# The Ten Themes of 3Q 2014

The 3Q 2014 period ended with increased uncertainties that led to more volatility in numerous financial markets around the world. This is in contrast to the "Low volatility" (one of our Ten Themes of 2Q 2014) that we experienced for the first half of this year. Here are the ten themes that we believe impacted global financial markets the most during the third quarter of 2014.

1. Geopolitical risks
2. Slowdown in Europe
3. Falling energy prices
4. Deflationitis
5. Re-acceleration of U.S. growth
6. Global central banks
7. U.S. dollar
8. Small cap underperformance
9. Chinese stocks
10. Global stock price divergences

**Geopolitical risks**

As the 3Q 2014 period began, the prevailing fear was that the Ukraine / Russian conflict would turn into something more. By the end of the quarter, the conflict is still unresolved but investors appear to have become less concerned about its global economic impact. Instead, new worries have grown about ISIS in the Middle East and protests in Hong Kong. While the geopolitical risks create headlines, the economic impact they have had on the overall U.S. economy appears to be negligible.

**Slowdown in Europe**

While some will blame the Ukraine / Russian conflict as the reason Europe's economy has cooled off, we have seen economic expectations weakening in the region for well over a year. Given the size of Europe's economy, any problems there will have an impact on the rest of the world. Just ask Asian exporters or Ford Motor Company, which announced near the end of the quarter that it would post losses of approximately $1.2 billion in its European operations this year and another $250 million of losses in 2015.

**Falling energy prices**

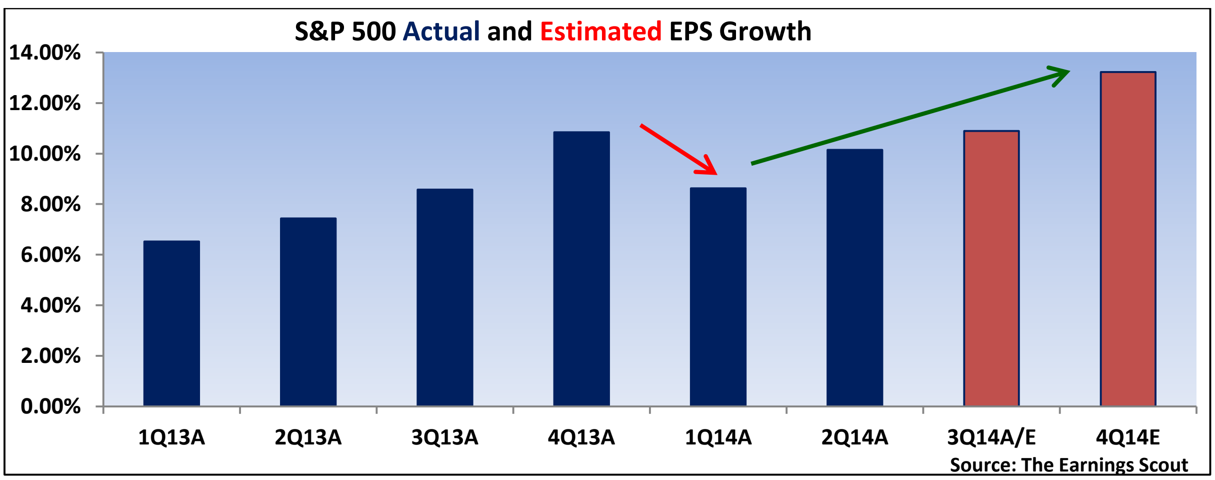
According to AAA, the national average for regular unleaded gasoline on June 30th was $3.71 a gallon. Numerous factors including the slowdown in Europe, increased production and a strong U.S. dollar saw energy prices get crushed during the 3Q 2014 and a gallon of gasoline on September 30, 2014 averaged $3.35 in the U.S.

## Deflationitis

The falling energy prices, along with other commodities, increased deflation fears. Make no mistake, the epicenter of the deflationary woes is rooted in Europe and appears to be contagious by impacting prices in economies outside of the Eurozone. Therefore, Mario Draghi, the head of the European Central Bank, will most likely have to adopt further accommodative monetary policies to fend off what Christine Lagarde, the head of the International Monetary Fund, has referred to as “low-flation.” While deflation sounds like a good thing as it leads to lower prices for consumers, it ends up being very bad because it causes companies to lose pricing power and adversely hurts their profits.


