

Stocks fell sharply in the last week of July, erasing the month's gains. Large caps lost 1.4% for July, though they remain solidly positive for the year to date with the S&P 500 up 5.7%. Small caps fell 6.1%, a particularly rough month for the asset class, which has now lost a little over 3% year to date. The late-month volatility occurred amidst increased geopolitical tensions, concern about changing monetary policy, and global credit issues—even as U.S. economic data showed improvement.

Specifically, U.S. GDP (a broad measure of economic health) grew 4% in the second quarter after a first quarter decline that most economists had dismissed as temporary due to seasonal factors. While the second quarter number is an initial estimate that will likely be revised, it was good to see some of the first quarter's weather-related slowdown reversed. Job growth continued at a relatively strong pace, with more than 200,000 jobs added in July. Unemployment now stands at 6.2%, though this number would be much higher if the underemployed were accounted for. For example, those who have not been able to get full-time employment despite their attempt to do so, and those that have stopped looking for jobs.

Also adding to month-end volatility was the statement following the July meeting of the Federal Open Market Committee. In it, the Fed acknowledged the rebound in economic growth and noted that inflation has edged closer to its 2% target. However, it also commented that while the labor market has improved—sufficient to warrant another increment down in the Fed's monthly bond purchases—it remains concerned about overall labor-market health based on a range of indicators (including wage growth, the prevalence of part-time jobs among those seeking fuller employment, and others). The Fed's bond purchase program remains on track to conclude in October. Its guidance continues to indicate that it expects to keep rates low for a considerable time beyond that—mid-2015 according to market speculations—though part of the decline in

stocks for July may have been driven by fears that stronger growth could prompt rate hikes sooner than expected.

Despite intensification of the conflicts between Israel and Gaza, and between Russia and Ukraine, emerging markets were a bright spot for July, rising 1.4% for the month. Emerging markets have gained 7.6% so far this year, marking the strongest showing among diversified global equity benchmarks we track. China's growth has shown some signs of firming (second quarter GDP rose 7.5%, slightly beating expectations), helped in part by increased government spending and credit expansion. However these stimulus measures may have only a temporary effect and add to the risks related to China's excessive debt levels. Other news included a setback for Argentina in its 12-year judicial battle with a group of hedge fund investors who own the country's bonds. (The issue dates back to Argentina's bond default in 2001–2002.) Among developed markets, Europe joined the United States in adopting harsher sanctions against Russia in response to the situation in Ukraine, prompting some concern that these actions could harm Europe's fragile economic recovery.

Core bonds suffered very slight losses in July, with Treasury yields ticking modestly higher to 2.56% following a month-end decline amidst indications of stronger U.S. growth. Concerns about geopolitical tensions have potentially been a stabilizer for Treasury prices by prompting investors to seek safer holdings. Riskier bond market segments, including high-yield bonds, declined alongside the stock market (as can often be expected). Liquidity in this market segment may be another concern, which we discuss below.

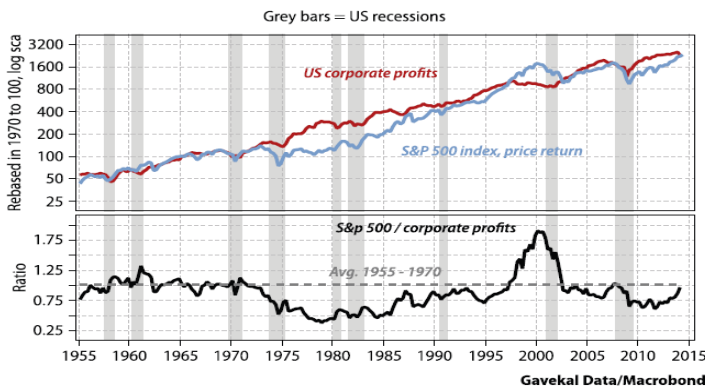
Research Highlights

Here is a quick rundown of some interesting research we reviewed during the past month and thought was worth passing along to our readers.

Corporate Profits & the Stock Market

A recent GaveKal study reviewed the long-term relationship between corporate profits and the stock market from 1955 to present. The chart below shows that over the (very) long-term profits and the stock market tend to track each other closely. In the chart US profits are shown from the national accounts and are adjusted for inventories. Over shorter time-frames, the ratio of stock prices to corporate profits can swing widely between periods of significant undervaluation (1978) and overvaluation (2000), with the current relationship close to the average since 1955. Suggesting that today's market is reasonably valued.

