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Financial Market Commentary: 2nd Quarter 2014

Markets Have Been Influenced Less By Politics and Policymakers in 2014 and More By Growth

After the first quarter slowdown caused by extreme winter weather, the U.S. economy began to thaw with the warmer temperatures in the spring. U.S. economic growth is on track to accelerate owing to the return of business spending and the elimination of the drag from fiscal policy. As a result, the Federal Reserve (Fed) is likely to continue to taper its bond purchases and end its bond buying program in the fall, leaving rate hikes on the calendar for some time next year which could signal a welcome relief for fixed income investors.

The strong results from equity markets over the quarter have been encouraging. Investors have rightly cheered their gains and, at least in the U.S., have also benefited from a strengthening recovery.

Equity markets weathered a rise in geopolitical tensions during the second quarter, as all major global equity indices posted strong returns despite increased turmoil in the Middle East and continued conflict in the Ukraine. Macroeconomic data showed the U.S. economic recovery regained its footing after a disappointing first quarter, while easing measures announced by the European Central Bank (ECB) were also a welcome development. Meanwhile, signs that economic growth in China was stabilizing helped emerging markets rebound after a rough start to the year.

For the quarter, the Standard and Poor's (S&P) 500, Russell 1000, Russell 2000, MSCI EAFE, and MSCI Emerging Markets Indices returned 5.23%, 5.12%, 2.05%, 4.09%, and 6.60%, respectively.

The Crisis in Iraq Led to a Spike in Oil

With volatility indicators continuing to hover near historic lows throughout the quarter, investor confidence has the potential of turning into complacency. While stimulative monetary policies adopted by central banks around the world have certainly helped reduce the potential for negative catalysts to disrupt markets, the fact remains that volatility has nowhere to go but up, even if only marginally. Unfortunately, familiar sources of volatility – geopolitical turmoil and instability in the Middle East – reared their ugly heads during the quarter, or at least reminded market participants that they haven't gone away.

As the current crisis in Iraq intensified, oil prices spiked in June, however they retreated toward the end of the month following reports that the situation was coming under control. This is not a great way to kick off the summer driving season which historically signals a temporary increase in fuel costs. In the past, this might have coincided with a sell-off in equity markets and rise in volatility, but this time investors seemed to shrug it off.

This was likely due to the fact that America has reduced its dependence on foreign energy and that investors perceive the conflict as being a short-term dislocation rather than a long-term risk to the supply of oil, thus concluding that the economic impact is likely to be minimal.

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Improving U.S. Macroeconomic Data While the ECB Announced Easing Measures

Rather than focusing on events happening abroad, investors instead fixed their attention on improving U.S. macroeconomic data, and put the first quarter's negative GDP growth in the rearview mirror. A strong U.S. corporate earnings season provided support to equity markets as top-line growth re-accelerated and 71% of companies in the S&P 500 beat their earnings estimates. The labor market also continued to show signs of improvement with jobless claims, continuing their downward trend throughout the quarter. Following June's Employment report, monthly payroll gains have now exceeded 200,000 workers for five consecutive months, and the unemployment rate is now down to 6.1%, the lowest level since September 2008. A string of other macroeconomic data pointed to a second quarter rebound as well – auto sales continued to rise, Manufacturing PMI remained firmly in expansion territory, and consumer confidence edged up. The housing market recovery, an important driver of economic growth, also got back on track during the second quarter with data indicating a pick-up in housing activity which had been suppressed by the harsh winter weather. Despite the positive U.S. macroeconomic data, one area of concern was sluggish consumer spending, which is likely being held down by low wage growth. However, it is likely that U.S. economic growth will accelerate in the coming quarters, allowing for income growth which should boost both consumer confidence and spending.

In Europe, ECB president Mario Draghi announced a series of easing measures at the ECB's June monetary policy meeting with the goal of stimulating growth and fending off deflation. In addition to cutting its main interest rate and imposing a negative interest rate on banks for their deposits, the ECB also introduced another round of long-term refinancing operations (LTRO) which the ECB will use to lend to banks at low rates thereby injecting liquidity into the lending markets. The hope was that this will spur greater lending to households and non-financial corporations. These measures are similar to those adopted by the Federal Reserve shortly after the 2008 recession. These actions came on the heels of weaker data in the eurozone as inflation dropped to 0.5%, the lowest since autumn 2009, and the euro area's Manufacturing PMI declined to the lowest level since November 2013, with notable declines in France and Germany. As anticipated, European economic recovery will take much longer to materialize than market consensus has indicated.

Strong Markets Should Not Breed Complacency

The strong results from equity markets over the quarter have been encouraging. Investors have rightly cheered their gains and, at least in the U.S., have also benefited from a strengthening recovery. However, the time for caution is just when things look best. Market volatility has declined to very low levels, which historically has signaled storms ahead. The international scene remains turbulent, especially in the oil-producing states of the Middle East, and the potential for disruption there remains.

Although we see no signs of immediate concern, we are aware that the current positive conditions are very likely to change at some point, with a potential negative reaction in the financial markets. Such a correction would be normal in the greater scheme of things. We remain confident in the U.S. economy and in our excellent positioning in the world, as well as in the strength of our financial markets. We believe that a well-diversified portfolio, rebalanced regularly, is still the best way to meet financial goals over time and should be maintained through good times and bad.

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 6/30/2014	1 Year Return As of 6/30/2014	3 Year Return As of 6/30/2014	5 Year Return As of 6/30/2014	10 Year Return As of 6/30/2014
Russell 1000 TR	U.S. Large Cap Stocks	7.27%	25.35%	16.63%	19.25%	8.19%
Russell MidCap TR	U.S. Mid Cap Stocks	8.67%	26.85%	16.09%	22.07%	10.43%
Russell 2000 TR	U.S. Small Cap Stocks	3.19%	23.64%	14.57%	20.21%	8.70%
MSCI EAFE NR	Foreign Develop Stocks	4.78%	23.57%	8.10%	11.77%	6.93%
MSCI EM NR	Foreign Emerging Stocks	6.14%	14.31%	-0.39%	9.24%	11.94%
DJ US Real Estate TR	Real Estate	16.42%	13.03%	10.72%	22.38%	8.49%
DJ UBS Commodity TR	Commodities	7.08%	8.21%	-5.17%	1.99%	0.87%

Fixed Income Performance

Fixed Income Index	Style	YTD Return As of 6/30/2014	1 Year Return As of 6/30/2014	3 Year Return As of 6/30/2014	5 Year Return As of 6/30/2014	10 Year Return As of 6/30/2014
BarClays US Aggregate Bond TR	U.S. Core Bonds	3.93%	4.37%	3.66%	4.85%	4.93%
BarClays US Corporate High Yield Bond TR	U.S. High Yield Bonds	5.46%	11.73%	9.48%	13.98%	9.05%
BarClays Global Aggregate Bond TR	Foreign Developed Bonds	4.93%	7.39%	2.57%	4.60%	5.06%
Morningstar Emerging Market Bond	Foreign Emerging Bonds	6.88%	9.57%	4.62%	11.65%	8.54%
CitiGroup 3-Month T-Bill	Cash	0.02%	0.04%	0.05%	0.08%	1.54%

Source: Morningstar®

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