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Financial Market Commentary: 1st Quarter 2014

A Severe Winter Held Back Economic Growth but the Trend Remains Somewhat Positive

Past market commentaries focused on what is happening at the Federal Reserve. An important driver of economic activity in the U.S., and by extension Fed policy, is the continued improvement in the health of the consumer balance sheet. A positive balance sheet gives consumers better access to consumer loans, supporting the continued recovery of the housing and automotive industries, among others.

Extreme weather in the U.S. likely held back economic growth in much of the country during the quarter. However, the question is, how much of the recent softness in economic data can be attributed to poor weather alone? As the quarter wore on, investors gained comfort in the view that weaker economic data was more a byproduct of inclement weather, rather than reflecting a broader economic slowdown. Comments from Fed Chair Janet Yellen during the quarter also seemed to support this theory.

Seasonal winter doldrums likely had a temporary negative impact on housing activity that should be reflected in upcoming data releases. Therefore, the pace of consumer balance sheet reconstruction may slow somewhat over the next quarter or two as housing activity picks up, but the general positive trend remains.

Initial jobless claims maintained their downward trend throughout the quarter, approaching its post-recession low after the four-week moving average of claims fell to 317,000 in the most recent release. Continued improvements in the labor market should support consumer spending and the U.S. housing sector – keys to the success of the U.S. economic recovery.

Despite Volatility in the Quarter, the Results Were V-Shaped Among Most Indices

After a positive 2013, the first quarter of 2014 proved to be challenging for equities. Concerns about economic growth in emerging markets, geopolitical turmoil in Ukraine, and somewhat softer macro data in the U.S. injected more risk aversion into markets. However, profit-taking and tempered expectations for a repeat performance of stellar 2013 returns drove down investor risk tolerance in the first quarter. With investors taking a more cautious approach toward equities, it was not surprising to see markets get off to a rough start in January, though most major global indices rebounded in February and March, finishing the quarter in positive territory, led by U.S. equities.

The quarter ended with small gains for most major indices despite bouncing up and down. The minimal changes masked significant volatility, with markets taking a dive on news of the Russian invasion of the Crimea, before recovering. The Russian annexation of Ukraine's Crimea region at the start of March was the major geopolitical news of the quarter. Markets dropped the next day but recovered as the situation appeared to stabilize. Still, the crisis has yet to be resolved. The U.S. continues to use diplomatic actions to penalize Russia, and this has resulted in greater uncertainty. Furthermore, the current concentration of Russian troops near Ukraine's border is a reason for concern.

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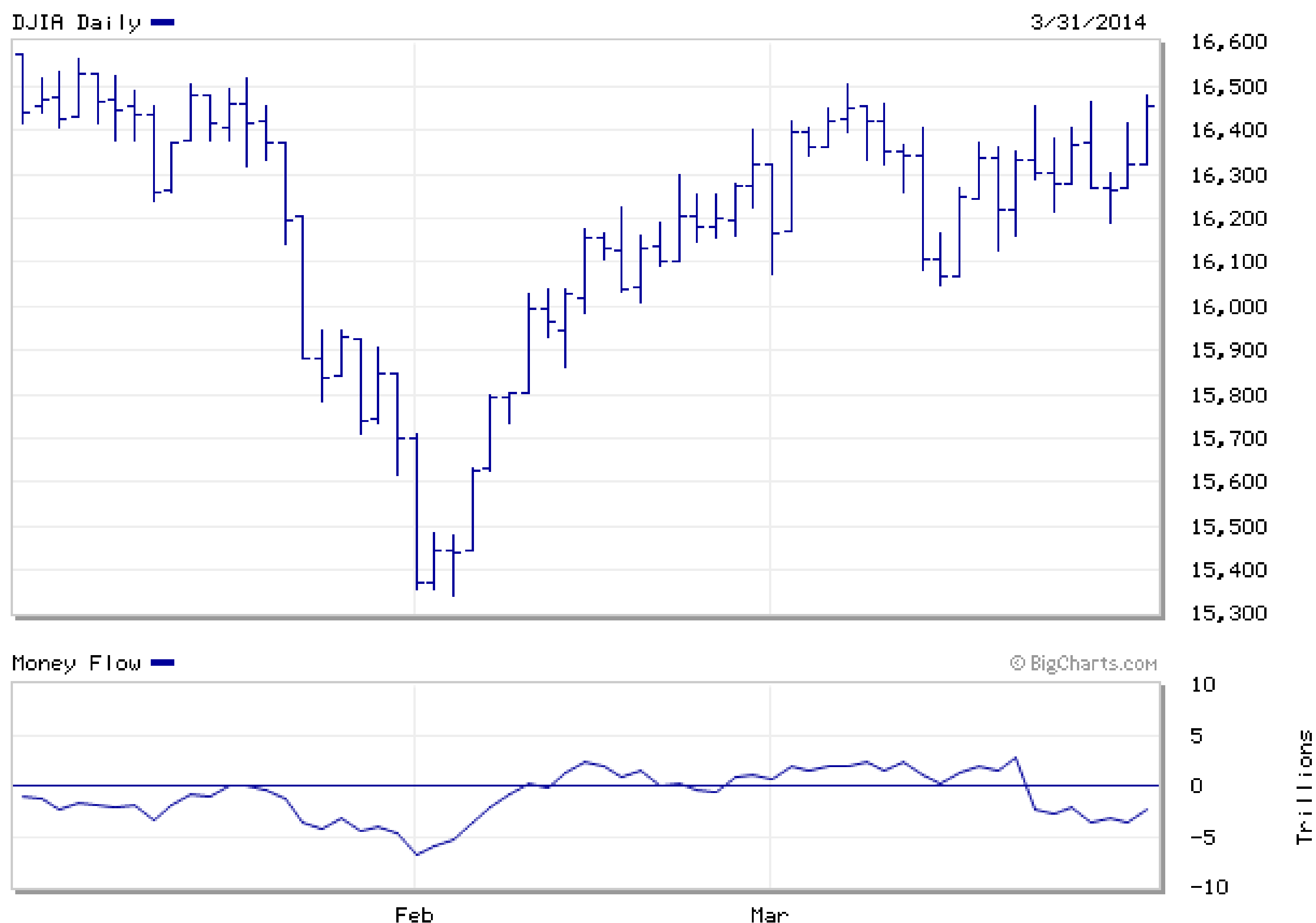
Other countries in Europe were also affected by Russia's actions. Many European Union nations rely on Russia for natural gas. This has made their decisions regarding how to counter Russian aggression particularly difficult. Even if there is no further military action, harsh negotiation tactics could derail the European recovery.

