***<u>Outlook for June, 2014: "Calm Before The Storm?…"</u>***

Despite fears that this summer might bring greater volatility due to a number of factors, the exact ***opposite*** appears to be happening. If anything, ongoing declines in the VIX Index - a proxy for volatility (also used as a gauge of "fear") and reduced trading volumes suggest that this could well be the "calm before the storm" as equity markets continue their relentless grind higher.

Economic data released in the US have, on balance, been positive: The economy ***added 217,000 jobs*** during the month of May bringing the total number of jobs added in the past twelve months to 2,379k – an average gain of just under 200k per month. Indeed, May marks the first time since the late 1990s that the economy has added over 200k jobs for four months in a row.

The month of May also represents a ***milestone*** of sorts for the economy: This is the first time that the total number of employed persons are now above the previous peak witnessed in early 2008. In other words, all the jobs lost during the Great Financial Crisis have now been regained by the economy. As to the quality of these jobs and the period it took to regain this level, it is an entirely different story.

The US economy has essentially taken a little over six years since the end of the recession to regain the jobs lost in the recession – a period that is ***twice as long*** as the last recovery (from the recession in 2001). This is the ***slowest*** recovery since World War II and does not bode well for those that have been unemployed for longer than six months. Also, the jobs that are being added in sectors like leisure and hospitality (+39k in May), and education and health (+63k) are lower paying than the manufacturing jobs (+10k) that have been lost.

The unemployment rate remained unchanged at 6.3% as did the participation rate (62.8%) and the employment to population ratio (58.9%). The ***U-6 measure*** of underemployment – in our opinion a more robust measure of labor market conditions – did decline by 0.1% to 12.2% in May. In addition, Average Hourly Earnings increased 5cents to $24.38 per hour while the hours worked stayed the same at 34.5 hours per week during the month of May.

In other economic data, the Institute of Supply Management's ***Purchasing Manager's Index*** (a diffusion gauge of the manufacturing sector) rose slightly to 55.4 in May from 54.9 in April. Also, the Non- Manufacturing Index (a diffusion gauge of the service sector) posted a small gain to an index level of 56.3 in May from 55.2 in April. Many of the components of these two surveys suggest that businesses are beginning to get out from under the weather related disruptions that they suffered during the winter months.

An ongoing feature of equity markets this year has been the relentless ***decline*** in volatility. Indeed, the telling statistic is the rolling 90 day measure of daily standard deviation of the S&P500 that we track internally. The daily average standard deviation has declined to 0.50% - a level very rarely witnessed in the past few years. In the past 39 trading days (going all the way back to mid-April of this year), we have not seen a move up or down greater than 1.0% in the S&P500.

Clearly, the VIX Index – a measure of volatility on the Chicago Board Options Exchange – based on the weighted average of implied volatilities for a wide range of strike prices on options (more financial gobbledygook than you need to know!) has trended down ***inexorably*** as well this year. While the five year average of the VIX has been 28.15, its current level is an abysmally low 11.60 leading many analysts to conclude that there is a pronounced lack of fear or even ***complacency*** among market participants.

We suspect that all the excess ***central bank liquidity*** sloshing around in the global financial system is partially responsible for this decline in volatility. Admittedly, while the Federal Reserve is on pace to end its quantitative easing program by the end of this year, the FOMC continues to add US Treasuries and mortgage paper to its burgeoning balance sheet at a pace of $45 Billion in aggregate per month.

The real question is whether this decline in volatility is ***cyclical*** or ***more secular***. Since we have been around markets long enough to never utter the phrase "this time is different", we suspect that the decline in volatility will likely reverse over time and is probably of the plain vanilla cyclical variety. As to a catalyst for such a change, it could well be something as simple as an inflation scare, a tightening of monetary policy or a geopolitical event.

The European Central Bank (ECB) has now telegraphed its desire for a weaker Euro (relative especially to the Yen and the US Dollar) by cutting both its main refinancing rate by 10bp to 0.15% as well as by lowering its deposit facility rate to a ***negative 0.10%.*** The ECB also announced other Targeted Long Term Refinancing Operations to induce European banks to lend more to the non-financial private sector – excluding loans to households for house purchases.

With this move, the ECB has become the first major central bank in the world to use ***negative interest rates*** as a measure to jump start bank lending and therefore economic growth. Mario ("do whatever it takes") Draghi, the President of the ECB continues to push the envelope with the objective of ***engendering some inflation*** in Europe – especially since both wholesale and retail price inflation appears to be mired well below the ECB's "target" of around 2.0% per year.

The ECB's move did cause a slight weakening of the Euro currency relative to the US Dollar and the Yen, but we suspect that the depreciation is likely ***ephemeral***, since many analysts believe that economic growth prospects as well as relative inflation differentials favor Europe and the US – certainly relative to Japanese growth prospects.

Farther afield, ***the mess in Iraq continues***: It appears that a splinter group of al-Qaeda called the "Islamic State in Iraq and the Levant" has taken over that country's second largest city, Mosul as well as Tikrit. Reports also indicate that the group is within 70 miles of the capital Baghdad. Further, many Iraqi military personnel seem to have deserted their posts - an outcome that reiterates the fragile nature of Iraq and its institutions.

The unrest in Iraq has caused a predictable increase in crude oil prices on the global market. With Saudi Arabia long serving as the "swing" producer within OPEC, it will be interesting to see how long the current increase in prices will be sustained. Given the ***dynamics of global supply and demand*** for crude oil, one would expect excess supply to put downward pressure on prices – but this does not seem to be happening currently.

Another ***interesting facet*** of markets this year has been the steady decline in interest rates globally. In the good old US of A, ten year Treasury rates that began the year just north of 3.0% are now down almost 50bp. With the Japanese Government ten year note yielding a mere 0.60% (yes, that is not a misprint or a typo!), and the German Bund at 1.38%, the US Treasury ten year yield looks almost attractive at 2.58%!

Given the ***unusual calm prevailing in the markets*** currently, we are a little wary of being bullish in the near term. However, we remain optimistic regarding the medium to longer term outlook for markets. It also 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 steadfast.

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