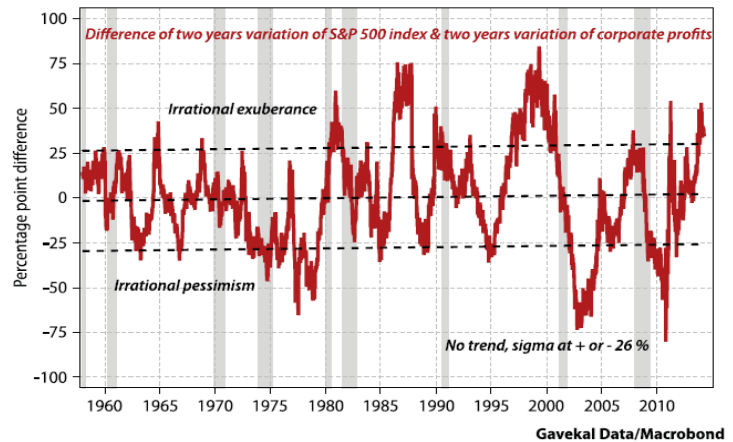
Given today's profits, stock market is not overvalued



Their research also highlighted that the differential between the growth rate of profits and stock prices can reveal a lot about current investor sentiment. For example, the chart below shows how much the differential between the growth of stock prices and corporate profits can vary over rolling two year periods. Their conclusion being that when the growth of the stock market exceeds the growth of profits by 26% or more there is excessive optimism in the market and vice-versa. Based on the chart below we are currently above that 26% threshold,

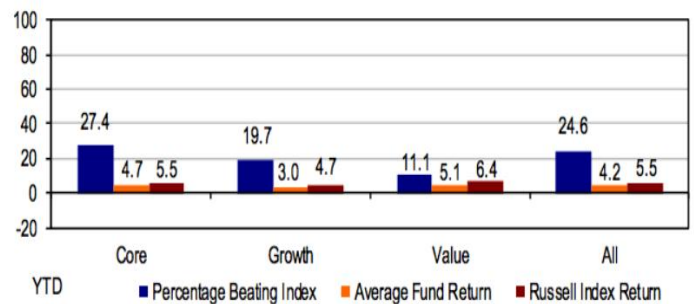
indicating that investors are towards the exuberant side and increasing the risks of a correction.

We are in a period of excessive optimism



Active Management

The chart below was posted on the blog site www.thereformedbroker.com and shows that active manager performance continues to struggle in 2014 relative to their passive (index) benchmarks. In aggregate, less than 25% of active managers are beating the benchmarks this year. Continuing a long streak of poor performance that we've highlighted before in the Standard & Poors (SPIVA) studies. The SPIVA studies show that the majority of active managers have struggled to outperform for over five years. For more information on the SPIVA research click here: <http://goo.gl/o23IDj>.



Note: Manager data and index returns are through July 31, 2014. Source: Lipper Analytical Services; BoFA Merrill Lynch US Quantitative Strategy.

The table below is from Morningstar and highlights that active managers continue to lose market share to both ETFs and passive (index-based) mutual funds. Their current “share of wallet” has dropped to 32%, a new low.

Net Sales, U.S. ETFs and Mutual Funds—Trailing 12 Months Through June 30, 2014

Morningstar Category	\$ Billions	Market Share
ETFs	146	35%
Passive Mutual Funds	138	33%
Active Mutual Funds	134	32%

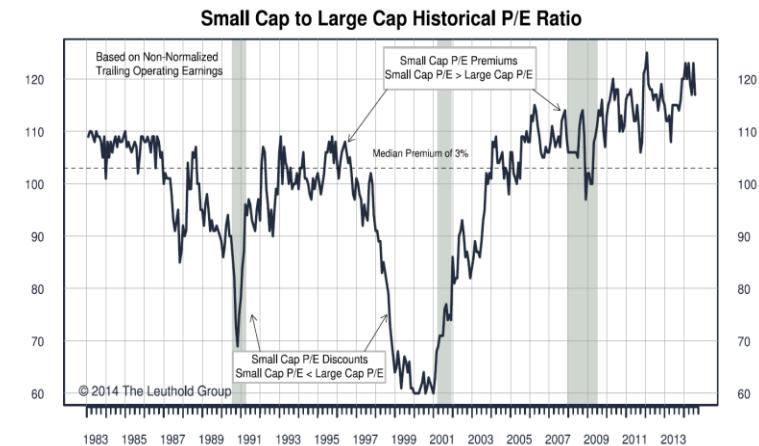
Source: Morningstar Data.

