

QUARTERLY ECONOMIC UPDATE

A review of 1Q 2014

QUOTE OF THE QUARTER

“If there is no struggle, there is no progress.”

– *Frederick Douglass*

QUARTERLY TIP

Given the choice between a great lifestyle today and financial freedom tomorrow, many people opt to live for today – but no one becomes wealthy by spending or living on margin. Living below your means is a principle of wealth building, and over time it separates the truly wealthy from those who merely look rich.

THE QUARTER IN BRIEF

Bulls didn't quite trample bears in the opening quarter of 2014. The S&P 500 slid 3.56% in January, advanced 4.31% in February and gained another 0.69% in March. Still, Q1 ended with the Dow in the red YTD and only minor YTD gains for the Nasdaq, S&P and Russell 2000; the broad commodities market outperformed the stock market. Some fundamental economic indicators were unimpressive during the quarter, and analysts wondered if a ferocious winter was partly to blame. The Federal Reserve kept tapering QE3 as Ben Bernanke handed the reins to Janet Yellen. Unrest and currency problems hit some key emerging-market economies. Home prices kept rising as home sales leveled off. Wall Street hoped the year wouldn't mimic the quarter.¹

DOMESTIC ECONOMIC HEALTH

The quarter ended with a major jump in consumer confidence. The Conference Board's index reached 82.3 in March, up 4.0 points in a month. Consumer spending improved too, rising 0.2% in January and 0.3% in February. (In a contrasting note, the University of Michigan's consumer sentiment index slipped 2.5 points across the quarter to a final March mark of 80.0.)^{2,3}

Manufacturing and service sectors continued to expand, according to the Institute for Supply Management. ISM's manufacturing PMI rose in each month of the quarter (51.3 to 53.2 to 53.7). Its non-manufacturing PMI rollercoasted from January to March (54.0 to 51.6 to 53.1). Overall durable goods orders picked up 2.2% in February after a 1.3% pullback for January.^{2,4,5}

Unemployment was at 6.6% in January, 6.7% in February. By February, the good news was that the jobless rate was down a full percent from a year before; the bad news was that 37% of jobseekers had been out of work for at least 27 weeks.⁶

The federal government's Consumer and Producer Price Indexes recorded little inflation. Wholesale prices retreated 0.1% in February after rising 0.2% for January, and by February the headline PPI had only increased 0.9% in 12 months. Consumer prices rose 0.1% in both January and February, with the headline CPI up 1.1% annually. Speaking of consumers and prices, retail sales declined 0.6% in January but advanced 0.3% the next month.⁷

Janet Yellen kept things lively in her first month as chair of the Federal Reserve. At the press conference following the Federal Open Market Committee policy meeting on March 19, Yellen was asked how long the Fed might wait to raise the benchmark interest rate once QE3 was over. Her response contained the ballpark guess “around six months” – which led to raised eyebrows and a few minutes of rampant selling on Wall Street. Stocks turned north quickly before the trading day ended, though. On March 31, Yellen issued a dovish remark that sparked a rally, noting that the central bank's stimulus “is still needed and will be for some time.” Across Q1, the Fed trimmed its monthly asset purchases from \$85 billion to \$55 billion.⁸

GLOBAL ECONOMIC HEALTH

March brought a major geopolitical event – Russia's annexation of the Autonomous Republic of Crimea, formerly part of Ukraine. At month's end, roughly 40,000 Russian troops were massed at Ukraine's borders, suggesting the possibility of a takeover. As the U.S. and other western nations issued economic sanctions against Russia, the crisis affected wheat and natural gas prices in particular. February brought a short-term exodus of capital from the economies of South Africa, Turkey, Brazil, India and Indonesia when the average implied volatility of their currencies touched 3-month lows.^{9,10}

Word came during February that the eurozone's recession was over: eurozone GDP was +0.3% in Q4 2013 after four straight negative quarters. Germany saw 0.4% growth in Q4, France 0.3% growth. Eurozone annualized inflation was 0.8% in January, 0.7% in February and 0.5% in March, nowhere near the European Central Bank's 2.0% target.^{11,12}

Euro area unemployment was still up at 11.9% in February, but there was a bright spot – the jobless rate fell in each month of the quarter in Germany. The eurozone's Markit PMI was at 54.0 in January, 53.2 in February and 53.0 in March.¹³

China's factory sector revved down, and that led some economists to wonder if the PRC might resort to a stimulus to keep growth at its 7.5% target. The HSBC manufacturing PMI for China was below 50 all quarter, and the March reading of 48.0 was an 8-month low. Even China's official PMI reading was only at 50.3 by March. A stimulus might also be in order in Japan - its manufacturing PMI fell 1.6% in March, and industrial production slipped 2.3% in February.^{14,15}

