



## Market Commentary July 2013

### Overview

To put a twist on the old saying, the second quarter of 2013 came in like a lamb and went out like a lion. Though there were some short-lived interest rate spikes that hinted at storms brewing on the horizon, April and the first half of May were marked by much of the same low volatility equity rallies and complacency that we saw throughout the first quarter. The mood of the market dramatically shifted following the May 22<sup>nd</sup> comments by Fed Chairman Ben Bernanke who cited the possibility of tapering quantitative easing, the Fed's program to buy \$85 billion in Treasuries and mortgage securities each month. Volatility returned to global markets and interest rates skyrocketed on both the improved economic outlook and potential reduction of QE3. In our earlier May rebalance, we decided to reduce the impact of a rise in interest rates by shortening our fixed income duration which shielded the portfolios from a portion of this interest rate volatility. The uncertainty in markets accelerated following the June 21<sup>st</sup> Federal Open Market Committee (FOMC) minutes and press conference with several days of across the board asset class selloffs. Among the hardest hit asset classes were emerging market bonds and gold, as the dollar rose beyond most expectations and the reduction of easing came into view. This year looks and feels similar to the last few years, where the first half brought an equity rally followed by volatility during the summer months. We continue to hold a defensive stance since markets seem to be more influenced by the actions of the Fed and other central banks than by the usual economic factors.

### Domestic Equities

US stocks continued their first quarter rally through the beginning of the second quarter with the S&P 500 reaching a peak of 1669 on May 21<sup>st</sup> ahead of Ben Bernanke's first comments mentioning tapering QE3. Equities declined on significantly higher volatility following the Bernanke comments and the S&P lost nearly 5% coming into the June FOMC meeting. The Fed surprised the market, which had expected the tone of the meeting to be reassuring following the negative reaction to the earlier comments, by declaring that downside risks to the market had diminished since the economy was showing definite signs of improvement and, for the first time, setting some guidelines regarding the timing of the taper. Equities declined sharply following the meeting before recovering somewhat by the end of the quarter as some investors became more bullish on stocks given the improving economic conditions that are driving the Fed's tapering decision. The selloff in equities at the end of the quarter did have the benefit of making equities cheaper and a better value at a time when earnings are at an all time high. While the stock market declines we have witnessed this quarter seem dramatic following such a long correction-less rally, the magnitude of the decline is far from alarming when you consider that 10-15% corrections are common in equity markets. We have also seen signs of improvement in the labor market, as the number of jobs created increased, the size of the labor force increased, layoffs reached pre-recession lows, and in manufacturing as data showed improved sentiment and tight inventories. Once the market adjusts to the idea of eventual reduced stimulus, this improved economic outlook should make the US the cleanest shirt in the laundry basket compared to other economies.

### International Equities

Both international developed and emerging market equities underperformed domestic equities. International developed returned 4.10% (MSCI EAFE Index) and emerging markets returned -9.57% (MSCI Emerging Markets Index) through June 30. Issues surrounding international developed economies (primarily Europe) are still apparent and growth is low or nonexistent, but recently investors have shifted their concerns to emerging markets, whose underperformance this year stems in part from a slowdown in China. Much of China's growth out of the 2008 financial crisis has been through investment in infrastructure. While the process of building has kept their economy growing, the practical uses of these projects have not yet been recognized. When China's growth slows, it hurts both European exports as well as commodity prices. Despite these issues, other emerging markets are now trading at significant discounts to other developed nations and still have more impressive growth prospects, with much less debt than the developed world. Frontier markets outpaced both international developed and emerging markets, as these regions continue to increase exporting output to the rest of the world. We expect developing markets to be a growth driver for years to come, with increased domestic consumption within emerging markets, lessening their reliance on exporting to the developed world.

## **Fixed Income**

After reaching a low of 1.63% on May 2<sup>nd</sup>, yields on 10 year treasury bonds increased to a high of 2.59% during the second quarter, climbing 0.96% during that period (Chicago Board Options Exchange 10-Year T-Note Index). Rising interest rates began with a healing economy and were exacerbated by talks from the Federal Reserve concerning the inevitable slow down of quantitative easing through the Fed's bond buying program. Longer maturity bonds across the board felt more of a pullback as longer term rates increased more than shorter term rates. The additional worries surrounding the Federal Reserve caused investors to move assets to the most heavily traded parts of the bond market (most liquid), causing less liquid asset classes such as emerging market debt to underperform. The issue was not the quality of the bonds but the maturity and liquidity, particularly in the high yield space which saw a decline of 1.87% without a reduction in loan quality. Floating rate bonds, which are short term loans to companies whose yields' reset as interest rates increase, performed very well as these investments are designed to outperform in rising interest rate environments. Everything from equities to treasuries began to move a similar direction with unusually high correlation. We do not expect this phenomenon to continue as it is an extremely rare occurrence for equity and bond markets to trade higher or lower at the same time.

## **Alternatives**

Last quarter we discussed the increased risks in both stocks and bonds compared to a few years prior and this past quarter was a perfect example of this. Both stocks and bonds moved in tandem and traditional diversification was not enough to keep a balanced portfolio afloat. This is the reason we depend on alternatives, and not just fixed income, to provide diversification to equities. Master Limited Partnerships (MLPs) had another positive quarter, and are now up 24.11% year-to-date (Alerian MLP Index). We expect this asset class to benefit from the energy renaissance currently under way in the US in crude oil and natural gas. Gold significantly underperformed, as the announcements from the Federal Reserve on a slowdown of quantitative easing caused the US dollar to rally, although we continue to expect this to hedge our portfolios against future debt ceiling debates and potential future inflation. Managed futures, which is a trend following system that can make long and short investments in various futures markets, returned 0.40% for the quarter (AQR Managed Futures), providing diversification in a quarter where many assets lost value at the same time.

## **Real Estate**

The US residential housing market continued to be a bright spot despite facing significant headwinds in the form of rising mortgage rates, diminished affordability levels, continued high unemployment and weak wage growth in the US labor market. Housing starts hit levels not seen since 2008 and the Case Schiller index rose a very healthy 1.7% in April, equivalent to a 21.5% annual rate. New home sales jumped in May in every region except the South with inventory continuing to remain tight as builders show caution. Lower end homes and cash purchases have been making up larger portions of the market than they have historically and homebuilder sentiment is more optimistic than it has been since March 2006. While mortgage applications have been down since mortgage rates have increased, the decline is due to the reduction in refinancing, not reduced demand for new purchases.

## **Conclusion**

While the US economy is showing moderate improvement and the stock market ended the quarter higher year to date even after a rocky June, we are still concerned about a number of issues and are managing our portfolios accordingly. As QE3 must end eventually, the volatile market reaction to Fed comments this quarter is an area of concern. The disproportionate weight placed on Fed decisions relative to actual economic fundamentals makes the job of an asset manager particularly difficult, though we are seeing signs that the markets are moving towards once again treating good news as good and bad news as bad. We are also closely watching developments overseas in emerging and developed markets alike because the global nature of today's economy means that economic issues are rarely contained within borders. We are becoming cautiously optimistic about the state of the US economy and are focused on riding out the current volatility by maintaining our defensive stance while being prepared to capture more upside should the opportunity present itself.

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