## Re-acceleration of U.S. growth

After a sharp slowdown in the 1Q 2014 period, the economy re-gained its footing in the 2Q 2014 period. Many blamed the bad winter weather for the 1Q 2014 slowdown and that certainly was a factor, but we have contended all along that higher interest rates at the beginning of the year were also a factor. The decline in interest rates in 2014 has helped companies to exceed Wall Street earnings expectations. Our research is indicating that S&P 500 earnings growth will show even more improvement for the 2nd half of 2014.




## Global central banks

To combat decelerating economic growth and deflation, the European Central Bank (ECB) made a decision to tax banks holding deposits even more to encourage them to lend, resulting in negative interest rates. In addition, the ECB also began its TLTRO program, which are targeted low interest loans to commercial banks. The amount of banks requesting funds disappointed. However, they will get another chance to go to the ECB well in December.

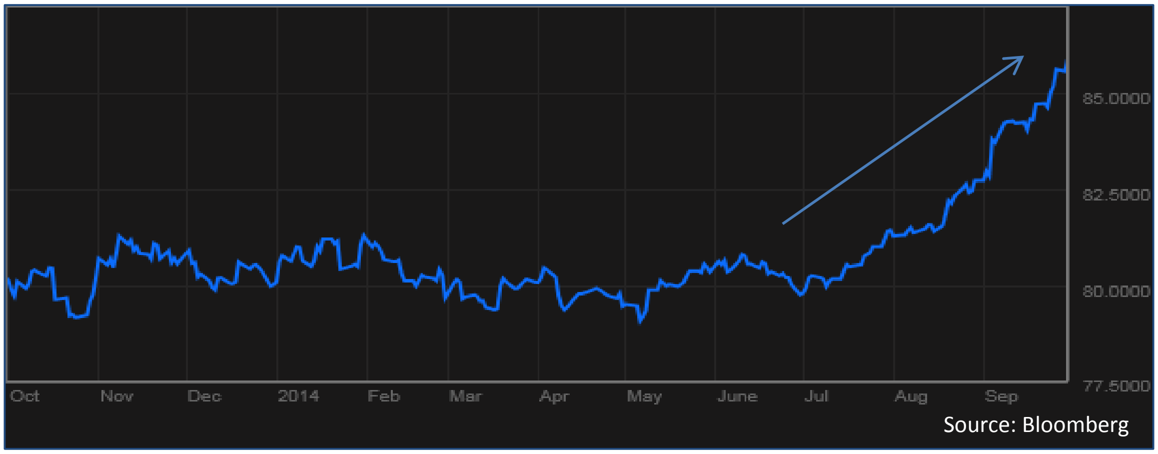
In addition to the ECB, the Bank of Japan maintained its current level of stimulus and talks of a new, more accommodative head at the People’s Bank of China swirled during the quarter.

As most global central banks either maintain or increase their stimulative measures, the U.S. Fed is going in the opposite direction. It continued to scale back on its QE bond buying program and hinted that it plans to raise short-term interest rates in the not too distant future.

**U.S. dollar**

With stronger relative economic growth, extraordinarily low European yields and the Fed hinting it would soon start raising interest rates, the U.S. dollar has rallied sharply against most other global currencies. While a strong dollar gives us good feelings of patriotism and makes us want to chant, "USA, USA. USA," the reality is if the dollar strengthens too much it will begin to negatively impact U.S. multinational profits, U.S. exporters and growth in emerging market economies where many U.S. companies conduct business.

