<u>Outlook for May, 2014: "Cognitive Dissonance…"</u>

"The existence of dissonance, being psychologically uncomfortable, will motivate the person to try to reduce the dissonance and achieve consonance" said ***Leon Festinger***, the famous American social psychologist. The messages being relayed by the equity market and the fixed income (bond) market appear to be in cognitive dissonance.

The U.S. ***economy grew 0.1%*** (seasonally adjusted annual rate) in the ***first quarter of 2014***, well below consensus estimates of a 1.1% rise. Net exports and private inventories reduced 1.1% and 0.6%, respectively, from the headline rate while personal consumption added 2.0%, driven mainly by the services sector.

While the GDP report suggested that the U.S. economy may be on fragile footing, there is strong evidence that unusually cold winter weather in the first quarter kept a tight lid on growth. Leading indicators of growth including auto sales appear to suggest that economic growth is rebounding nicely during the early part of the second quarter.

The ***employment situation*** turned considerably rosier in April, as the establishment survey reported a gain of 288k jobs, well above consensus estimates for 215k and a healthy jump from March (203k). The private sector accounted for 273k jobs, led by professional and business services (+75k), retail trade (+35k), and food services (+33k). Revisions for February (+25k) and March (+11k) added a net 36k to overall payrolls.

In the household survey, the ***unemployment rate*** dropped from 6.7% to 6.3%. Over the past year, the rate has declined by 1.2%, representing an increase of 1.9 million jobs. Among worker groups, teenagers continue to feel the impact of 2008, with the unemployment rate at a disturbing 19.1%. The long-term unemployed declined by 287k, but is still at an alarming level of 3.5 million people, representing roughly 35.3% of the total unemployed.

The much publicized decline in the ***unemployment rate*** is misleading: The unemployment rate drop of 0.4% was heavily influenced by an outsized 806k civilians leaving the labor force (read giving up on looking for work). It is also not encouraging that the make-up of the filled positions is trending to lower quality, part-time work and the labor force participation rate (62.8%) is close to cyclical lows.

Employment opportunities may be limited, but the economic backdrop, at least from the confluence of data points we observe, is still moving forward: The ***ISM surveys*** on manufacturing and services were both well above the critical 50 level, indicating expansion in these sectors. Regional manufacturing surveys from the Dallas Fed, Philadelphia Fed, and Richmond Fed, all came in strong suggesting that regionally the economy seems to be healing well.

Farther afield, ***Chinese GDP*** growth disappointed coming in at 7.4% (seasonally adjusted annual rate) for 1Q2014. While the salad days of growth greater than 10.0% might indeed be behind us, China and its leaders are embarking on a large scale (after all nothing in that country is small) experiment to reorient that economy from an export driven model to a domestic demand driven model.

We have talked in previous missives about the contrast between ***China and India***: China has a lot of order, but very little in the way of enforceable and predictable laws. India on the other hand is chaotic and sometimes quite mystical and yet it appears to have laws that are both time honored as well as enforceable.

While the equity market continues to ***"tread water",*** being mere percentage points away from its all-time highs (as the S&P500 is), ***yields*** in the US Treasury market have posted ***substantial declines recently***. Indeed, the ten year US Treasury yield has declined by almost 50bp since the start of the year signaling either that another recession is right around the corner or that the unusual accommodation put in place by the Federal Reserve is unlikely to be removed – despite all the talk of ***"tapering"***.

In other words, Treasury market participants appear to be ***believing*** that the Federal Reserve is far away from raising administered interest rates and thus tightening monetary policy. Clearly, ***inflation data*** from around the world seem to reiterate and underscore the lack of any significant increase in reported inflation. If anything, there are parts of Europe and Asia that appear to be in the grip of deflation – especially for consumer goods.

In another indication of ***cognitive dissonance***, markets for precious metals remain well bid – with spot ***gold prices*** staying above $1,300 an ounce for the yellow metal in the face of well-behaved inflation reports both in the US and elsewhere. However, silver (whose fundamentals are more complex driven as it is by greater industrial uses), has remained weak further confusing analysts about the prospects for these assets.

Within the equity market, the best performing sector in the S&P500 by a wide margin is ***utilities.*** This also flies in the face of normal logic given that utilities are theoretically lower down on the risk scale compared to other high flying sectors like technology or bio-technology. While a decline in interest rates has been the primary reason, it is still hard to comprehend the attractiveness of this sector for investors.

A word about ***earnings***: With over 80% of the S&P500 companies having reported so far (=402 companies), the aggregate share-weighted ***earnings growth rate*** for 1Q2014 is ***around 5.0%*** (which is quite favorable given that expectations were around 1.0% going into the start of earnings season). This represents a per share earnings figure of $28.20 for the quarter (compared to expectations around the $26.77 per share figure earlier in vogue for this quarter).

71.1% of the companies that have reported so far have had ***positive earnings surprises*** (=286 companies) which also compares favorably with the 66.8% of companies that beat expectations during the same quarter last year (2013). Also, a mere 20.0% (=80 companies) disappointed investors from an earnings standpoint compared to 24.1% of the companies during 1Q2013, while 9.0% (=36 companies) met expectations for the quarter (which was close to the same proportion in 1Q2013 as well).

Valuation multiples for the S&P500 companies in aggregate at around 17 times remains ***reasonable***. While 2013 witnessed a big ***upward re-rating*** of equity multiples (which explains the outsized market gain), we do not expect to see such an outcome this year. Indeed, if S&P500 companies in aggregate are able to grow earnings by around 6 to 8% for the year as a whole, this ought to augur well for investors for 2014.

US corporate balance sheets appear to be quite healthy with many large companies returning capital either through greater dividends or share buybacks. Indeed, the incongruity of Apple, Inc. borrowing money cheaply in the debt market (at a low spread of 77bp relative to the ten year Treasury) in order to turn around and pay dividends to shareholders is symptomatic of the ***Federal Reserve's largesse.***

Given the cross-currents within markets (and the inherent cognitive dissonance this brings), we do feel a little cautious 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.

This report was prepared by

Suresh Raghavan, CFA and Clark Blackman III
MBR Financial
2000 West Loop South, Suite 1510
Houston, TX 77027

www.mbrfinancial.com

For further information please contact us at
Voice: 832.667.8787
Fax: 281.974.2108
Email: contactus@mbrfinancial.com

Important Disclosures

MBR Financial is registered with the SEC as a Registered Investment Advisor.

Investing involves risk including the potential loss of principal. There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment. No investment strategy, such as asset allocation, can guarantee a profit or protect against loss in periods of declining values.

Past performance is not a guarantee of future results.

This memorandum is based upon information generally available to the public from sources believed to be reliable. No representation is made that it is accurate or complete.