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Investment Review & Outlook
Third Quarter 2014

Moving Into Choppy Waters

You could say that the markets took a breather in the third quarter of 2014, but you would come to that conclusion only if you looked at the overall returns and ignored the drama of the past 30 days. The markets experienced a difficult month of September, giving up some of the gains from the prior eight months and causing investors to worry that we are about to experience more of the same. The end of the month was especially difficult, with a general market slide starting September 22nd, and some indices dropping more than 1% on the final day.

Large cap stocks were the market leaders over the past three months, but the gains were modest. The Wilshire U.S. Large Cap index gained 1.13% in the second quarter, and is now up 8.38% so far this year. The Russell 1000 large-cap index eked out a positive 0.70% return for the quarter, but it still provides 7.97% gains so far this year. The widely-quoted S&P 500 index of large company stocks posted an even smaller gain of 0.60% for the quarter. The index is up 6.7% since January 1st, but it has fallen back from its record highs on September 18th.

The Russell 2000 Small-Cap Index fell 7.60% in the third quarter, representing its worst quarter in three years--and is now down 4.40% so far this year. Meanwhile, the technology-heavy Nasdaq Composite Index managed to gain 2.45% for the quarter, and is up 7.88% for its investors so far this year.

The rest of the world put a drag on diversified investment portfolios. The broad-based EAFE index of companies in developed economies fell 6.39% in dollar terms during the third quarter of the year, and is now down 3.63% so far in 2014. The stocks across the Eurozone economies contributed to the foreign stock slide, dropping 7.37% for the quarter, but the red ink spilled over to most of the foreign indices in Asia as well. Emerging market stocks of less developed countries, as represented by the EAFE EM index, represented a bright spot, losing “only” 4.33% over the last three months, and are still up 0.26% so far this year.

The expected rise in bond rates never materialized, confounding the experts yet again. The Bloomberg U.S. Corporate Bond Index now has an effective yield of 3.07%, while Treasury rates held steady. 30-year Treasuries are yielding 3.20%, and 10-year Treasuries currently yield 2.50%. At the low end, 3-month T-bills are still yielding a miniscule 0.02%.

Nobody seems to have a convincing explanation for the recent stock market slump. The economy still seems to be pushing along in a long slow, steady growth process, and corporate earnings are well-above historical averages. Oil prices are at their lowest level since November 2012 and consumer spending has rebounded. Although the Fed will cease its bond purchases this month, there is no indication that it is going to sell its inventory back on the market, and its policymakers are projecting low interest rates well into 2015. Corporate cash at larger corporations is near an all-time high.

Pullbacks don't always reflect reality; they are also affected by the sentiment of investors--in other words, human emotions and a crowd (or herd) mentality. Investors seem to be worried that stocks are overdue for a correction, and if these things operated on a schedule, they would be right. We are in the fourth-longest bull market since 1928, without having experienced even a small 10% correction since 2011. The Conference Board reported that U.S. Consumer Confidence slipped dramatically and unexpectedly in September, lending some credibility to the surmise that the investing herd has been startled--and their expectations appear to be creating market reality.

Does that mean we should take action? Unfortunately, nobody knows whether the markets are poised to act on the good economic news and move up, or are ready for another fearful selloff that would finally deliver that long-delayed correction. History tells us that it's a fool's game to try to anticipate market corrections, and that investors usually get rewarded for sailing through choppy waters, rather than jumping off the ship when the waves get higher.

You can't know in which direction the markets will experience their next 10%, 20% or 30% move. But unless you believe the world is about to end, you do know, with some degree of certainty, in which direction it will make its next 100% move. That's the best prediction of the markets you're likely to get, even if it doesn't come with a timetable.

The FAM Team