

SIGNATUREFD

SUMMER 2013

MARKET SENSE: U.S. Market Strength Masks Difficult Quarter Abroad



There is an old adage: “When America sneezes, the world catches a cold.” From an investment perspective, the implication is that the world is so interconnected that market-impacting events are rarely limited by geography. The fact that S&P 500 companies now generate a third of their revenues from international sources is anecdotal evidence of this increasing interconnectedness. Given the increasingly connected nature of the world, it is natural to assume that the performance of global investment markets would trend together over time. However, the performance dispersion between global equity markets has in fact widened during the second quarter and continues to be an underappreciated story in 2013.

The U.S. equity market remained one of the few bright spots during the second quarter, as most other investment markets faced much more turbulence. The benchmark S&P 500 index gained 2.9% during the second quarter, bringing the year-to-date return to 13.8%, the strongest first half since 1998. Unfortunately, the good news ends there. Global ex-U.S. stocks (MSCI World Ex-U.S. Index) fell 3.1% during the quarter and are flat so far in 2013. Emerging market stocks (MSCI EM Index) fared even worse, falling 7.9% during the quarter and nearly 10% so far this year. Diversified commodities (DJ Commodity Index) fell 9.5% during the quarter and are down over 10% on the year. Even bonds, typically a stabilizing influence in portfolios, faced pressure over the quarter as they grappled with the dual headwinds of rising interest rates and widening credit spreads. High-quality, intermediate-maturity bonds (BarCap Aggregate Bond Index) fell 2.3% during the quarter and sit 2.4% lower on the year.

The implication is that 2013 has not been a “rising tide lifts all boats” market environment. Focusing too acutely on the U.S. equity markets gives an incomplete picture of the current investment landscape. The growing disparity between domestic markets and other investible assets furthers a trend dating back through the past market cycle. While the S&P 500 finished the second quarter just 4% from its all-time high, global developed stocks and emerging markets are at least 20% below their 2007 peak levels.

There are a number of possible causes of U.S. outperformance, including the revival of abundant, affordable natural resources (natural gas revolution), resurgent domestic manufacturing, a recovering housing market and accommodative monetary policy. To varying degrees, these have all contributed to the stabilization of the economy and a rally in equity markets. Perhaps the simplest way to describe this phenomenon is that the U.S. has successfully navigated its share of potential market-impacting events (GDP soft patch, fiscal cliff, debt ceiling) with minimal market disruption while developing and emerging markets have been derailed by their own unique market risks (Euro sovereign credit crisis, economic growth scare).



THE FED SAID THAT ANY REDUCTION IN MONETARY STIMULUS WOULD BE DATA DEPENDENT AND CONTINGENT ON FUTURE ECONOMIC STRENGTH. THIS ESSENTIALLY MEANS THAT RELEASES OF ECONOMIC DATA HAVE BECOME AN IMPORTANT VARIABLE IN MONETARY POLICY.

Unfortunately for global investors, it does not appear that the U.S. recovery is as infectious as the infamous cold.

In our view, two main macroeconomic factors broadly affected global markets during the second quarter: signals from the U.S. Federal Reserve that it would eventually end its monetary easing policies and reduced economic growth expectations in emerging markets, notably China. While boiling down the quarter to these two factors may obscure the importance of other notable events, it provides a framework for analysis.

IMPACT OF THE FED'S "TAPER" TALK

Ben Bernanke's term as U.S. Federal Reserve Chairman ends in January 2014; it is almost certain that he will not be appointed to another term. With the Federal funds rate (the Fed's primary rate-setting tool) near zero for the foreseeable future, Bernanke's focus over his last few quarters as Chairman is transitioning from policy rate setting to managing and communicating around the Fed's quantitative easing (bond-buying program). Currently, the Federal Reserve is purchasing \$85 billion of agency mortgage-backed bonds each month. During Congressional testimony following the May 22 Federal Open Market Committee (FOMC) meeting, Bernanke discussed the possible timing and mechanism of reducing the current QE program by tapering bond purchases. Bernanke's words reverberated through the fixed-income markets, driving bond prices down, interest rates up and credit

spreads higher. The 10-Year U.S. Treasury rate increased from 2.0% at the time of the May Fed meeting to 2.5% by the end of June and the yield on high-yield corporate bonds spiked from 5% to 6.6%. Equities sold off and the dollar strengthened against most other currencies.

In addition to higher rates, one other implication of Bernanke's comments is an elevated level of overall asset class volatility, especially around economic data releases. The Fed said that any reduction in monetary stimulus would be data dependent and contingent on future economic strength. This essentially means that releases of economic data have become an important variable in monetary policy. Given that the Federal Reserve is explicitly active in the fixed-income markets (it is actually buying bonds) and implicitly active in the equity markets (it is not buying equities, but its actions are arguably driving other market participants to do so) we would expect that releases of economic data will continue to add to volatility across most asset classes with an acute impact across the fixed-income spectrum. The VIX index, a broad measure of stock market volatility, steadily increased beginning in mid-May to peak near the end of June, coinciding with the period following Bernanke's testimony.

