The Ten Themes of 1Q 2014

Every calendar year generally begins with an increased focus on financial markets. Having the first quarter behind us creates the opportunity to review how things are playing out so far. As in most years, there are some outcomes that are going as expected and some that are not going as many would have predicted. Here are ten themes that we believe impacted global financial markets the most during the first three months of 2014.

1. Fed taper
2. Interest rates
3. Weather
4. Food inflation
5. Ukraine
6. China
7. Deflation
8. Global Central Banks
9. Earnings
10. Global stock price divergences

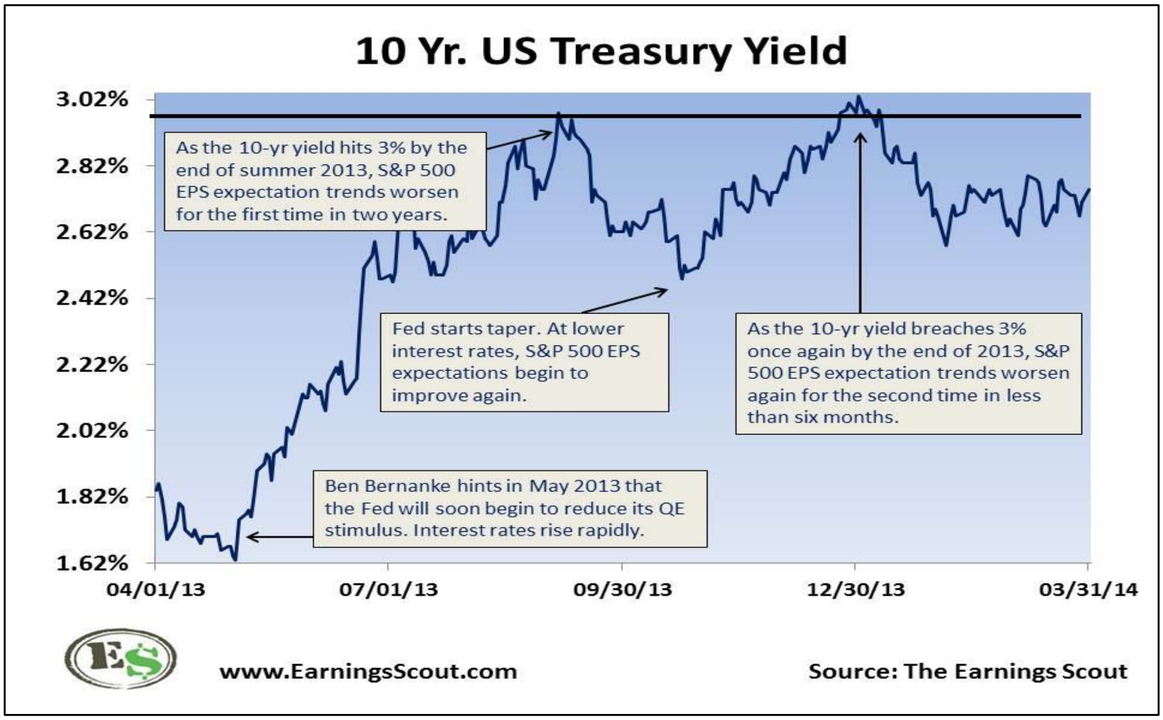
Fed taper

Last May, Ben Bernanke gave the warning shot across the bow that the Fed was planning to scale back on its $85 billion a month Quantitative Easing (i.e. QE) bond buying program. In its last three meetings, under the new leadership of Janet Yellen, the Fed has tapered back on its QE purchases by $30 billion and currently "only" buys $55 billion a month in bonds to stimulate the economy. Yellen has said the Fed's plans are for the complete exit out of QE by the end of this year, while at the same time hinting the Fed could keep QE going longer in the event the economy starts to struggle.

Interest rates

The consensus call on Wall Street was that any Fed taper with regards to its QE bond buying program was going to lead to sharply higher interest rates. This call seemed reasonable given that an improving economy is typically correlated with rising interest rates. However, interest rates ended the 1st quarter lower than they were at the beginning of the year. The fact that bond prices have held up, sending interest rates lower, has definitely been one of the big surprises of the 1st quarter. See chart 1 – Interest Rates, on page 2.

Chart 1 – Interest Rates



Weather

Let's face it for most of us in the U.S., it has been a long, cold winter. There is little doubt this impacted economic activity. However, in Chart 1 above, our research indicates the greater cause for the weaker than expected economic data in January and February was from the rise in interest rates toward the end of 2013, with the bad weather adding insult to injury. As the weather "warmed" in March (relatively speaking), the economic data started to become more positive. This warming weather trend coincided with lower interest rates. In our view the "weather effect" was more coincidental to up and down economic data and interest rate movement was more substantive.

