Review & Outlook

FIRST QUARTER 2014

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Review

Despite a considerable number of disturbing headlines in 2013, the stock market did exceptionally well. During the first quarter of 2014, however, that trend reversed itself, with a more volatile stock market in the face of more positive economic news. In late March, the Wall Street Journal noted that GDP growth in the fourth quarter of 2013 was revised upward from 2.4% to 2.6%, and reported that, "The solid pace of growth in the waning months of 2013…showed an economy that entered the New Year with fresh momentum."[1] Then again, the WSJ also noted that the revision to GDP growth was almost exclusively due to more spending in healthcare, and suggested that the momentum in the economy was somewhat tenuous. This seems an appropriate sentiment when reviewing the market's performance for the first quarter of 2014.

Emotional investors caused some notable swings in performance across market sectors during the first quarter of 2014. Utilities, a disappointing underperformer for all of 2013, surged ahead in 2014. Meanwhile, the Consumer Cyclical sector stumbled in 2014, after a strong 2013. Small and mid-cap stocks significantly outperformed large cap stocks during the first two months of the year, then lagged following Russia's incursion into Crimea, only to pull sharply ahead for the last two trading days of the quarter. Confident investors tend to favor small and mid-cap stocks, so the constant swings in performance for those two sectors during the quarter illustrates just how unsure people were about where to put their money. The S&P 500 index had a modest return of 1.81% (including dividends) for the quarter.

Many bond funds with negative yields in 2013 had small positive gains in early 2014. The improved performance in this area can most likely be attributed to geopolitical tensions, and declining anxiety about the Fed reducing its bond purchases (the great "tapering"). Barclay's Short-Term Government Debt index increased 0.04% in the first quarter, and Barclay's Intermediate-Term Government/Credit Bond index, which was volatile during the quarter, ended at 1.00%. We think the volatility and relatively poor performance for bond indexes will continue through 2014, and beyond. We expect tapering to continue, but think that interest rates could stay low for quite some time, as we do not see enough economic factors at play to allow the Federal Reserve to increase rates in the short-term.

Outlook

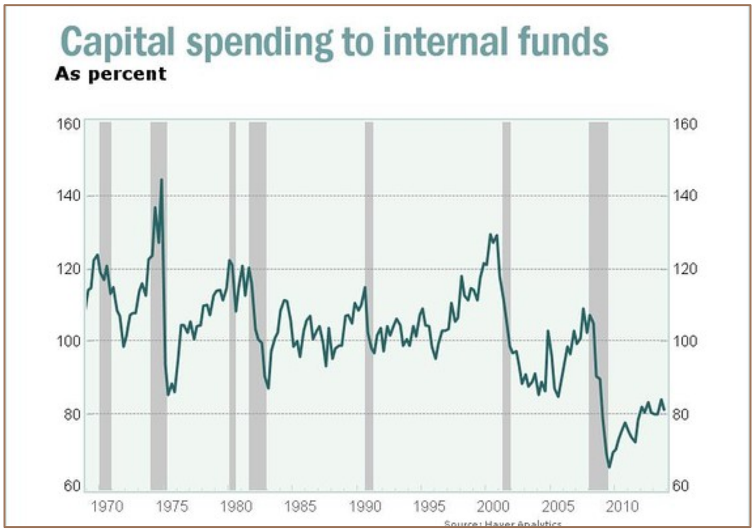
We have identified two factors that may portend slower economic growth: changing employment patterns, and capital spending trends. While what follows may sound like a dour forecast, we would like to note that the possibility of slow growth does not imply disaster.

> *"As employment patterns shift to accommodate new efficiencies, corporations do not appear to be reinvesting in capital as they have in the past"*

Our Review and Outlook for the third quarter of 2013 discussed how the labor market has struggled for the past 14 years. We are able to produce more goods and services with fewer workers than in the past. We also have workers who are trained for jobs that have changed significantly, or that don't exist at all anymore. While US unemployment rates are falling, the labor market is likely to continue to struggle until it can accommodate the economy's need for workers with a higher skill level. This may result in a negative impact on consumer spending.

As employment patterns shift to accommodate new efficiencies, corporations do not appear to be reinvesting in capital as they have in the past. Figure 1 shows the low level of capital spending relative to cash flow after the recession of 2001, and even less spending in recent years.

Figure 1: Capital Spending



This business cycle since the end of the 2008 recession is the first in which the 'capital spending-to-cash flow' ratio did not rise above 100% for a single quarter. But this could also be a result of improved cash flows. Corporate earnings have been good, and stock prices have been moving up. The ratio of capital spending to cash flow may be below average because cash flows are up, not just because capital spending is down. Of course, this theory is small comfort to the long-term unemployed.

As long as business investment and labor demand are down, we believe interest rates and inflation will remain low. It will take time for consumers, with less income in a weak labor market, to increase their spending in a way that will make businesses want to invest capital. It is a difficult cycle, and uncertainty due to geopolitical unrest abroad, and political gridlock at home, only makes business investment more difficult.

In Focus

A third factor, consumer demographics, also suggests a period of slower growth. Baby-boomers are past their peak spending years, and the next age group, Generation X, is much smaller. Consumer spending is likely to be lower until Generation Y (or the Millennials) enters their peak spending years. At the same time, there are many reasons to question the belief that consumer spending will decline as baby-boomers retire. It isn't clear what retirement really means for that generation, or when they will actually do it. We also can't know what will happen as boomers transfer wealth to Generations X and Y. Or what it will mean for corporate spending and earnings when smaller age groups in developed countries are offset by larger identical groups in other countries.

Figure 2: Consumer Demographics

Traditionalists	Born 1925 - 1945	44 Million
Baby Boomers	Born 1946 - 1964	80 Million
Generation X	Born 1965 – 1980	46 Million
Generation Y/Millennials	Born 1981 - 2006	92 Million

Economic and demographic conditions seem to point towards a period of slow growth. But that is not necessarily a bad forecast for the economy. Slow economic growth that is predictable, and allows equity prices to grow at a reasonable pace, is better than many alternatives. While we worry about short-term volatility, and have questions about the Federal Reserve's ability to "unwind" the stimulus of the past several years, we are not particularly fearful of a slow growing economy.

1. Figure 1 & Quote: Bartash, Jeffry. "U.S. fourth-quarter GDP nudged up to 2.6%". *MarketWatch, The Wall Street Journal.* Web. March 27, 2014.
   Note: Gray bars indicate recessions in Figure 1.
2. Figure 2: Trowner, Cathy A. "Traditionalists, Boomers, Xers, and Millenials: Giving and Getting the Mentoring You Want". Slide from Presentation. Mentoring Luncheon, Brown University. October 16, 2009.