Investment Update

First Quarter 2014

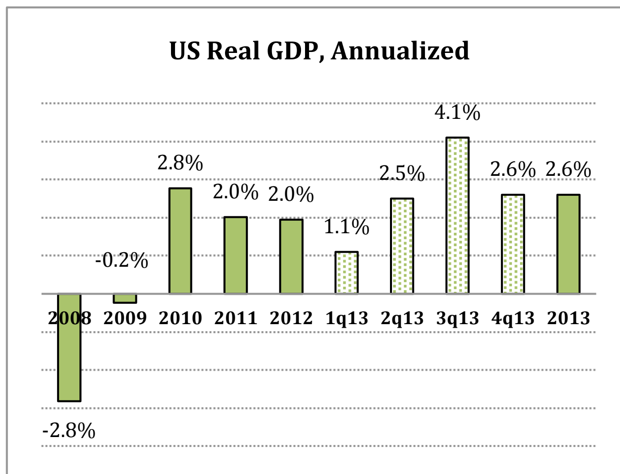
Markets:

Equities: Just over five years into the US economic recovery, domestic stock markets continue to regularly reach new highs. The S&P 500, Midcap, and Smallcap indexes have all rebounded from January's 6-7% corrections and have returned +1.8%, +3.0%, and +1.1% respectively in 2014.
MSCI's EAFE foreign developed markets index has returned -0.2% year-to-date, and its emerging markets index has returned -0.5%.

Bonds: Shorter-term interest rates and yields are essentially unchanged from year-end, while longer-term rates and yields have declined. The decline in the 30-year US Treasury yield from 3.94% to 3.65% has been especially pronounced. Barclays' intermediate investment-grade bond index has returned +1.0% year-to-date, while the comparable long bond index has returned +6.6%.

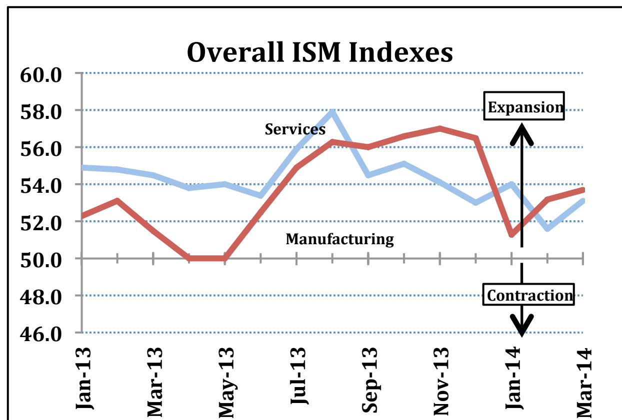
US Economy:

In the US, the pace of overall economic activity almost surely slowed in the first quarter from last year's real GDP growth rate of 2.6%. Federal Reserve officials have estimated that weather might have subtracted 0.5-1.0% from growth, and we expect the headlines about the first quarter to be quite negative. However, as winter weather was uncommonly bad in much of the country we don't read too much into what is likely to be a temporary slowdown, and still expect overall growth in 2014 to improve compared to 2013.



To put this past winter's weather into perspective, January 2014 was the coldest January in 20 years, according to the heating degree day (HDD) data compiled by the US National Oceanographic and Atmospheric Agency (NOAA). In terms of snow and ice storms and their economic impact, February might have been even worse. The NOAA's HDD data is especially useful in determining the likely impact of severe weather on economic activity because it measures the weather that affects the US on a population-weighted basis. This means that it gives more weight to unusual weather that affects large population centers, where lots of economic activity tends to occur.

We won't see the first official estimate of first quarter growth until April 30, but a number of broad data series that are released more frequently are consistent with a temporary, weather-related slowdown. For instance, railcar loadings, which are economically sensitive but not very affected by weather, show no downturn.