**U.S. Dollar Index (DXY) – measures the dollar against a basket of other major currencies**




**Small cap underperformance**

During the 3Q 2014 period, the Russell 2000 index (a small cap stock proxy) declined -7.65% taking its 2014 YTD loss down to -5.32%. Conversely, large cap stocks, as measured by the S&P 500 index, were up +0.62% during the quarter and are up +6.70% YTD. Market bears are highlighting the massive small cap underperformance as a precursor of what is to come for the broader markets. Our research on the EPS estimate revision trends of small caps versus large caps does not agree with what the bears are suggesting.

| Stock index | 1 month Return | 3Q 2014 Return | *2014 YTD Return |
|---|---|---|---|
| **S&P 500** | **-1.55%** | **0.62%** | **6.70%** |
| **Russell 2000** | **-6.19%** | **-7.65%** | **-5.32%** |

*Price change through 09/30/2014 Source: Bloomberg

**Chinese stocks**

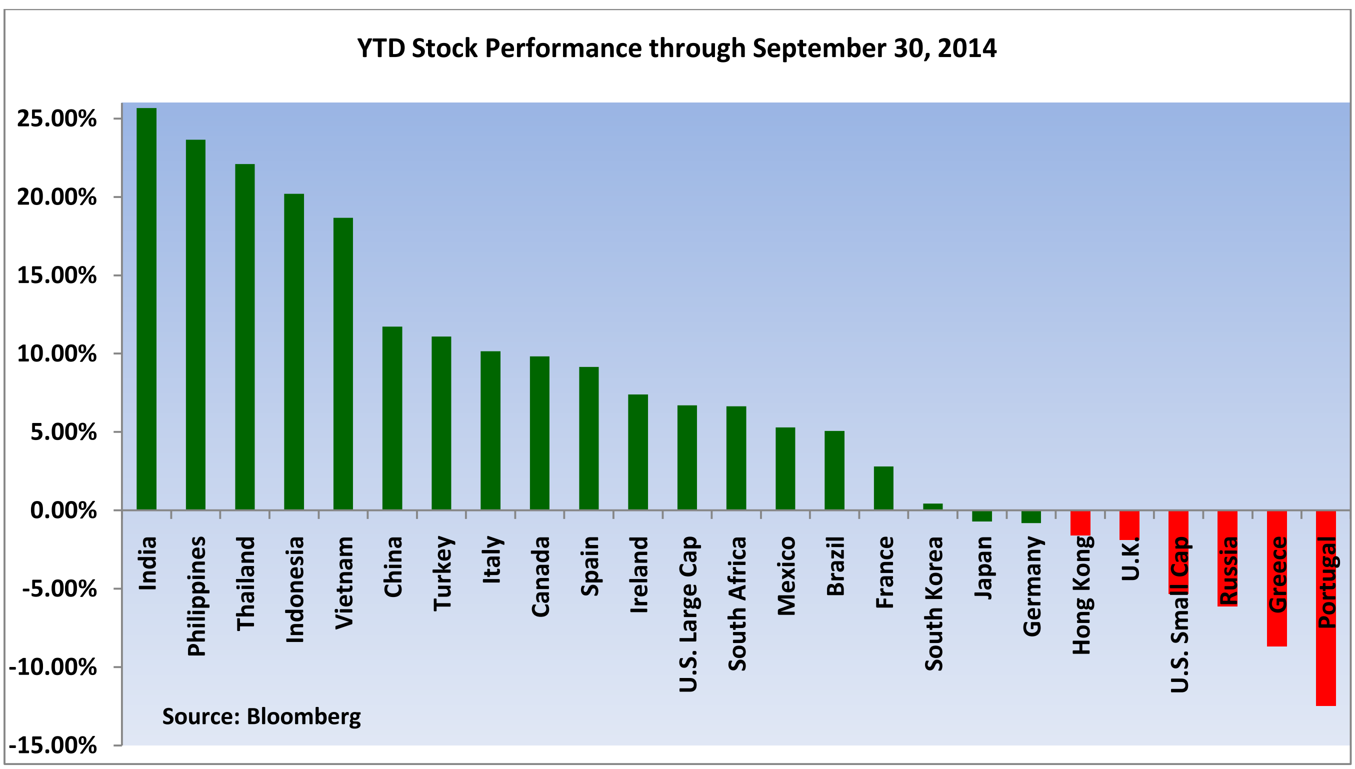
While many major stock indices declined during the 3Q 2014, including some very sharp drops in Europe, Emerging Markets and U.S. small caps, Chinese stocks quietly rallied +15.40%. The outperformance of Chinese stocks is interesting because many have cited slowing growth from the country as a big reason for the global sell-off during the 3Q 2014 period. Furthermore, many Chinese economic data points ended up disappointing economists in the last three months, so why the rally? Our research has observed that the severity of the decelerating economic trends in China has stabilized. Therefore, it is quite possible the worst of the cuts to Chinese growth forecasts may be a thing of the past.


