crisis as it were – unintended though these consequences may be. Let us remember that the FOMC is made up of human beings, who are all subject to the same behavioral biases and flaws that we all are. They cannot predict the future, let alone "look around the bend", especially on something as complex as the economy and markets.

Markets gave some gains back in July as investors digested a slew of crises abroad and at home. Small capitalization companies, as measured by the ***Russell 2000 index***, were down more in July as investors worried about valuations. Indeed, Federal Reserve head Janet Yellen, even opined on the subject by professing that valuations in the small-cap sector, namely biotechnology and social media stocks appeared ***"substantially stretched."*** Oh, well!

On the fixed income side, ***high yield debt*** suffered its worse price decline in over a year as individual investors weighed valuation concerns along with stronger economic data causing selling pressures in Exchange Traded Funds that invest in high yield debt or "junk bonds". We are keeping a watchful eye on corporate bond spreads and leveraged loan markets with a view to assess whether we should reduce our exposure to this sector in the near to medium term.

Second quarter earnings have come in quite strong: As of last week, 76.6% of the companies in the S&P 500 have reported second quarter earnings and numbers clearly show rising earnings momentum. On a share weighted basis, earnings increased 10.7% (year on year) in 2Q2014 relative to 2Q2013. Almost 69% of those reporting have ***beat consensus expectations***, an increase from the 66.6% pace in 2Q2013. Companies with negative surprises, or those companies that failed to meet expectations, fell from 24% in 2Q2013 to 20% in 2Q2014.

We believe that the U.S. will continue to grow over the next couple of years, but that growth will be inhibited by mounting geopolitical risks, Washington gridlock, and onerous regulatory burdens. Banks are still shelling out billions of dollars in penalties and fines. Large banks are also scrambling to comply with thousands of pages of new regulations: JP Morgan Chase said it expects to ***add 13,000 compliance officers*** by year end and Citigroup will have close to **30,000** people in compliance by the end of the year (clearly a "growth" industry!").

Farther afield, worries about escalating tensions in Ukraine (and Russia's flippant response to US and EU sanctions), Iraq and Afghanistan (where a two-star US General was killed recently at a training college) have played havoc with European equities. While our foray into European equities (since Mid-March) might have been a tad early (to say the least), we remain of the opinion that longer term, valuations in Europe remain quite ***attractive relative to the US.***

Despite of all these cross currents, we feel it is important to stay nimble and perhaps take some gains off the table in the near term, in anticipation of some market weakness ahead going into the mid-term elections. It goes without saying that our abiding faith in a ***fully diversified portfolio*** - that has a balanced approach to both risk and return - as the main way to attain ***favorable investment outcomes*** over the long haul, remains resolute.

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