However, a recent study from by Sungarden investment research makes us wonder if it is just a by-product of investors chasing performance in a bull market. Their study compared active vs. passive investment performance and concluded that during the past few cycles passive investment strategies tended to outperform in bull markets, while active managers clearly outperformed in down markets. Our conclusion is that passive strategies can play a significant role in investment strategies, due to their low costs and tax advantages. However, we think active managers may be due for a period of outperformance, and that investors may regret swinging the pendulum too far towards passive indexing if we see a significant correction. For more information on the study, click here <http://goo.gl/BSn86S>.

Relative Valuation: Large vs. Small-cap

The chart below from Leuthold highlights the valuation of small caps stocks relative to large caps. Based on the P/E ratio small-caps clearly look overvalued. This chart and other valuation measures continue to support our thesis that small

caps relative to large cap stocks should be underweighted in portfolios.



Bond Liquidity

There has been a lot of debate lately about the potential liquidity risks in the high-yield bond. Resulting from increased retail holdings of risky issues and a lack of dealer inventory due to regulatory capital constraints. What we have seen over the last few years is dealer inventory of corporate bonds in general has declined dramatically. What this means is dealers have fewer items on the shelf for sale.

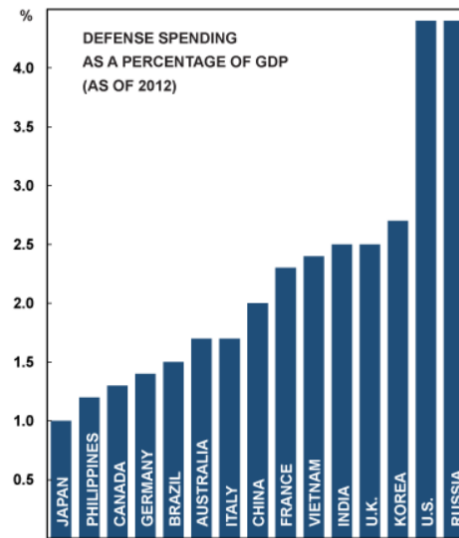
It may be helpful to walk through a simple example to illustrate what is different today. Let’s assume an investor informs a dealer they want to sell \$30 million of a bond at a specified price. The dealer, however, finds only one investor who wants to buy \$10 million of that bond at the price level. In the past, the dealer might take the \$30 million of bonds, sell \$10 million to that one buyer, and hold the remaining \$20 million of the bond, especially if they think it’s a good company, knowing that they could sell it at a later date. That’s not the case today. Dealers are now less likely to hold the inventory, and therefore make a market in a security, because of worries over potential regulatory violations.

The concerns then are, if dealers, because of regulatory changes, are not able to hold as many bonds on the shelf, how much risk can one sell, if you will, in a down market, and what happens to prices when the market sells off? While we don't know for sure, it is likely that lower dealer inventory increases the magnitude of short-term price declines, as it could be harder to quickly exit positions. Whether this means prices trade down six or seven points, whereas in the past they would have traded down five points, we don't know. One thing to keep in mind in an abrupt and sharp sell-off is that it's usually the case that selling pressure exceeds the short-term liquidity of the market, exacerbating price declines. It is also often the case that some amount of this type of selloff proves to be a temporary result of investor overreaction and, as such, usually corrects (to varying degrees) as pricing regains greater rationality. In general, we believe high-yield bonds are overvalued and that the risk vs. reward does not warrant an allocation of capital.

Multi-Polar World

Finally, BCA research wrote a report on the geopolitical transition of US being the sole "superpower" to more of a "multi-polar" world. A world in which countries like China, Russia and others attempt to flex their muscle and challenge the hegemony of the US around the globe. We are seeing this manifest in areas such as Russia invading Ukraine, the Middle-East, and the military buildup of China and other countries in the East. The chart below highlights the level defense spending around the world, something we expect to grow as the US pulls back and countries look to look to capitalize on our absence. The transition to a multi-polar world is something we will watch closely as we believe it will lead to greater uncertainty and volatility over time.

Military Spending As A Share Of GDP



SOURCE: STOCKHOLM INTERNATIONAL PEACE RESEARCH INSTITUTE (SIPRI).
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Summary

Here is a summary of some of the higher conviction recommendations we are making in portfolios. We remain underweight core investment grade bonds in portfolio strategies and have allocated some of that capital to absolute return fixed income managers. Managers that we believe have the flexibility and ability to generate positive returns in up and down markets. In US equities we are underweight small-cap stocks relative to large-cap, and have allocated some of our equity capital into the alternative manager asset class. Our alternative allocation is focused on managers that have a relative low correlation to traditional assets classes (stocks and bonds) and have an emphasis on real and absolute returns. Lastly, in July we reduced our recommended allocation to international stocks from an overweight to neutral. If you have any questions on these recommendations or would like to discuss portfolio strategy, please give us a call.

—AWM Investment Team (8/14)