Food inflation

The Commodity Research Bureau's BLS Foodstuffs index, which is a price composite of hogs, steers, lard, butter, soybean oil, cocoa, corn, Kansas City wheat, Minneapolis wheat and sugar, has risen more than 19% in 2014. Partly to blame for the rise in food prices is the weather, along with increased geopolitical risks; however, the rise in prices must also be put into perspective as most soft commodity prices are at lower levels today than they were just one year ago. Additionally, with decelerating economic trends in China and the rate of Europe's economic growth beginning to stall out, we believe sustained rises in food prices going forward are less likely. The real question is will these rising food costs, which serve as input costs for many consumer staples companies, be passed on to consumers or will they erode their corporate profit margins? Based on weakening EPS expectations among consumer staples companies, Wall Street analysts are anticipating at least some of the rising costs to be absorbed by companies and possibly some of it to be seen in rising prices to consumers, which could hurt future demand.

Ukraine

Global markets, particularly in Eastern Europe, were hit hard in early March on fears of Russia's involvement in Ukraine. The increased geopolitical risks with regards to Ukraine have subsided precipitously since then; however, they still remain elevated. Given the times we live in, the next conflict always seems to be right around the corner.

China

The world's second largest economy, as measured by GDP, is growing faster than most countries on an absolute basis. However, the rate of its economic growth continues to decelerate faster than most economists forecast. This has led to continued underperformance of Chinese stocks, as measured by the -3.91% decline in the Shanghai Composite index during the 1Q. Routinely, data on Chinese manufacturing and service sectors, industrial production, retail sales and exports came up short of expectations during the quarter, as it has been for the last three years now. Also during the 1Q, the Chinese government refused to bail out certain companies allowing them to default on their debt obligations adding another layer of risk. An overheated real estate market has been the main reason the People's Bank of China has had to tighten policy over the past year. Market views are now starting to shift and many are expecting China's central bank to reverse course and adopt more accommodative policies.

Deflation

While food inflation has been rising and is worrisome, the fact remains most other commodities are not. In fact, the S&P GSCI commodity index, which measures 24 different commodities across energy, industrial metals, agricultural products, livestock and precious metals, is only up 2.94% in 2014, which is a far cry from the 19% rise in food prices. So while inflation fear mongers will say the rise in food prices will lead to accelerating inflation, the fact remains that most of the developed world remains in a very low inflationary environment.

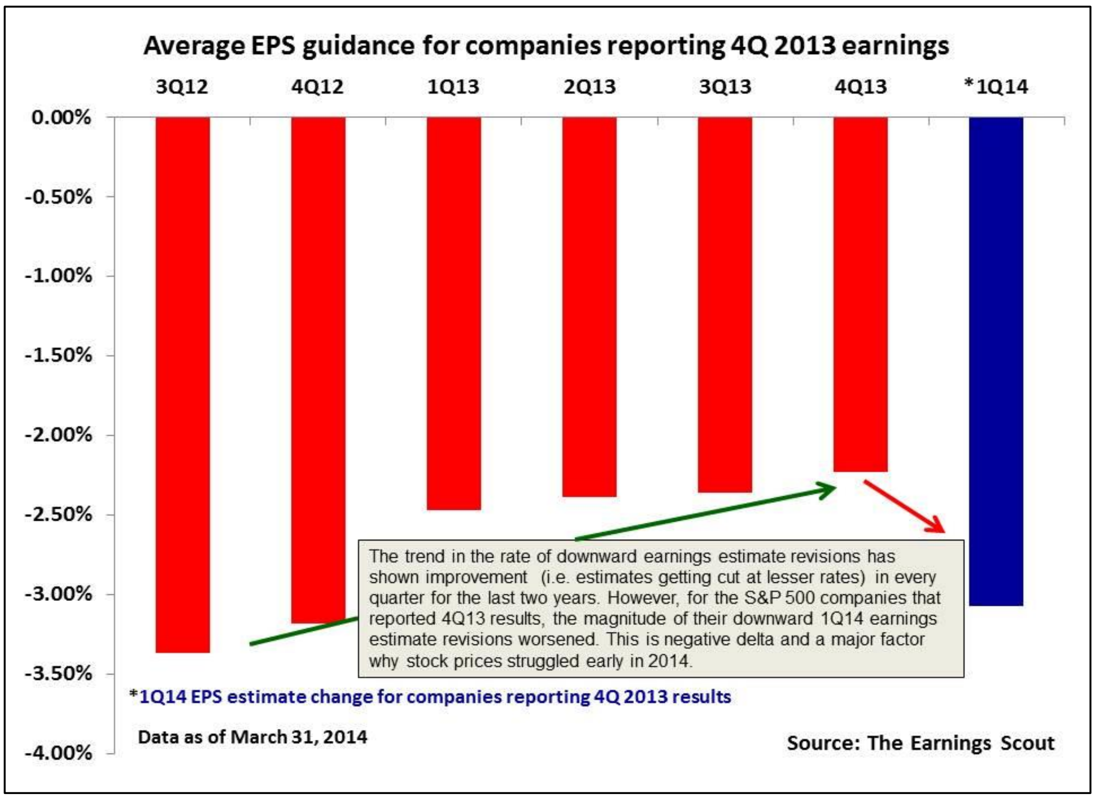
Global Central Banks

The rate of inflation continues to come in well below central banks targets in the U.S., Europe and Japan, despite years of aggressive monetary policy. The reality is we remain in a debt deflationary cycle and global central banks have been doing all they can to prevent it from being more painful as multiple developed countries work down their debt levels. As the 1Q came to a close, global financial markets have begun to price in additional stimulus from the Bank of Japan, the European Central Bank and the People's Bank of China. This could set the stage for disappointment if the central banks choose to stand pat.

