SIGNATUREFD

SUMMER 2014

MARKET SENSE:
Steady as She Goes

We would characterize the markets as grinding higher this year. Certainly the pace is not as strong as it was last year, but after a 30% year in the U.S. markets, padding those gains slightly is not a disagreeable outcome. The results during the first half of 2014 in the U.S. and Europe are not that surprising. But at least three shifts in the market this year have caught many off guard.

- **Interest rates:** The best-performing asset so far this year has been long-term bonds, especially U.S. Treasuries. Many anticipated that long-term rates would continue higher during 2014 (as rates rise, bonds typically lose value). Though SignatureFD has had a more sanguine view than some, we too have been surprised at the durability of the lower rates. We continue to hold core bonds in our portfolio to hedge the risk of an economic downturn or deflation. However, our holdings are at the low end of our historic levels and in our opinion the long-term trend for bond rates is higher, and the countertrend rally so far in 2014 is likely to exhaust itself soon.

- **Volatility:** In our January newsletter we noted that "investors are likely under-appreciating the potential for more volatility." Thus far, everyone has been surprised that volatility has stayed low and is even trending lower. We are approaching levels not seen since early 2007. In many ways, the perceived stability in the financial system and the markets is similar to the pre-crisis period. Predicting the timing of higher volatility is difficult, but we remain aware that events can change quickly.

- **Emerging markets:** The final "surprise" is one that we had actually been planning for this year: the return to a more fertile environment for emerging-market equities. As of July 1, we added a small allocation back into broad emerging-market positions. We wrote in January that valuations were becoming much more attractive. Though the fundamentals remain challenged in the near term, we are witnessing some positive flows into these markets and we took the first of what could be two or three small steps toward a larger position.

"Steady as she goes" would be the best way to sum up the first half of 2014. Most asset prices have pushed higher, and though many risks are within investors' peripheral vision, nothing has occurred to derail either the economy or central bank policy in a material way. We do believe some changes are on the horizon, and we will turn to that story next. Before doing so, however, we have provided index returns for various markets over the past quarter and 12 months in the following table.

"HIGHLY ACCOMMODATIVE MONETARY POLICIES IN THE ADVANCED ECONOMIES PLAYED A KEY ROLE IN LIFTING THE VALUATIONS OF RISK ASSETS THROUGHOUT 2013 AND THE FIRST HALF OF 2014."

	2nd Quarter	52 Weeks
S&P 500	5.2%	24.6%
Dow Jones Industrials	2.8%	15.6%
MSCI EAFE (International)	4.1%	23.6%
MSCI EM (Emerging Markets)	6.6%	14.3%
Bloomberg Commodity	0.1%	8.2%
Barclays U.S. Aggregate (Taxable Bond)	2.0%	4.4%
Barclays 5-Year Muni (Tax-Free Bonds)	1.3%	4.0%

WHERE ARE THE BOND VIGILANTES?

The colorful political commentator James Carville once said, "I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody." But anyone watching the markets today would guess that the bond vigilantes might be asleep at the switch. In fact, one would think that the current battle between central bankers and various regulatory leaders would get the attention of bond investors. This escalating war of words is likely to spill over into the market before long. Before outlining our view of the current bond debate, we will provide some context.

In a recent report, the Bank for International Settlements (BIS), which is actually the "bank for central bankers," drew attention to the artificial nature of recent market gains, saying, "Highly accommodative monetary policies in the advanced economies played a key role in lifting the valuations of risk assets throughout 2013 and the first half of 2014. Low interest rates and subdued volatility encouraged market participants to take positions in the riskier part of the investment spectrum." Then, in reviewing the current state of central banking, the report states, "The temptation to postpone adjustment can prove irresistible, especially when times are good and financial booms sprinkle the fairy dust of illusory riches. … The consequence is a growth model that relies too much on debt, both private and public, and which over time sows the seeds of its own demise." Finally, the report encourages the central banks (especially the U.S. and U.K.) to begin withdrawing stimulus. The conclusion of the BIS is not encouraging: "It will be difficult to ensure a smooth normalization. … The prospects for a bumpy exit together with other factors suggest that the predominant risk is that central banks will find themselves behind the curve, exiting too late or too slowly."[1]

THE SEMIANNUAL RISK REPORT FROM THE OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC) HIGHLIGHTED GROWING RISKS IN THE DOMESTIC LENDING MARKET.

A separate report was less scathing, but nearly as concerning since it comes from a U.S.-focused regulator. The semiannual risk report from the Office of the Comptroller of the Currency (OCC) highlighted growing risks in the domestic lending market. According to the report, "Competition for limited lending opportunities is intensifying, resulting in loosening underwriting standards, particularly in indirect auto and leveraged lending." The report then goes on to identify two reasons that the use of the new so-called macroprudential tools could have limited impact if a lending bubble is truly underway. First, the report finds that "with a finite pool of lending opportunities, banks are competing among themselves and with nonbank firms seeking to expand into traditional banking activities … [and] helping fuel loosening credit standards." Second, the OCC questioned the speed with which these tools can have an impact, saying, "Anytime you put out guidance, it's going to take some time. … There's a large pipeline of deals that takes some time for people to implement."[2]

For some of you, the above information may seem tedious, but we want to emphasize the clear spotlight on risk. As in the months before the subprime mortgage collapse, there is no shortage of observers who are warning that things are moving too fast. This makes the response of the major central bankers, especially Fed Chair Janet Yellen, all the more alarming.

