PINNACLE Capital Management, LLC

April, 2014 COMMENTARY

The first quarter of 2014 looked nothing like 2013. Whereas stocks as measured by the S&P 500 appreciated over 30% for 2013 stocks "only" returned 1.79% in 2014's first quarter. Not exactly a home run, but not bad for the sixth year of a bull market. In reviewing the quarter we came up with three significant factors affecting investments: 1) the actions of the Federal Reserve, 2) the events taking place in the Ukraine and Russia, and 3) the continued slow but upward growth of the U.S. and global economy. Let's take them one at a time.

ECONOMIC STATISTICS					
	1st Qtr (3/31/14)	4th Qtr (12/31/13)	*% Change*	1 Yr Ago (3/31/13)	*% Change*
S&P 500 Index	1,872.34	1,848.36	*1.3%*	1,569.19	*19.3%*
10 Year Treasury Yield	2.72%	3.03%		1.85%	
Gold Spot ($ / oz)	$1,284.01	$1,205.65	*6.5%*	$1,596.82	*-19.6%*
WTI Crude Oil (next future)	$101.58	$98.42	*3.2%*	$97.23	*4.5%*
GDP Qtr / Qtr	N/A	2.6%		1.1%	
CPI Y / Y	1.1% (Feb)	1.5%		1.5%	
Unemployment Rate	6.7%	6.7%		7.5%	

What's all the Yellen about?

On October 9, 2013 President Obama announced that Janet Yellen would be his nominee to replace Ben Bernanke as Chair of the Federal Reserve. What was significant about this nomination is that she was considered a "dove" – that is, she'd be inclined to continue pumping money into the economy in the hope that this would stimulate job growth. The equity markets cheered her nomination and the S&P 500 appreciated by just over 6% by month end. The bond markets also reacted favorably at first with the 10 year Treasury yield falling by 11 basis points (11/100 of a percent) by month end. However, interest rates rose, peaking just at the beginning of 2014. It has turned out, on the other hand, that Yellen may not be as dovish as first thought. While the Chairwoman still intends to keep short term interest rates low, she has already reduced the Fed's purchases of longer term bonds. This "tapering", though not evidence of tight monetary policy, does represent a policy that is not as loose as it had been. Despite the tapering, interest rates have drifted lower in the first quarter. There are several causes for this, including events such as Russia's involvements in the Ukraine. Speaking of which…

The Russians are coming! The Russians are coming!

Perhaps the most significant event of the quarter in geopolitical terms was for the most part a yawner from an investment standpoint. The Ukraine is one of the former Soviet Socialist Republics that became an independent nation after the collapse of the Soviet Union. Since independence, the country has been aligned with Russia though it has from time to time leaned towards the West. Enticed by the European Union (EU), President Viktor Yanukovych agreed to a loan package in 2013 and moved closer to the West. The Russians objected to this shift and twisted Yanukovych's arm. He reneged on the EU loan, agreeing to a new package from Russia. Many Ukrainians, especially the young in Kiev, objected to Moscow's intervention and began protesting. As the government clamped down on protesters, violence erupted with approximately 100 dead. Yanukovych lost the support of his parliament and he fled the country on February 21. In a series of fast moving events, Russia seized the Crimea on March 6 and has continued to mass troops on the Ukrainian border.

The markets' reaction to this? For the most part, not much of any. Whereas in the past we've argued that the markets have overreacted to so-called crises, in this case, there was little reaction, if any. Between Yanukovych's flight from the country and Russia's annexation of the Crimea, the S&P 500 returned 2.1% – returning another 0.5% by quarter end. Ironically, in recent years the threat of nations such as Greece or Cyprus leaving the Euro caused more consternation than these recent events. This is just more evidence that suggests one should focus on the fundamentals and not try to time the market based on world events. But, since you asked about the economy…

A Tortoise, not a Hare

The economy continues to grow slowly, while job growth remains anemic. Specifically, GDP growth has averaged just below 2.4% since the recession ended, unemployment stands at 6.7%, and labor participation rates are near long time lows. We've heard it before and we'll likely hear it again. When the economy first emerged from the downturn in 2009, we expected acceleration would be not far off. But it's clear that this has not been the case. While this might be bad news for job seekers, we think this has actually been and will continue to be good news for investors.

Business cycles tend to end when too much money chases unsustainable profits resulting in excess capacity. Coupled with Fed tightening, the edifice eventually tumbles down. We saw this in 2000 when funds pouring into dot com companies reached excessive levels leading to a market crash. We certainly saw it in 2007 when over investment in real estate led to a global financial collapse. Today, investors are afraid of risk, government regulators are afraid of risk, banks are afraid of risk, and business people are afraid of risk. As a result, capacity investments remain muted. Growth remains steady and profit margins remain strong. What this means is that five years into an economic up cycle (long by historical standards), the usual signs of an economic top are not there. As a result, we can expect several more years of expansion and – we hope – several more years of profitable investments.

Of course, there are risks. One of the downsides of the slow growth is that the economy remains vulnerable to shocks. Perhaps Russia might threaten one of its neighbors. Oh wait, that already has happened! But still, escalation of the Ukrainian situation and threats to Europe's energy supplies are potential risks. Additionally, the lack of job growth can result in the stalling of final demand. Finally, attempts to rectify the low growth through the use of fiscal and monetary policy can end up causing more damage than good. Still, we have confidence that the economy will continue to grow. Stock market levels remain reasonable though an interim correction wouldn't surprise us. Interest rates are still too low with savers not compensated for the risk.

While not a perfect situation, we think the current environment can be very constructive for investors. It will not necessarily be easy. Individual stock picking will become more important for investors and it is probable that the upward path will be interrupted from time to time. Therefore, as always, it is essential to focus on long term goals. There are no shortcuts. The good news is that tortoise will likely win the race!