Fundamentals were mixed during the quarter, with earnings growing but companies projecting slower future gains. Declining growth expectations, combined with rising perceptions of risk outside the U.S. and the ongoing Federal Reserve (Fed) "tapering" of its asset purchase program, made investors more cautious.

The Fed continues to reduce its purchases of Treasury and mortgage bonds. The taper has the Fed reducing its amount of stimulus as the economy normalizes, and the rate of reduction remained steady during the quarter.

Notes released from the March Fed meeting indicated that the Federal Open Market Committee believes that the economy is continuing to strengthen. This, along with a comment from new Fed chair Janet Yellen that rates would increase about "six months" after the end of the taper, led to some market turbulence. Still, the Fed's overall message that the economy was exhibiting a sustainable upward trend provided a reason for optimism.

Dow Jones Industrial Daily Moving Average and Money Flow for 1st Quarter 2014



Source: MarketWatch.com

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Winter is Over and Spring is Here Yet Caution is the Best Strategy for the Financial Markets

The first quarter of the year has certainly provided surprises, but remember that every coin has two sides. Every downward data point has an upside opportunity. To avoid any unexpected occurrences stay diversified. Trends are clearly in the right direction, and the fact that people are now moving back into the workforce shows that the psychology has shifted, which will have positive economic effects across the board in time.

For the first time in years, it looks like we may be set for accelerating growth as we start to move back to a really normal economy. Risks remain, of course. Unlike in previous springs, the average worker now seems to think things are really getting better, and is proving it by returning to the workforce. This is a big change, and a very welcome one.

While the U.S. economy appears likely to continue its recovery, risks are becoming more apparent—both in the financial markets and in the world at large. Unanticipated events can make a large difference, and the Russian annexation of the Crimea has only reinforced this lesson.

With Europe facing new geopolitical risks, and China showing more signs of a potential slowdown, risks to financial markets are very real. In the long term, these factors are not worrisome, but they could cause short-term volatility. Given this uncertainty, investors should maintain a properly diversified portfolio and a long-term focus to maximize their chances for success. Although some concerns may be warranted, most won't significantly affect markets, and long-term return expectations should overcome any short-term worries.

Disclosure: Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Free Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. It excludes closed markets and those shares in otherwise free markets that are not purchasable by foreigners. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moodys, Fitch, and S&P is Ba1/BB+/BB+ or below.

Equity Performance

Equity Index	Style	YTD Return As of 3/31/2014	1 Year Return As of 3/31/2014	3 Year Return As of 3/31/2014	5 Year Return As of 3/31/2014	10 Year Return As of 3/31/2014
Russell 1000 TR	U.S. Large Cap Stocks	2.05%	22.41%	14.75%	21.73%	7.80%
Russell MidCap TR	U.S. Mid Cap Stocks	3.53%	23.51%	14.39%	25.55%	10.05%
Russell 2000 TR	U.S. Small Cap Stocks	1.12%	24.90%	13.18%	24.31%	8.53%
MSCI EAFE NR	Foreign Develop Stocks	0.66%	17.56%	7.21%	16.02%	6.53%
MSCI EM NR	Foreign Emerging Stocks	-0.43%	-1.43%	-2.86%	14.48%	10.11%
DJ US Real Estate TR	Real Estate	8.75%	2.08%	9.20%	27.09%	7.04%
DJ UBS Commodity TR	Commodities	6.99%	-2.10%	-7.37%	4.24%	0.43%

Fixed Income Performance

Fixed Income Index	Style	YTD Return As of 3/31/2014	1 Year Return As of 3/31/2014	3 Year Return As of 3/31/2014	5 Year Return As of 3/31/2014	10 Year Return As of 3/31/2014
BarClays US Aggregate Bond TR	U.S. Core Bonds	1.84%	-0.10%	3.75%	4.80%	4.46%
BarClays US Corporate High Yield Bond TR	U.S. High Yield Bonds	2.98%	7.54%	9.00%	18.25%	8.68%
BarClays Global Aggregate Bond TR	Foreign Developed Bonds	2.40%	1.88%	2.78%	5.10%	4.50%
Morningstar Emerging Market Bond	Foreign Emerging Bonds	2.68%	0.07%	3.75%	15.78%	7.79%
CitiGroup 3-Month T-Bill	Cash	0.01%	0.05%	0.06%	0.09%	1.56%

Source: Morningstar®

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