TRILLIUM | Market Commentary

COMMENTARY
June 30, 2014 (2nd Quarter)

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The second quarter of 2014 brought welcome relief to U.S. investors. Large capitalization stocks, as measured by the S&P 500, returned 5.05% for the quarter, bringing the year to date return to 7.03%. Small and mid-sized stocks, as measured by the S&P 1000, returned a still-respectable 3.65%, while the Barclays Government/Credit Bond Index returned 1.23%. Stock returns strengthened through the quarter, with May and June results substantially better than April's.

Good decisions on portfolio strategy depend on making a couple of calls right. We need to understand where we are in the business cycle, i.e., whether the economy is growing slowly, growing rapidly, slowing down, or declining rapidly. We also need to assess the level of valuation: what will investors be willing to pay to participate in growth or, conversely, to avoid exposure to a declining economy. So far in 2014, we have been broadly right on the level of valuation, and somewhat too optimistic about the strength of the economy.

We have been positioned for a strengthening economy. We did not anticipate the first quarter's sudden, sharp, and apparently weather-related decline in economic growth. However, the moderate stock market valuation levels dampened the stock market response: the market returns were limited and modest, but not negative. In the second quarter, economic growth is unfolding as we expected, although along a stretched-out time frame: employment is strengthening, housing starts are rising, and total sales strengthening. We have been positioned for an improving economy, judging that the improvements in corporate and consumer balance sheets, the aging of business equipment and consumer automobiles, together with an improving trend in housing prices, would combine to drive higher consumer spending and greater willingness by businesses to invest. As we discussed in last quarter's letter, this expectation was thwarted by the weather and weather-related slowdowns in the first quarter of 2014 – first quarter 2014 US GDP growth was a shockingly low 2.9% decline, more than reversing the 2.6% increase in the fourth quarter of 2013. In addition to maintaining our overweight to equities, we positioned our stock sector holdings for increasing economic strength, with slightly higher exposures to more cyclical sectors that do better when the economy is strengthening, and away from more stable sectors. In April, as the readings on first quarter economic activity came in, stable sectors such as utilities and healthcare did significantly better than the more cyclical sectors. Small stock prices declined, and larger stocks, as measured by the S&P 500, increased only slightly.

In May and June, economic reports showed signs of renewed economic growth, especially in employment figures. On a month-to-month basis, new jobs created can be quite variable, but the twelve month average provides solid guidance to the strength of the economy. Almost 2.5 million jobs were created in the past year, the most for any twelve month period since May of 2006. Aggregate hours worked expanded in the first quarter, another sign of an improving economy. While housing starts are at less than half the 2005 rate, they are at twice the rate seen in the 2009-2011 period, and continue to strengthen. Recovery in housing construction is even more important than recovery in housing prices as a stimulus to the economy. At the same time, consumer price inflation remains quiescent, anchored in the 1.6% to 2% range. As long as inflation remains in this low and limited range, the Federal Reserve will continue to have flexibility in the pace at which they taper off from quantitative easing.

U.S. STOCK VALUATION

Both the Dow Jones Industrial Index and the S&P 500 are hitting new highs; the Dow is approaching 17,000 and the S&P is approaching 2000, both of which are all time highs. While the NASDAQ is not near its all-time high of 5048, it is at the highest level since April, 2000. We don't believe that this means the market is overvalued. We also don't believe that the market is overvalued just because we are in a five-year plus bull market. We analyze valuation for any one asset, such as stocks or bonds, in the context of the expected returns and volatility of other available assets. Valuation is most usefully conceived of as a "unit price" rather than a "dollar price." Thus, knowing that the S&P 500 index is near 2000, or that the Dow Jones Industrial Index is near 17,000, is useless information unless you also have other, contextualizing information, about the companies in the index, such as the expected earnings (the Price/Earnings ratio), the expected dividends (the dividend yield); the expected cash flows (the Price/Cash Flow ratio) or the expected growth rate of the companies. It's the equivalent of knowing that a bag of kale at the market is $5.00 without knowing whether it weighs one, three, or five pounds.

CONTINUES ON REVERSE

We believe that current market valuations are reasonable, especially in the context of other possible investments. The price/earnings ratio, or the S&P 500 index divided by the expected earnings of S&P 500 companies over the next year, is 15.6, which is in line with the 25 year historic average of 15.5. Other measures of valuation, including Robert Shiller's CAPE, which measures the ratio of prices to the ten year historic average of inflation-adjusted earnings, are also in line with the 25 year average, with the current CAPE at 25.6 and the 25 year average at 25.1. In addition, we note that lower levels of inflation have historically supported higher P/E ratios, as investors are willing to pay more per dollar of corporate earnings when they do not expect high inflation to erode the future value of earnings.

BONDS

For now, short term interest rates remain extraordinarily low; we expect that short term rates will begin rising in 2015. In the year since Federal Reserve Chairman Bernanke announced that the Federal Reserve would eventually taper off on bond purchases, interest rates have increased for all maturities from two to 30 years. At these higher rates, intermediate-term U.S. bonds are slightly more attractive than a year ago, but our return expectations are still subdued. We have begun to extend our bond purchases out to the five to ten year maturity range from the prior two to five year range. We believe there is limited risk to intermediate term U.S. bonds at these levels, as we anticipate that future increases in interest rates will be gradual: the June, 2014 minutes for the Federal Reserve indicate that the U.S. economy is strengthening sufficiently for the Fed to complete its tapering process and cease additional bond purchases in October. This does not meant that the Fed will begin tightening monetary policy, but only that the Fed will be moving to a neutral policy.

OUTLOOK

Given our outlook for a strengthening U.S. economy, reasonable equity valuations, and the subdued expectations for bond returns, we are maintaining our overweight allocation to equities relative to bonds and cash. For those clients where we have the ability to move assets between stocks and bonds, we are at the maximum equity allocation. At current valuations, we expect equities to return about 7% more than bonds over the next year. We also expect the U.S. economy to continue to strengthen, and we are emphasizing more cyclical sectors such as information technology, financial services, and industrials.

While our expectation for U.S. economic growth is quite positive, growth in the broader Euro zone remains a concern, as is continuing financial fragility such as that exemplified by the recent news on Portugal's Espiritu Santo International financial conglomerate.

The primary risks to our outlook are political. We will be monitoring closely the rising violence throughout the Middle East, and any further moves by Russia to annex territory. So far, neither stock nor bond markets have reacted with alarm.