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## 2014: A Second Quarter Review

*A quick summary of economies & markets for you.*

Dear Client,

After a first quarter marked by dismal GDP and a tepid stock market, the second quarter of 2014 brought welcome change. The S&P 500 posted a Q2 gain of 4.69%. Hiring picked up, and so did inflation. The housing market left its winter slump behind. Gold rallied and so did oil, with unrest in Ukraine and Iraq providing some upward pressure on prices. The Federal Reserve incrementally reduced its bond purchases on schedule. Was the first quarter simply a bump in the road for the economy? History may record it as nothing more.[1]

**Domestic economic health.** Two notable trends emerged in the quarter. The job market improved, and yearly consumer inflation aligned with the Fed's target. In tandem, these developments made Wall Street wonder if the Fed might raise interest rates a little sooner than anticipated.

By the end of Q2, the unemployment rate was down to 6.1% following job gains of 304,000 in April, 224,000 in May and 288,000 in June. In fact, by June the economy had created at least 200,000 jobs in five straight months, something that hadn't happened since the late 1990s. The U-6 rate (the unemployed + the underemployed) reached a 69-month low of 12.1% in June.[2]

While the jobless rate went south, consumer prices moved north. The federal government's Consumer Price Index rose 0.3% in April and 0.4% in May, taking yearly inflation to 2.1%. Retail sales were up too – they rose 0.5% during April and another 0.3% in May, even as consumer spending was flat in April and up but 0.2% for May. The University of Michigan's consumer sentiment index wobbled – it was at 84.1 in April, 81.9 in May and 82.5 in June. On the other hand, the Conference Board's consumer confidence index reached a 6-year peak in June at a reading of 85.2.[3,4]

The manufacturing and service sectors continued expanding, according to the purchasing manager indices kept by the Institute for Supply Management. By June, ISM's service sector PMI indicated growth for a 53rd straight month with a 56.0 reading. The ISM factory PMI stood at a healthy 55.3 in June.[5] Annualized wholesale inflation ticked down to 2.0% in May from 2.1% in April, in part thanks to an unanticipated 0.2% dip in May's Producer Price Index. Factory orders and hard goods orders also dipped in May: orders for durables fell 1.0% after a 0.6% rise in April, and factory orders followed up their 0.8% April rise with an 0.5% May decline.[3,6]

The Fed kept tapering QE3. By June, the central bank had moved to reduce its monthly asset purchases to $35 billion. As Q1 GDP was a subpar -2.9%, it revised its full-year economic growth expectations down to 2.1-2.3%. All these moves were expected, but what was unexpected was St. Louis Fed president James Bullard going out on a limb and telling Fox Business in June that he expected an interest rate hike by the end of Q1 2015. If current hiring and inflation trends continue, could it even occur sooner?[3,7,8]

**Global economic health.** Armed conflict (and the threat thereof) gave investors pause in the quarter. The Islamic State's takeover of some of Iraq raised worries about oil exports from that country being disrupted; some interpreted Russian troops hovering on the border of Ukraine as a prelude to invasion and possible interruption of natural gas delivery to the eurozone. While these fears exerted pressure on natural gas and oil prices in the quarter, there were no systemic shocks. Most of Iraq's current oil output occurs south of the present combat zone, and Russian natural gas deliveries to the euro area through pipelines in Ukraine were not slowed (though Gazprom, the giant Russian energy supplier, cut 100% of its natgas supply to Ukraine in mid-June).[9,10]

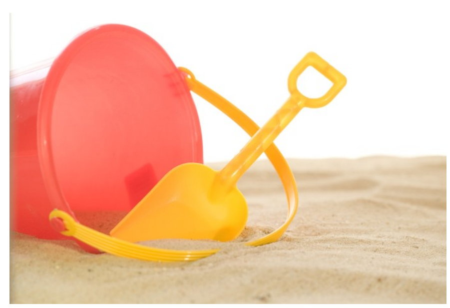
The eurozone factory sector was expanding, but its lack of inflation was worrisome for the European Central Bank. During the quarter, the Markit manufacturing PMI for the eurozone averaged 52.4. Any reading above 50 means sector growth, but the Q1 average was 53.4. Just as factory activity slowed a bit for the whole eurozone in the quarter, Markit manufacturing PMIs for Germany, Austria, and the Netherlands also signaled the pace of expansion slackening. In France, the factory sector contracted in the quarter. The eurozone unemployment rate was 11.6% as of May. The ECB actually cut its deposit rate to -0.10% in the quarter, in light of the fact that annualized eurozone inflation was merely 0.5% by June.[11,12]

Now as for China, its manufacturing PMIs went back into positive territory in the quarter – the PRC's official PMI was 50.8 in May and 51.0 in June, while Markit's PMI improved from 49.4 to 50.7 in those months. Analysts polled by Reuters, however, forecast China's annualized GDP at 7.3% for Q2 and for 2014; that would be a 24-year low.[13]

