October, 2014

COMMENTARY

At the end of the third quarter we can best describe the state of the markets as one of unease. While equity returns were positive in the quarter, things look somewhat unsettled as we enter the fourth quarter. Volatility has increased as the pace of advances decelerated. Perhaps a recent Wall Street Journal headline says it best: "Global Anxiety Roils Markets".

ECONOMIC STATISTICS					
	3rd Qtr (9/30/14)	2nd Qtr (6/30/14)	*% Change*	1 Yr Ago (9/30/13)	*% Change*
S&P 500 Index	1,972.22	1,960.23	*0.6%*	1,681.55	*17.3%*
10 Year Treasury Yield	2.49%	2.53%		2.61%	
Gold Spot ($ / oz)	$1,208.16	$1,327.32	*-9.0%*	$1,328.94	*-9.1%*
WTI Crude Oil (next future)	$91.16	$105.37	*-13.5%*	$102.33	*-10.9%*
GDP Qtr / Qtr	N/A	4.6%		4.5%	
CPI Y / Y	1.7% (Aug)	2.1%		1.2%	
Unemployment Rate	5.9%	6.1%		7.2%	

In the face of this one of our colleagues asked, "Should I be worried"? Half jokingly we responded, "Of course you should." Why only half jokingly? Because although we're positive about the long-term, we can't deny that there are real world problems. So let us start by outlining the situation. We promise we'll do our best afterwards to bring our readers a feeling of confidence. But even if we fail in that endeavor, we hope that our readers will at least have an idea of what's currently spooking the markets

We see four major interrelated concerns: 1) regional economic weakness, 2) geopolitical turmoil, 3) monetary policy, and 4) currency issues. While we'll attempt to cover them one at a time, the discussions by necessity will overlap. Let's start with economic issues. First of all, the U.S. economy is progressing nicely. The real concerns involve the rest of the world, with Europe primarily in focus. The irony is that European weakness is nothing new. The equity and currency markets until recently have tended to treat the lack of a crisis situation as evidence of economic health. Now that even Germany is showing weakness, long running difficulties of the continental economies have come front and center.

In addition, Chinese growth is slowing down and there are concerns that many loans on the books of Chinese banks are not sound. While recognizing the bad loan issues, we point out that this is nothing new and even the pessimists are talking about 7% GDP growth. That's astonishingly high, in our opinion, for the world's second largest economy. It's below where it has been, but we still consider it to be a positive.

Moving to Latin America, Brazil's economy has been weaker than expected. The currency sank as the Presidential election neared and it looked increasingly as if Dilma Rouseff would be reelected. While she won a plurality of the votes, the unexpected second place finish of center-right candidate Aecio Neves reversed some of the pessimism. Irrespective of who wins the runoff, we believe the government will be forced to take a more growth oriented stance. Back across the Pacific, it seems it doesn't matter who tries to stimulate the Japanese economy. It just won't take off. Now this is nothing new for Japan. The economy hasn't been a disaster. It just seems to be stuck in permanent neutral. What may be impacting investors is that many who had expected that accelerated growth was imminent are coming to realize this may not be the case.

The imbalance in global economic strength makes the situation tricky. Many are coming to believe that the Fed will begin reversing course from its current easing stance. While we would (and have) argued that this would be a net positive, the markets are very nervous about such a prospect. The combination of higher interest rates in the U.S. and attempts by other countries to stimulate their economies has led to a rapidly rising dollar. This in turn is perceived as negative for U.S. competitiveness and corporate profitability.

All of these concerns are interspersed with geopolitical concerns. We've talked about many of these before: Syria, Iraq, Russia, and the Ukraine, to name a few. Throw in a touch of Ebola and investors really get spooked. But what is different this time? We believe what is changing is not the magnitude of the global issues but the sense that no one is taking the lead in dealing with them. While one could take issue as to whether there is effective leadership in the U.S. and abroad, the keys are markets' perceptions – and we don't think they're positive.

We lay out the above scenario in the context of a market that by quarter end had appreciated (as measured by the S&P 500) 42% over the prior 24 months. During that period there have been no significant corrections. Perhaps we've become to accustomed to that. However, as prices are set at the margins, it doesn't take a lot of fear to drive prices down. The fact is markets can be extremely emotional, especially in the short run.

We promised that we would try to allay our readers' concerns. We've certainly painted a less than rosy picture. However, we believe the key to investment success is to take the long view. If funds are needed in the short run, they have no business being in stocks or other risky, volatile asset. If one's time horizon is longer, then the picture is considerably brighter.

First, we've argued for sometime that markets were inexpensive. This was based on our belief that the risk premium was too high. In other words, prices were low because investors demanded a higher potential return given the risks involved. As prices have advanced, that risk premium has shrunk. But it is still high by historical standards. What has happened in the markets over the last month or so is that the risk premium has increased a bit. Put another way, the potential returns are higher with lower prices.

Against these lower prices, the long term outlook is no worse. There have always been negatives and risks. The expansion nonetheless remains in place. We've argued that the weak pace of expansion has resulted in very few excesses. As a result, there is less risk that the expansion will be cut short. Combined with weak commodity prices, the situation augurs well for sustained profit growth. Reasonable prices and sustained profits are what drive long term returns.

The road to success is not a straight line. This is perhaps one of those diversions. The situation may not improve for some time, or it may improve tomorrow. The only thing we know for certain is that instead of worrying or getting overly enthused about each move in the market, investors would do better by focusing on their long term goals. And when we look at the long term, we like what we see.