## Global stock price divergences

| Country | Stock Index | 3Q14 Return | July Return | August Return | September Return | *YTD Return |
|---|---|---|---|---|---|---|
| India | SENSEX | 4.69% | 1.88% | 2.89% | -0.12% | 25.68% |
| Philippines | PSEi | 6.41% | 0.30% | 2.71% | 3.29% | 23.66% |
| Thailand | SET Index | 6.73% | 1.12% | 3.94% | 1.54% | 22.10% |
| Indonesia | JSE Composite | 5.31% | 4.31% | 0.94% | 0.01% | 20.20% |
| Vietnam | Ho Chi Minh | 3.58% | 3.10% | 6.81% | -5.95% | 18.66% |
| China | Shanghai Composite | 15.40% | 7.48% | 0.71% | 6.62% | 11.72% |
| Turkey | BIST 30 | -5.23% | 4.91% | -2.68% | -7.17% | 11.10% |
| Italy | MIB | -1.84% | -3.35% | -0.58% | 2.16% | 10.15% |
| Canada | TSX Composite | -1.22% | 1.22% | 1.92% | -4.26% | 9.83% |
| Spain | IBEX | -0.90% | -1.98% | 0.20% | 0.90% | 9.16% |
| Ireland | ISE | 3.72% | -1.11% | 2.91% | 1.91% | 7.39% |
| U.S. Large Cap | S&P 500 | 0.62% | -1.51% | 3.77% | -1.55% | 6.70% |
| South Africa | FTSE/JSE All Share Index | -3.16% | 0.88% | -0.85% | -3.18% | 6.65% |
| Mexico | Bolsa IPC | 5.26% | 2.53% | 4.13% | -1.41% | 5.29% |
| Brazil | Ibovespa | 1.78% | 5.01% | 9.78% | -11.70% | 5.06% |
| France | CAC | -0.15% | -4.00% | 3.18% | 0.80% | 2.80% |
| South Korea | KOSPI | 0.89% | 3.69% | -0.37% | -2.34% | 0.44% |
| Japan | Nikkei 225 | 6.67% | 3.03% | -1.26% | 4.86% | -0.72% |
| Germany | DAX | -3.65% | -4.33% | 0.67% | 0.04% | -0.82% |
| Hong Kong | Hang Seng | -1.11% | 6.75% | -0.06% | -7.31% | -1.60% |
| U.K. | FTSE | -1.80% | -0.21% | 1.33% | -2.89% | -1.87% |
| U.S. Small Cap | Russell 2000 | -7.65% | -6.11% | 4.85% | -6.19% | -5.32% |
| Russia | MICEX | -4.20% | -6.45% | 1.97% | 0.43% | -6.14% |
| Greece | ASE | -12.58% | -3.73% | -0.62% | -8.63% | -8.70% |
| Portugal | PSI | -15.61% | -12.09% | -0.61% | -3.40% | -12.48% |

*Price change through September 30, 2014

Source: Bloomberg



**Conclusion**

As we begin the home stretch of 2014, it will be interesting to watch for the themes that persist through the end of the year, and those that will be replaced, especially the geopolitical risks. The one major theme over the past three years that has persisted is that an economic recovery is underway in the United States and our economy is looking much better than many across the world. This recovery has been gradual and it still remains fragile. The pace of economic activity has been slower than most of us would like and any spike in interest rates, another really bad winter, a sharp rise in the value of the U.S. dollar or any other unforeseen shock, could have an adverse impact on whether macroeconomic expectations improve or worsen.

We take great pride in our measurement and understanding of the economic data because it is important to portfolio design. It would be great to know every major market factor in advance, however, that is not possible. Because of this we continue to apply our fundamental beliefs that risk and return are related, markets are efficient over time, profitability matters 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®**