# Economic & Market Commentary

The biggest surprise for investors so far this year has to be the performance of the bond market. The 10 year Treasury ended 2013 yielding 3.03%, and there was unanimity that rates were headed higher in 2014. This turned out to be wrong and that same bond ended June at 2.50%, leading to a positive return for the major bond indices. Long Treasuries were the stars, easily trouncing most asset classes, including stocks. The equity side had its surprises as well. Volatility of stocks (as well as bonds and currencies) is very low. The Wall Street Journal recently pointed out that the S&P500 had gone 51 sessions in a row without a move (up or down) of 1%. This has been the longest period since 1995, and the VIX (a statistical measure of equity volatility) is at its lowest level since 2007. In addition, the best performing sector of the equity market for the 6 months (and second best for the quarter) was utilities, a group that virtually no one had on their radar screen at the beginning of the year. In spite of these factors stocks continued to grind their way higher, and produced a respectable return for both the quarter and first half.

Once again, the US was the best geography for equity investors, and this was true for both periods. Large cap did better than small cap for both periods, and value and growth were very close for both. Low quality continued to outpace high quality by a substantial margin, which reflects the increased appetite for risk that has occurred. Energy stocks reversed their laggard behavior of the first quarter to become the top performing sector in the second and utilities continued their surprising strength to more than double the index return for the first half. In spite of a decent second quarter, only three of the ten S&P sectors did better than the index, while five of the ten did so for the full six months. Disappointingly two of our overweights, industrials and financials, were not among the better performing sectors for either period.

The coincidence of stellar performance from bonds and utility stocks can be read as having implications for the economy. When combined with the dreadful first quarter final GDP report (-2.9% annualized real) it calls into question the expected performance of the US economy for the year. Those who expected a more robust economic performance in 2014 compared with the recent +2% rate since 2009 (including us) have got to be rethinking their assumptions. The final revision of the first quarter's economic performance – a 2.9% annualized contraction – was among the worst of the post war era, and the only one of its size that did not occur during a recession (according to the NBER's Business Cycle Dating Committee). Even with robust growth for the balance of the year the arithmetic of the economic equation makes it difficult to have a full year of +3% or higher. Many of the economic prognosticators (Federal Reserve, World Bank, OECD, etc) have taken down their forecasts for US and world growth for the year. The National Association for Business Economics released their most recent survey and found that economists expected growth of 3% for the second quarter, down from 3.5% in the prior survey, and +1.6% for the year down from +2.5%. While we recognize the difficulty of the GDP arithmetic, and were surprised by the depth of the first quarter's decline, we are not yet ready to throw in the towel on our expectations. First of all we all recognize that the earlier period was highly unusual (weather, etc.), and is now history. So, Q1 is water under the bridge. What is more important is the pace of growth during the next several quarters. If it is good, say in the +3 – 3.5% range we can have an environment much as we had expected. We discussed our reasoning in our last quarterly outlook, and most of the points made are still valid. Reduced fiscal drag (remember fiscal austerity trimmed at least 1% off growth over the past several years), continued good job growth, lapping the 2013 tax hike, and a consumer that continues to spend should allow for a good rebound. Personal consumption expenditures and income have diminished over the past 10-15 years, but are still increasing in the 2% area. Job growth has been good recently which should impact incomes. Household net worth has increased about $25 trillion since 2009 (about 80% of that is from financial assets). These factors should leave the US consumer room to keep spending.

The fly in the ointment, as we look ahead, has been the muted recovery in capital expenditures. We had expected business spending to be an important ingredient in the economic recovery. So far, it has been less than robust. This was discussed, at some length, in our last outlook, and the points made are still valid. Our capital stock is old, capacity utilization is increasing, corporate balance sheets are laden with cash, the economy is growing providing demand pull for spending, yet expenditures are stalled. The missing ingredient seems to be confidence. As we said last time confidence is an elusive quality to measure, and we don't have an answer for building it. However, we think that if we continue on our current path, eventually business will be compelled to spend, as capacity use will tighten, and the returns on capital are high while the cost of capital is low. So, we are not inclined to alter our view at this point, but rather to watch carefully as the next couple of quarters unfold.

