# Market Insights

2nd Quarter 2014 | Economy | Capital Markets

ADVANCE CAPITAL management

## Economy

After a record cold winter and anemic growth in the first quarter, indications of a pick-up in economic activity during the second quarter improved investor sentiment and propelled the capital markets forward. The hand-off from a Federal Reserve induced easy money policy of the past few years into an economy which can stand on its own with a sustained economic expansion, appears on track. While still early, both the economy and capital markets seem to be absorbing this transition quite confidently and without too much volatility. The general economic themes of improving housing and manufacturing sectors, combined with higher trending employment, are the lynch-pins in this relatively positive economic equation.

We maintain our baseline economic view that global growth will likely accelerate this year, supported by the reduced fiscal drag and Federal Reserve stimulus policies. Developed economies could be the main beneficiaries of these trends. In particular, we believe the United States will likely see a further boost to growth without weather-related distortions and with fewer headwinds from private sector deleveraging. The most recent data supports this thesis as consumer confidence moved higher and the labor market showed a noticeable improvement in recent months.

We think overall domestic growth for the rest of the year could be between 2 to 3 percent. There has been an estimated $8 trillion increase in household wealth over the last 12 months from rising stock and home prices which should continue to work its way to bottom-line economic growth. Further, the drag from the reinstatement of the Payroll tax and other fiscal tightening from last year are largely behind us. Finally, corporate earnings continue to grow at a modest pace with a projected 7 percent increase this year. Although corporate revenue growth is underwhelming, companies appear more willing to invest in new plans for growth and expansion in this modest growth environment.

On the other hand, emerging markets continue to be challenged by cyclical and structural forces, which have prevented sustained growth and kept many investors on the sidelines. Without some stabilization of growth and loan defaults in China, the reversal of fiscal deficits in Brazil or the reduction of political risk in Ukraine, Turkey and Thailand, emerging market risks may continue to be elevated. We are not avoiding emerging markets, but remain cautious and plan a more in-depth analysis in this environment.

As the economy posted somewhat volatile data, investors pushed asset prices higher during the quarter. For the quarter, the S&P 500 Index returned 5.23 percent while the S&P Mid Cap 400 Index returned 4.32 percent. In the bond market, the yield on the 10 year U.S. treasury bond fell about 0.19 percent while the 30 year was down about 0.20 percent for the quarter. Falling interest rates helped produce solid results across most fixed income categories for the quarter.

There are many reasons to be cautiously optimistic about the U.S. economy. The combination of financial healing, greater balance in the housing market, less fiscal restraint and, of course, continued monetary policy accommodation bodes well for economic growth in the coming quarters. Yet, if experience teaches us anything, it is that we should be cautious in our forecasts.

While points of strength include housing and energy, the economy is still lacking in many respects. We continue to think the economic momentum will build gradually and in a choppy fashion with much of Main Street still not feeling fully empowered to create and consume. Further, the global growth story is mixed. Global central bankers were once synchronized in their efforts to lower interest rates and keep monetary policies very accommodative. Now they are moving in different directions. The Federal Reserve is reducing quantitative easing, while the Bank of England is attempting to cool its housing market by raising rates. Meanwhile, the European Central Bank (ECB) and Bank of Japan are trying to fight potential deflation and have intensified asset purchases in their efforts to keep rates low. While this dichotomy in global monetary policy is not necessarily a major risk to global growth and markets, it could increase interest rate volatility going forward.

With this backdrop of marginally improving economic conditions and the potential for rising uncertainty domestically and internationally, there is little room for error. While investor sentiment remains remarkably high, should economic conditions deteriorate or the Federal Reserve unexpectedly deviate from their stated policies, investors might pull back. Although the environment is a bit more tenuous, we still expect positive returns for the full year in equities and most fixed income sectors.

As always, investing in the capital markets comes with some risk and uncertainty. We thank you for your continued support of our investment process as we work hard to deliver positive risk-adjusted portfolio returns to clients. Should you have any specific questions, please do not hesitate to reach out to your financial adviser.

### Economic Statistics
Economy from a Historical Perspective

| | Latest | Average* | Definition | Comments |
|---|---|---|---|---|
| U.S. Unemployment Rate | 6.67% | 6.22% | Represents the number of unemployed persons as a percent of the labor force | Continues to decline at steady rate |
| Consumer Price Index | 2.10% | 4.30% | Represents changes in prices of all goods and services purchased for consumption | Low with slightly higher trend |
| U.S. Capacity Utilization | 79.10% | 80.60% | The greatest level of output that a plant can maintain within the framework of a realistic work schedule, accounting for normal downtime | Steadily improving |
| Gross Domestic Product+ | -2.90% | 2.90% | Total value of all goods and services produced indicates strength or weakness of the economy | Weak for recent quarter, but expected to rise |
| 10 Year Treasury Yield | 2.53% | 6.74% | Yield on the current 10 year treasury bond | Remains low and in trading range |
| Annual Housing Starts | 1,001,000 | 1,459,000 | New privately owned housing unit starts annualized rate | Continues to improve |

*Average from 1966 to Present
+ Annualized
Source: Bloomberg

## Capital Markets

During the quarter, equity investors remained a bit cautious and tended to favor large stocks over small stocks. In fixed income, U.S. treasury bonds produced very good results as a direct result of subdued economic data domestically and heightened issues overseas. For the quarter, the S&P 500 Index posted solid results while many sectors of the fixed income markets produced above average returns. The yield on the 10-year U.S. treasury bond fell 0.19 percent and investors continued to favor adding risk in their portfolios. Investors will be watching the moves by the Federal Reserve along with economic data to determine their next move.

### Market Index Performance (%)
As of June 30, 2014

| | 2nd QTR | YTD | 1 Year | Annualized 3 Year |
|---|---|---|---|---|
| S&P 500 | 5.23 | 7.13 | 24.57 | 16.54 |
| Dow Jones Industrial Average | 2.83 | 2.68 | 15.54 | 13.53 |
| Nasdaq Composite | 5.32 | 6.20 | 31.21 | 18.28 |
| Barclays Aggregate Bond | 2.05 | 3.93 | 4.37 | 3.67 |
| Barclays Corporate Bond | 2.66 | 5.68 | 7.73 | 6.21 |
| MSCI World | 5.05 | 6.57 | 24.83 | 12.55 |

Disclosure Note: It is not possible to invest directly into an index. The indices listed above are unmanaged and are not affiliated with the Advance Capital Companies.