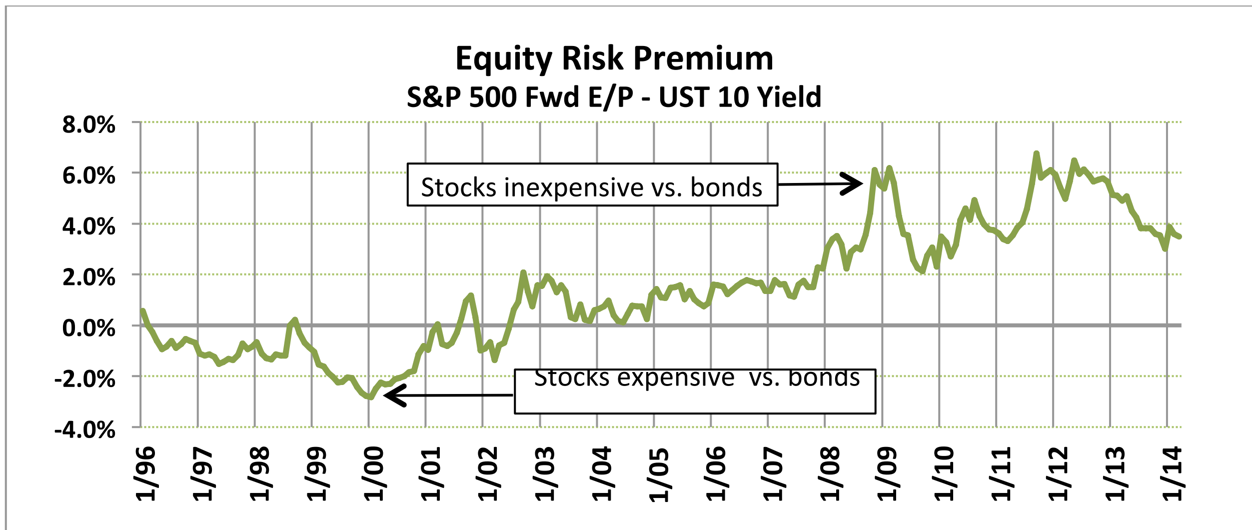


In March, the overall Institute for Supply Management's (ISM) manufacturing index improved from January and February and remains well into expansionary territory. The production component of the index increased 7.7% in March, more than recovering from the 6.6% decline registered in February.
The overall ISM services index, which is somewhat less affected by weather, also improved in March from a small decline in February.

Federal Reserve Policy:
Despite the Federal Reserve remaining steadfast in its intention of tapering and eventually ending monthly bond purchases under quantitative easing (QE), yields on longer-term US Treasuries have actually fallen since the end of 2013. Geopolitical concerns stemming from Russia's actions in Ukraine have made traditional safe-haven investments like US Treasuries and gold more attractive to some investors, and markets have been continually re-evaluating the likely course of Fed policy under its new chairman. We do still expect market-based interest rates to trend higher over time as the economy continues to slowly grow, QE ends, and the Fed eventually raises the Fed funds rate.

The transition of Federal Reserve Chair from Ben Bernanke to Janet Yellen has gone relatively smoothly, as we expected. The Fed continues to give quite clear guidance of its intention to keep the short-term Fed funds interest rate low until there is a real structural improvement in the jobs market. Compared to previous guidance, there is now somewhat more ambiguity about which metrics in addition to the unemployment rate will be used to make that assessment.

Investment Outlook:
With our expectations of growing US and global economies; no major changes to an economic environment in which companies have been able to report healthy revenue and profit growth; and a Federal Reserve that does not appear ready to raise interest rates any time soon, we still favor stocks over bonds (and particular over long-maturity bonds). However, intermediate-term bond yields have increased enough over the last nine months that they now offer reasonable value, offering sufficiently high returns over cash and cash equivalents.
Early last year we discussed the equity risk premium (ERP) as a measure of the relative attractiveness of stocks versus bonds. Recall that when the ERP, which has averaged about 2% over the long term, is especially negative, the implication is that stocks are expensive compared to bonds. When the ERP is far above 2%, stocks are inexpensive compared to bonds.



By this measure, stocks are currently not nearly as inexpensive compared to bonds as in early 2009 or from mid-2011 to early 2013. The 30% increase in the major US stock market indexes last year combined with the relatively large increases in bond yields last year has narrowed the valuation gap. However, stocks in general are still relatively undervalued compared to bonds.