Just ahead of the Independence Day holiday, Yellen pushed back on the tactics recommended by the BIS to reduce market speculation, saying, "I do not presently see a need for monetary policy to deviate from a primary focus on attaining price stability and maximum employment in order to address financial stability concerns." Yellen added, "I do see pockets of increased risk-taking across the financial system." Nonetheless, Yellen has full confidence that the macroprudential rules will be adequate at reducing speculation for the foreseeable future. In discussing the state of macroprudential tools, she said, "In the United States, considerable progress has been made. … Changes in bank capital regulations, which will include a surcharge for systemically important institutions, have significantly increased requirements for loss-absorbing capital."[3] In our opinion, however, these tools remain untested and they would seem to be ineffective if confronted by the larger incentive of borrowing capital that is mispriced in the market.

We have two primary concerns as it comes to this policy. First, can macroprudential tools be implemented quickly enough and with enough rigor to offset excess liquidity? Second, will the speculation just move into nonregulated parts of the economy? This second point is critical. The Federal Reserve may not be explicitly concerned about speculation in the overall market. Its job is to oversee the largest banks and minimize systemic risks. The Fed isn't necessarily worried about investors losing money—possibly a lot of money—as long as it doesn't affect the proper functioning of the overall economy.

THE MARKETS WILL LEAD THE FED

The key 10-year Treasury yield has bounced around in recent weeks depending on the strength of economic data, but the figure remains below the 3% level that existed at the beginning of this year. However, the steady track of the 10-year Treasury so far this year does not necessarily mean all is docile in other parts of the Treasury market. The shorter-term rates have been more affected by the strengthening economy and may start to put

pressure on the Fed in upcoming months. The two-year yield, which is very sensitive to rising rates, has now broken above 0.50% and is at three-year highs. For most of this time, the rate has been between 0.2% and 0.4% until recently breaking higher. Similarly the five-year yield is close to breaking into multiyear highs after ending a recent week at just under 1.75%.

The spread (the yield difference between two Treasuries of different maturities) between these rates tells more about the market expectations for upcoming Fed moves. The spread from one- to two-year maturities is at its widest since 2011, and the spread between the two- and five-year maturities is also holding at wide levels. These are the most sensitive to rate rises and seem to be telling us now that the time for rate increases is being accelerated in the eyes of the market. Yet the relatively low level in the 10-year yield seems to be telling us that the market believes the economy remains sensitive to higher rates and thus the "end point" of a Fed rate rising cycle is unchanged even with the stronger recent economic data.

In our view, the market is starting to pick up on the approaching need for rates to move higher, but still remains confident that the Federal Reserve will manage the process well. We would not bet against the Fed in the long run, but the possibility that there will be periods of second-guessing during this process is likely higher than is currently built into asset prices.

MARKET ASSESSMENT AND PORTFOLIO POSITIONING

As the cycle continues to mature, we find it harder and harder to comfortably add money to key segments of the market. Recognize that this has more to do with asset valuations than our view of the economy. We believe the fundamentals are actually very strong and likely gaining momentum. But the question is, "When is this all factored into asset prices?" In other words, at what point is the data so good it is bad? Specifically, we view the available options in the domestic market as having become less interesting. We have recently trimmed our U.S. equity allocations and have maintained a modest allocation to core U.S. fixed income. We have begun shifting capital toward international markets, including Europe and emerging markets. What follows is a brief recap of our portfolio positioning for the third quarter.

- **Domestic equity:** As of July 1, we have reduced our core domestic equity position to approximately 40% of each client's overall equity portfolio. This is the lowest level in the past five years. We maintain investments in dividend-paying stocks and active managers that are mostly focused on growth and cyclically oriented stocks.

- **International/global equity:** This portion of this portfolio was raised with proceeds from the U.S. and stands at similar levels to U.S. equities. For the last few years, we have built out sizable positions in European equities and believe these positions have the opportunity to continue outperforming. We have also added frontier markets (with a focus on sub-Saharan Africa) and effective July 1, added broad emerging-market equity exposure.

- **Real assets:** We reduced exposure to pure commodities a few years ago, and we have not maintained traditional holdings in REITs or pipelines in the last two years. We currently have positions in energy, value-oriented commodity stocks and global infrastructure assets. These holdings have performed well in recent quarters and could be a source of capital for new ideas.

- **Alternative:** Given the low valuations we expect from fixed income, we have generally had an underweight there and pushed this capital to alternative investments to maintain appropriate risk in portfolios. The alternative category has been a difficult one, but we remain excited about the managers we use in the space. As equity markets continue higher, the opportunity cost of investing in alternatives is likely to continue to shrink.

- **Fixed income:** We continue to hold some core bonds, which has helped significantly year-to-date. However, we believe these are low-return investments if held continuously for the next few years. We have made few changes in the fixed-income portion of the portfolio, so it remains approximately 50% in traditional bonds and 50% in more opportunistic areas—mostly managers with shorter duration holdings and higher credit risk.

We continue to work hard to properly manage the return and risk of client portfolios and to maintain this through a full cycle. We are fully aware of the current view that now is a time to make hay, but we disagree slightly. The best time to take risk was early in the cycle (2009–2011). As the current cycle matures, the amount of return earned for risk taken is getting less attractive.

REFERENCES

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[2] Office of the Comptroller of the Currency. "Semiannual Risk Perspective." Spring 2014. occ.gov/publications/publications-by-type/other-publications-reports/semiannual-risk-perspective/semiannual-risk-perspective-spring-2014.pdf

[3] Janet Yellen Speech at IMF Conference, Washington, D.C., July 2, 2014. forextv.com/forex-news/fed-chair-janet-yellen-speech-imf-conference-washington-dc-july-2-2014-full-transcript