This has also been a tough environment for stock pickers. A grinding and slow market with low volatility has resulted in a compression of valuations. The Wall Street Journal pointed out that the difference in performance between the best and worst decile of stocks in the S&P500 had shrunk to 14.4 percentage points, the lowest level since data has been collected going back to 1990.

This has frustrated what many thought would finally be a stock picker's delight. Stock prices would cease being driven by domestic and/or global macro events, and respond to their own specific fundamentals. While individual company fundamentals have become important drivers of prices, being right has been minimally rewarded, and being wrong has been severely penalized. This has resulted in low performance dispersion, where the amount by which winners can win is small. Everything seems to be selling at 16-17 times earnings, making it difficult to find unusual value. With the aggregate market selling at that multiple as well, it is neither cheap nor expensive. As we wrote earlier, the economy is growing, and profits are increasing as well, although there is no question that profit growth will be harder to come by in the future. So, there still is money to be made from stocks.

Our recent portfolio strategy has been built on three legs. First is our constant search for good, profitable and growing businesses that we think are undervalued. This, of course, pervades the whole portfolio. These would include such holdings as Merck, Microsoft and Marsh & McLennan. Second, we try to find those businesses in economic sectors that will particularly benefit from our top down view. These would include our holdings in the industrial, and technology areas along with many financials. Finally we try to find businesses that will benefit from something unusual going on internally, where the macro environment will have less influence on their economic performance. This often includes companies undergoing restructuring, capital reallocation and/or management changes, often involving outside activists. These are often referred to as "self help" situations. Examples here include AIG, Baxter International, and Avery Dennison. Because of the compression in valuations mentioned earlier it has become harder to find ideas in the first two areas, and our recent efforts have focused on the last.

Fortunately, there is enough going on in corporate America to provide a wide range of choices in the "self help" area. Merger and acquisition activity during the first half was almost back to pre-crisis levels. With corporate balance sheets cash rich and the cost of capital low we would expect this to continue. Dividend increases and share repurchase announcements are a daily occurrence. Barron's pointed out that this year's dividend increases outnumbered last year's by 15.6%. Restructuring, spin offs, and other forms of business rationalization are frequent. We have already had a handful of these in our portfolio, and will probably have more. Finally, and importantly, activists are active. Large shareholders, and private equity firms are rattling the cages of many underperforming corporations, leading management to rethink strategy and take the action described. In a compressed market of stocks, we find this to be a fertile area to look for opportunities. We anticipate this continuing through the year, and are focusing on it.

# Fixed Income Review and Outlook

As written at the outset, the consensus at year end was that interest rates would rise throughout 2014. So far, the consensus has been wrong, giving rise to the major surprise of the first half. So, why have rates rallied this year? Certainly the large decline in GDP for the first quarter, and the geopolitical concerns (Ukraine and Middle East) all played a role. The European situation has also been a key ingredient. In July 2012, European Central Bank President Mario Draghi vowed to do “whatever it took” to preserve the Euro and get the economy going. Since then, CPI in the Eurozone has fallen from over 2% to 0.5%, GDP has not exceeded 1%, and sovereign rates have fallen. On June 30, the yield on the 10 Year German Bund was 1.25%. For contrast, the US Treasury note yielded 2.53%. This 1.28% spread represented one of the largest differences between the two bonds in five years. From a relative value standpoint, investors would rather own the US Treasury over Bunds. We’d argue that we won’t see a sizable increase in Treasury yields until European rates start to rise.