Historically, stocks and high-quality bonds have exhibited negative correlation, especially during periods of extreme equity market stress. This historical relationship is one of the core tenets of portfolio diversification and the source of the idea that bonds help insulate a portfolio during difficult periods. A subtle yet important



A SIGNIFICANT MACROECONOMIC STORY DURING THE SECOND QUARTER WAS THE FURTHER REDUCTION IN ECONOMIC GROWTH EXPECTATIONS IN EMERGING MARKETS, ESPECIALLY CHINA.

characteristic of the May and June selloff was that equity markets and high-quality bonds sold off in tandem. This “positive correlation” has a very meaningful implication for investors—that high-quality bonds did not provide the traditional source of portfolio protection during that period. The key question for investors is whether this relationship between stocks and bonds will continue. Our expectation is that the relationship between the two asset classes will eventually return to normal. Higher interest rates, provided they occur at a relatively measured pace with good supporting economic data, would hopefully correspond with continued strength in equity markets.

The natural question is if interest rates are likely to continue to rise over the long term, and rising interest rates are bad for bond prices, do bonds still make sense in diversified portfolios? While rising rates will certainly affect bond prices in the short term, historically bonds haven’t lost money over the long term during a sustained period of rising rates. From March 1962 to September 1981, interest rates on 10-year Treasury bonds rose from 3.9% to 15.8%; over the same time, corporate bonds returned 3.3% annually. While the inflation rate over that period was above the rate of return on bonds (so in real terms, bonds lost money), bonds can produce absolute positive returns even during extended rising rate periods. Additionally, bonds make sense as they provide valuable income and, in typical market environments, an important hedge against deflation and portfolio volatility. While we have drastically reduced our allocation to interest-rate-sensitive bonds over the past 24 months, we believe that for most clients, a modest allocation to intermediate bonds still makes sense.

EMERGING MARKET GROWTH DISAPPOINTS RELATIVE TO EXPECTATIONS

In addition to the shifting communication around U.S. monetary policy, the other significant macroeconomic story during the second quarter was the further reduction in economic growth expectations in emerging markets, especially China.

Coming into the year, China’s economic story was well known. Following three decades of double-digit annual GDP growth, China’s economy has started to moderate. This comes at the same time that the country works to transform itself from an export-driven economy to one more focused on domestic consumption. Expectations are now that China’s economy is growing 7-8% annually. On the surface, 7% economic growth is extremely healthy (and far superior to that of the U.S. or Europe), however, it is below market expectations. Previously, we have mentioned that we believe that the direction and trend of economic data is arguably more important than the absolute level of the data. Essentially, the GDP growth itself probably matters less than the direction of change in that GDP growth number relative to market expectations. Despite emerging market economies growing much more quickly than the U.S., emerging market equities and growth-sensitive commodities both fell by 9% over the quarter. The market had already priced in greater expectations and the equity market selloff is essentially a “repricing” of these lowered growth expectations.

Over the past three years, we have had the majority of our equity portfolios allocated to U.S.-oriented strategies, which has benefited portfolios as the U.S. has broadly outperformed

many global benchmarks. We believe this international market volatility and dispersion are beginning to create some international opportunities. When analyzing the long-term attractiveness of an investment, valuations are a critical starting point. For equities, some of the common measures are comparing the price of an asset to an underlying fundamental operating business metric (earnings, sales, cash flow, book value).

When looking at the domestic stock market through this prism, in part due to the strong price appreciation in these markets, U.S. stocks are currently trading at, or slightly above, their historical valuation levels. The S&P 500 currently trades at 14.2 times next year's earnings, 2.4 times book value and has a 2.0% dividend yield, while the MSCI EAFE index trades at 12.5 times next year's earnings, 1.5 times book value and has a 3.4% dividend yield. The MSCI EM Index trades at 9.8 times next year's earnings, 1.4 times book value and has a 3.0% dividend yield. While there are many variables in addition to valuations that factor into our investment decision-making process, valuations are becoming slightly more attractive internationally.

PORTFOLIO POSITIONING AND OUTLOOK

While we are cautiously optimistic as we head into the second half of 2013, we are conscious of how far we have come from the market bottom in March 2009. As such, we have made some meaningful shifts over the quarter to try to lock in some of these strong gains. We have reduced some exposure to market directional strategies (long-only stocks and long-only bonds), which require the market to continue to appreciate to generate returns, to fund new investments in alternative and hedged strategies with return profiles not tied directly to equity or bond market direction.

Looking forward, we continue to seek opportunities to lighten exposure to areas of the portfolio that have performed well and may now be trading close to fair value in favor of areas that we believe offer better longer-term opportunities. Along those lines, we are currently trimming some of our U.S. equity exposure to fund new investments in European equities.

We enter the quarter overweight to growth-oriented assets relative to fixed income, believing that over the longer term, stocks offer an attractive opportunity relative to bonds. Within our growth allocation, our U.S. equity allocation remains focused on larger-cap, stable businesses. Our international equity allocation is broadly diversified but mostly focused on global value-oriented markets. We maintain our allocation to real assets as an inflation hedge, but have diversified away from most of our direct commodity exposure in favor of more stable global infrastructure and natural resource investments. We have increased our allocation to hedged and lower volatility, non-market directional strategies, as these investments allow us to make portfolios more defensive without shifting into bonds. Our fixed-income investments remain shorter in duration with a focus on higher-yielding, credit-oriented alternative income strategies.

In short, we have positioned our growth investments to participate in future market upside but have increased our allocation to hedged strategies in anticipation of any market pullbacks. Within our fixed-income allocation, we have reduced our interest rate exposure in favor of credit, which should benefit from the positive interest rate carry in a stable economic growth environment with slightly higher trending interest rates.

As always, we appreciate your confidence and welcome any questions or comments.

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