**World markets.** What was the top Q2 performer among major world stock indices? That honor goes to the Sensex. India's benchmark went +13.52% for the quarter. If you include the minor indices, Argentina's MERVAL takes first place at +23.75%. Very few indices lost ground in Q2, as the following 3-month performance numbers bear out: Global Dow, +4.06%; Asia Dow, +6.64%; Europe Dow, +0.04%; STOXX 600, +2.26%; Shanghai Composite, +0.74%; Hang Seng, +4.69%; Nikkei 225, 2.25%; KSE 100, +9.18%; KOSPI, +0.84%; CAC 40, +0.71%; DAX, +2.90%; ISEQ, -5.91%; FTSE MIB, -1.88%; RTS, +11.42%; FTSE 100, +2.21%; Bovespa, +5.46%; IPC All-Share, +5.62; TSX Composite, +5.66%. The MSCI World Index rose 4.15% for Q2, while the MSCI Emerging Markets Index posted a 5.64% Q2 gain.[1,14]

**Commodities markets.** The comeback of gold continued as futures rose 3.0% on the COMEX in the quarter. COMEX silver climbed 6.6% in three months, and platinum 4.4%; palladium set the pace among precious metals by rising 8.5% in Q2 (putting it up 17.4% for the year). As for the dollar, it wasn't quite as fortunate: the U.S. Dollar Index went -0.40% in the quarter.[15,16]

NYMEX crude rose 3.7% for Q2, spiking in June but then falling at quarter's end as fears of supply disruptions in Iraq eased. Natural gas futures went +2.1% in Q2 while heating oil futures went +1.4% and unleaded gasoline futures +5.4%. In ag futures, corn had a bad quarter with prices dropping 15%. Year-to-date, Arabica coffee and lean hog futures were both up 55% at the end of Q2; a drought in Brazil had affected coffee prices, and a virus had thinned America's hog herd. The Thomson Reuters/CRB Commodity Index ended Q2 up 10% YTD.[17,18,19]



**Real estate.** Fortunately, the housing market heated up again with the arrival of warmer weather. Existing home sales rose 1.5% in April, and then another 4.9% in May – and in addition, the National Association of Realtors found pending home sales rising 0.3% and 6.1% in those successive months. The Census Bureau reported a 3.7% rise in new home buying in April, then an 18.6% jump for May.[3,20]

True, existing homes weren't quite moving like they had a year ago: NAR had the pace of resales down 5.0% year-over-year. Both housing starts (1.071M to 1.001M) and building permits (1.06M to 991K) logged April-to-May declines. On the bright side, home prices – as measured across 20 metro areas by the S&P/

Case-Shiller monthly index – had increased 1.1% in April and 10.8% in 12 months, and the pace of new home sales reached a 6-year peak in May.[3,21]

Another factor aided the real estate market: cheaper mortgages. Looking at Freddie Mac's March 27 and June 26 Primary Mortgage Market Surveys, you see some pronounced declines for average interest rates on home loans. By the June 26 survey, the average rate on the 30-year fixed had dropped 0.26% to 4.14%. The average rate on the refinancer's tool of choice, the 15-year FRM, had fallen 0.20% to 3.22%. The average interest rate on the 5/1-year ARM sank from 3.10% to 2.98%. Interest rates for 1-year ARMs averaged 2.44% in the March 27 survey and 2.40% in the June 26 survey.[22]

**Looking back … looking forward.** Q2 was the sixth winning quarter in a row for the S&P 500. (Only once in the past 50 years has it had seven straight winning quarters.) The Russell 2000 notched its eighth straight winning quarter (a new record) with a gain of 1.70%. As for the CBOE VIX, it ended Q2 down at 11.57, going -16.64% in Q2. At the close on June 30, the S&P was at 1,960.23, the DJIA at 16,826.60, the NASDAQ at 4,408.18 and the RUT at 1,192.96. Look at how the S&P is outperforming the Dow this year.[1,23]

| **% CHANGE** | **YTD** | **Q2 CHG** | **1-YR CHG** | **10-YR AVG** |
|---|---|---|---|---|
| DJIA | +1.51 | +2.24 | +12.36 | +6.12 |
| NASDAQ | +5.54 | +4.98 | +28.35 | +11.53 |
| S&P 500 | +6.05 | +4.69 | +21.38 | +7.18 |
| **REAL YIELD** | **6/30 RATE** | **1 YR AGO** | **5 YRS AGO** | **10 YRS AGO** |
| 10 YR TIPS | 0.27% | 0.48% | 1.78% | 2.10% |

Sources: online.wsj.com, bigcharts.com, treasury.gov – 6/30/14[1,24,25]
Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.
These returns do not include dividends.