Of course the actions of the Federal Reserve are also crucial to determining the path of interest rates. The minutes of the June Federal Reserve meeting confirmed the Fed governors’ intentions to end QE3 following the October 2014 meeting. While the Fed will not be actively buying Treasuries and Mortgages in the open market to provide stimulus, it will continue to reinvest coupon payments and mortgage prepayments in these securities. The market’s attention will now turn to the debate about when the Fed will start to raise the Fed Funds rate target. At her press conference following the March 19 Fed meeting, Fed Chair Janet Yellen speculated that the Fed could start raising rates after a considerable time or “on the order of around six months, that type of thing” following the end of QE3 bringing the first move to the first or second quarter of 2015. That comment set off a frenzy of bond activity as the market had priced in the first move for late 2015 or even early 2016. At quarter end, Fed Funds futures contracts were reflecting an initial tightening in September or October of next year. With GDP growth expected to rebound during the remainder of the year and inflation trending towards the Fed’s 2.0% target, we will focus on wage inflation pressures which could cause the Fed to move sooner or more aggressively than expected.

With this as background the Barclays Aggregate Bond Index returned 2.04% in the second quarter and 3.93% for the year to date. All major bond sectors posted positive returns for both periods. With the yield curve steep, longer maturity securities significantly outpaced shorter maturities. Treasuries and Agencies performed about equally, lagging the overall index, as the Treasury curve continued to flatten during the quarter, mortgages were better performers, benefiting from the drop in volatility and the slight slowdown in housing activity inducing a shortage of mortgage paper. The star of the year so far has been investment grade corporates.

In the environment described we are maintaining portfolio duration between 85% and 90% of the benchmark with a bias towards intermediate maturity Treasuries. This is in anticipation of short term rates moving up more than intermediate and longer term rates. We continue to use a barbell strategy that has us holding more cash equivalents and intermediate bonds in order to maintain a shorter duration though with curve exposure less dependent on the two and three year bucket. A consequence of this strategy is slightly higher yields to the overall portfolios since the curve is still very steep. While we expect rates to trend higher for the remainder of the year, we do not expect volatile moves like that experienced last year for the reasons discussed above. As mentioned earlier, the volatility of bonds, as well as stocks, has diminished significantly over the past 6 months. Volatility influences the price of any bond with an embedded option like a call. Think of a callable bond price as having two pieces: the price of bullet security (a bond with a pre-determined final maturity date) and the price of the call option which is deducted from the bullet price. As the investor, you are essentially selling the issuer the option to call the bond away from you. That option shows up as a discount to the bullet price. Low volatility decreases the discount the issuer pays and increases the price that the investor pays. We'd look for a rise in volatility before increasing our holdings in callable bonds.

We are continuing to add bullet agencies with less than one year to maturity as a highly liquid cash equivalent in order to generate a small yield advantage over that available in short Treasuries.

Our strategy with respect to corporates has not changed since the first quarter. With the spread over Treasuries back to pre-crisis levels we've reduced the holdings that didn't offer enough yield to compensate for owning the bond. In light of the strong mergers and acquisitions movement in the market we are looking to buy bonds that offer us the opportunity to put the bond back to an issuer at more than par, if the issuer is purchased and subsequently downgraded to below investment grade. Ideally, we can buy the bonds below that to benefit from both coupon and positive price action. We continue to prefer credits with the ability to raise prices or those engaged in ongoing balance sheet repair. And, as always, we tend to avoid those companies that issue debt in order to pay dividends or buy back shares.

Finally, we are not looking to add Mortgage Backed Securities. We see better value in Collateralized Mortgage Obligations (CMOs) that are carved from Fannie Mae and Ginnie Mae mortgages. We like structured paper priced below par that is designed to not get significantly more interest rate sensitive in the face of rising interest rates. Plain vanilla MBS can do just that, extend (get more interest rate sensitive) as rates are going up. By purchasing bonds below par, our client portfolios benefit from faster prepayments, as we get $100 back faster for a bond for which we paid less than $100.