WORLD MARKETS

Performances were definitely mixed in Q1. In the Americas, the Merval went +18.23%, the Bovespa -2.12%, the IPC All-Share -5.30% and the TSX Composite +5.24%. In the Asia Pacific region, the Nikkei 225 lost 8.98%, the Shanghai Composite 3.91%, the Hang Seng 4.96% and the Kospi 1.28%; the Asia Dow rose 0.39%, the Jakarta Composite 11.56%, the PSE Composite 9.15%, the KSE 100 7.52% and the Sensex 5.74%. As for Europe, Ireland's ISEQ gained 10.04%, Italy's FTSE MIB 14.36%, the DAX just 0.04%, the CAC 40 2.22%, the DJ STOXX 600 1.84% and the Europe Dow 3.22%; the FTSE 100 lost 2.23%. The MSCI World Index rose 0.77% in Q1 while the MSCI Emerging Markets Index slipped 0.80%; the Global Dow advanced 0.74%.^{16,17}

COMMODITIES MARKETS

Even with a fall of 2.9% in March, gold gained 6.8% on the quarter, settling at \$1,274.70 on the COMEX on March 31. COMEX silver closed Q1 at \$19.75 after a 2.0% rise in three months. Platinum rose 3.4% in Q1, palladium 8.2%. The U.S. Dollar Index, on the other hand, gained but 0.07% in three months.^{18,19}

Commodities on the whole looked very good in Q1: the Thomson Reuters/Core Commodity CRB Index advanced 8.7%. Coming in first out of its 19 futures: Arabica coffee, up 61% in three months on Brazil's record drought. Lean hog futures were up 48% in the quarter on fears of a porcine virus spreading in the U.S.; corn futures rose 19% in Q1, wheat futures 15% and soybean futures 11%. NYMEX crude gained 3.2% for the quarter and unleaded gasoline rose 4.5%; ethanol futures soared 81%, a new quarterly record.^{20,21,22}

REAL ESTATE

Homes weren't moving like they had in 2013. Sale prices were higher (an effect of tighter inventory), but higher prices were discouraging some potential buyers. Add brutal weather to all this, and the numbers weren't good. The National Association of Realtors reported a 5.1% decline in existing home sales for January followed by a 0.4% dip in February; by the latter month, resales were down 7.1% year-over-year. Pending home sales, NAR said, were down 0.2% in January and 0.8% in February. When January's S&P/Case-Shiller Home Price Index came out in March, it showed a 13.2% yearly increase (considering prices across 20 metro markets).^{2,23}

The Census Bureau initially noted a 9.6% improvement in new home sales for January, but then it revised that gain (way) down to 3.2%. The advance was tempered by a 3.3% February retreat.²⁴

Unsurprisingly, the Census Bureau said groundbreaking decreased 11.2% during January (its revised, final estimate) and another 0.2% in February. Building permits decreased (a revised) 4.6% in January, then rebounded 7.7% the next month.⁷

Interest rates on longer-term home loans descended during the quarter. Freddie Mac's Primary Mortgage Market Survey had the average interest rate on the 30-year FRM at 4.40% on March 27, compared to 4.53% on January 2. The average rate on the 15-year FRM declined from 3.55% to 3.42% in that interval. While the average interest rate for the 5/1-year ARM rose 0.05% to 3.10% across the same period, the average rate on the 1-year ARM declined 0.12% to 2.44%.²⁵

LOOKING BACK...LOOKING FORWARD

The Q1 scorecard reveals a rather humdrum performance for U.S. equities. The Russell 2000 rose 0.81% for the quarter, the CBOE VIX 1.17%. An exception: the NYSE Arca Biotechnology Index climbed 10.98% in three months.¹⁶

% CHANGE	Q1 CHG	Q4 CHG	1-YR CHG	10-YR AVG
DJIA	-0.72	+9.56	+12.93	+5.89
NASDAQ	+0.54	+10.74	+29.63	+11.06
S&P 500	+1.30	+9.92	+19.86	+6.63
REAL YIELD	3/31 RATE	1 YR AGO	5 YRS AGO	10 YRS AGO
10 YR TIPS	0.60%	-0.65%	1.43%	1.48%

Sources: online.wsj.com, bigcharts.com, treasury.gov - 3/31/14^{16,26,27,28}
 Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.
 These returns do not include dividends.

At the start of 2014, analysts figured a plateau was ahead for the market this year. So far, stocks are doing little to prove them wrong. The S&P 500 can't gain nearly 30% every year, and already some are worried about a bubble. Maybe this statistic will offer some reassurance: at the end of March, fewer than 4% of industries making up the S&P's market value have conventional P-E ratios higher than 30 (about two times the historical average). Just before the dot-bomb of 2000, 70% did. April often proves to be a strong month for equities, and fundamentals seem acceptable right now. If (as Janet Yellen and other economists speculate) the weather hindered America's economy in January and February, March and April indicators might surprise to the upside more than the bears think. Even if the upcoming earnings season is mediocre, stocks might have enough momentum to move slightly higher off of those improved indicators. If geopolitical developments don't cause Wall Street to think twice, spring might bring some nice gains and Q2 might be much more encouraging for the investor.²⁹

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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. 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