Earnings

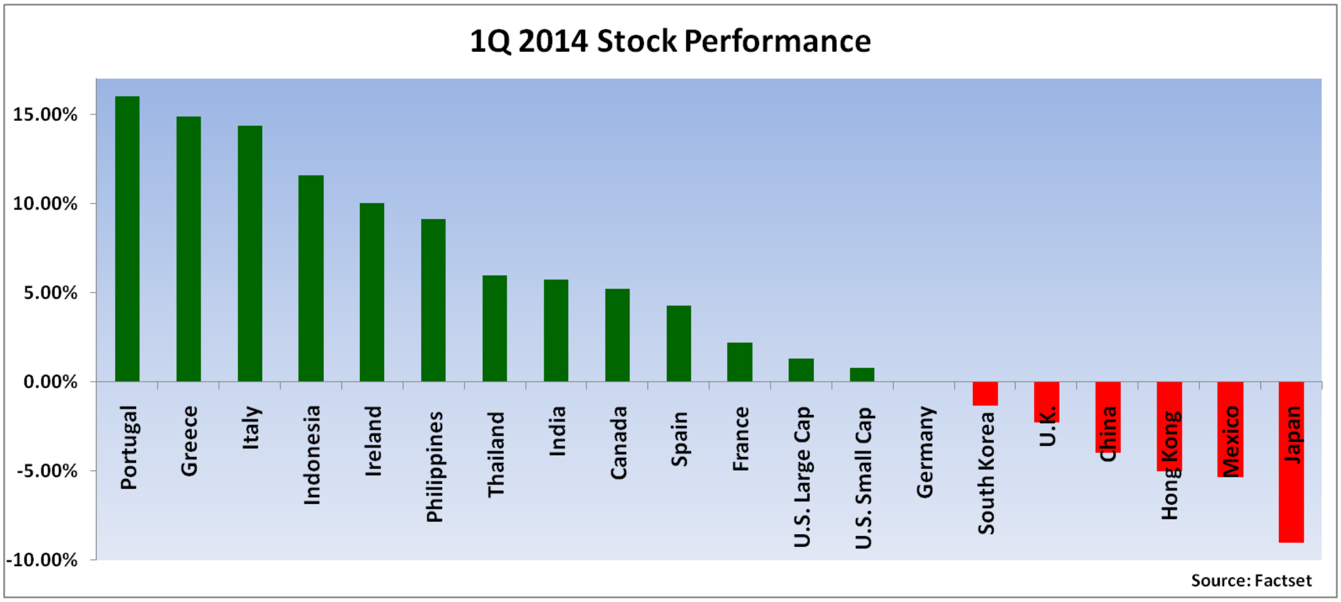
The good news was that 4Q 2013 earnings were stellar. The bad news for investors in 2014 was that those solid 4Q 2013 earnings were priced into stocks last year. Beat and lower was again the theme during 4Q 2013 earnings season. As a matter of fact, a majority of companies in the S&P 500 have seen their next quarter's earnings estimates reduced after reporting results in each of the last 11 quarters. The rate of downward earnings estimate revisions has become steadily less severe over this 11 quarter timeframe. However this changed with the 4Q 2013 earnings season where the magnitude of the downward 1Q 2014 EPS estimates increased showing a worsening trend. We believe this shift to a worsening trend for the 1Q 2014 EPS estimates is due mostly to rising interest rates at the end of 2013, and less to weather. It will be interesting to see if earnings estimates will become less negative and expectations improve now that we have seen lower interest rates so far in 2014. See Chart 2 – below.

Chart 2 – EPS estimate guidance



Global stock price divergences

During the financial crisis, there was much said about the high correlation of global markets. At that time, it did seem that all markets were moving in the same direction. Through that period we held onto the belief that global diversification is important and that deviating from that in a major way is not our preference. As you will see in the first quarter of 2014 there is a wide variance of returns across various global markets. In our view, diversification is still a critical building block of portfolio design.



Conclusion

As we continue to move further into 2014, there will likely be some of the 10 themes that persist, and some replaced. If we knew the absolute direction of these factors in advance (which we do not) then making lots of money in short periods of time would be easy. Understanding the impact of economic data and other factors is important to portfolio design and it continues to lead us to our fundamental beliefs that risk and return are related, markets are efficient, and diversification is key. These fundamental beliefs continue to be core to our short term and long term investment approach.

We hope you found this information useful, and encourage you to approach us with any questions you may have. We look forward to our next conversation.

Strategic Investment Advisors Investment Committee,

Scott Hohman, CFP®, AIF® **Mark Klopfenstein, AIF®** **Nick Raich, CFA®**