The major geopolitical crises of 2014 (the tensions between Ukraine and Russia, the Islamic State's take-over of parts of Iraq and Syria) have had no profound effect on Wall Street. While volatility hasn't been absent from the market, we haven't seen much of it of late. Investors seem more preoccupied with what the Fed might do over the next 6-12 months.

The possibility of sudden crises aside, the feeling persists that a return to equilibrium in central bank policy might rein in the bull more than anything else. As QE3 presumably has a few more months to go and as an interest rate hike seems at least a couple of quarters away, Q3 might amount to relatively smooth sailing on Wall Street – and decent earnings and solid economic indicators might provide a little more of a tailwind for stocks.

In the first part of October, we'll provide a handy review of markets and economic developments in Q3. Please feel free to call or email between now and then.

Sincerely yours,
Lars Knudsen, Dan Stober and Randy Williams-Gurian

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The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. It is not possible to invest directly in an index. NYSE Group, Inc. (NYSE:NYX) operates two securities exchanges: the New York Stock Exchange (the "NYSE") and NYSE Arca (formerly known as the Archipelago Exchange, or ArcaEx®, and the Pacific Exchange). NYSE Group is a leading provider of securities listing, trading and market data products and services. The New York Mercantile Exchange, Inc. (NYMEX) is the world's largest physical commodity futures exchange and the preeminent trading forum for energy and precious metals, with trading conducted through two divisions – the NYMEX Division, home to the energy, platinum, and palladium markets, and the COMEX Division, on which all other metals trade. The price-weighted MERVAL Index (MERcado de VALores, literally Stock Exchange) is the most important index of the Buenos Aires Stock Exchange. The Bovespa Index is a gross total return index weighted by traded volume & is comprised of the most liquid stocks traded on the Sao Paulo Stock Exchange. The Mexican IPC index (Indice de Precios y Cotizaciones) is a capitalization-weighted index of the leading stocks traded on the Mexican Stock Exchange. The S&P/TSX Composite Index is an index of the stock (equity) prices of the largest companies on the Toronto Stock Exchange (TSX) as measured by market capitalization. Nikkei 225 (Ticker: ^N225) is a stock market index for the Tokyo Stock Exchange (TSE). The Nikkei average is the most watched index of Asian stocks. The SSE Composite Index is an index of all stocks (A and B shares) that are traded at the Shanghai Stock Exchange. The Hang Seng Index is a freefloat-adjusted market capitalization-weighted stock market index that is the main indicator of the overall market performance in Hong Kong. The KOSPI Index is a capitalization-weighted index of all common shares on the Korean Stock Exchanges. The Asia Dow measures the Asia equity markets by tracking 30 leading blue-chip companies in the region. The IDX Composite or Jakarta Composite Index is an index of all stocks that are traded on the Indonesia Stock Exchange (IDX). The main Philippines Stock Exchange index is the PSE Composite Index, which is composed of thirty (30) listed companies. Karachi Stock Exchange 100 Index (KSE-100 Index) is a stock index acting as a benchmark to compare prices on the Karachi Stock Exchange (KSE) over a period. BSE Sensex or Bombay Stock Exchange Sensitivity Index is a value-weighted index composed of 30 stocks that started January 1, 1986. The ISEQ Overall Index is a capitalization-weighted index of all official list equities in the Irish Stock Exchange, excluding U.K.-registered companies. The FTSE MIB (Milano Italia Borsa) is the benchmark stock market index for the Borsa Italiana, the Italian national stock exchange. The DAX 30 is a Blue Chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange. The CAC-40 Index is a narrow-based, modified capitalization-weighted index of 40 companies listed on the Paris Bourse. The Dow Jones STOXX 600 Index captures more than 90% of the aggregate market cap of European-based companies. The Europe Dow measures the European equity markets by tracking 30 leading blue-chip companies in the region. The FTSE 100 Index is a share index of the 100 most highly capitalized companies listed on the London Stock Exchange. The MSCI World Index is a free-float weighted equity index that includes developed world markets, and does not include emerging markets. The MSCI Emerging Markets Index is a float-adjusted market capitalization index consisting of indices in more than 25 emerging economies. The Global Dow (GDOW) is a 150-stock index of corporations from around the world, created by Dow Jones & Company. The US Dollar Index measures the performance of the U.S. dollar against a basket of six currencies. Additional risks are associated with international investing, such as currency fluctuations, political and economic instability and differences in accounting standards. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. Past performance is no guarantee of future results. Investments will fluctuate and when redeemed may be worth more or less than when originally invested. All information is believed to be from reliable sources; however we make no representation as to its completeness or accuracy. All economic and performance data is historical and not indicative of future results. Market indices discussed are unmanaged. Investors cannot invest in unmanaged indices. The publisher is not engaged in rendering legal, accounting or other professional services. If assistance is needed, the reader is advised to engage the services of a competent professional.

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