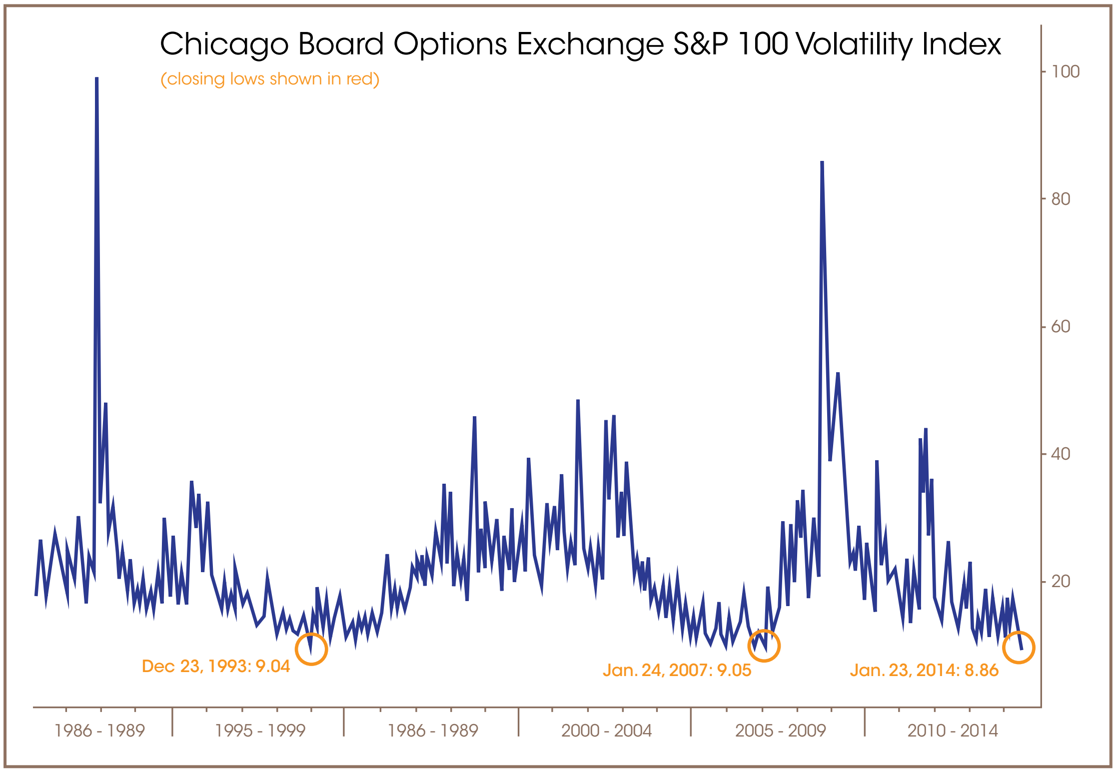
Investment Outlook

Second Quarter 2014

As we discussed in our first quarter note, equity returns in 2013 were phenomenal and most investors, including us, expected a subpar 2014.

While there is still half the year left and anything can happen, the markets turned in a surprisingly strong first half of 2014. The S&P 500 increased by 7.1% and now sits in record territory at 1960. The fixed income standard-bearer, the Barclay's Aggregate, increased by 3.9% after a much ballyhooed decline in 2013. Other assets such as gold and real estate have also posted strong returns after weak performances in 2013. Single family and multi-family housing prices have continued their upward march through the year, helping to fuel the real estate sector. Typically all assets don't rise in lock-step as we've seen so far this year, which gives us pause as we worry about what the downside could bring. Until then, we appreciate the Fed's continued generosity with easy money designed to fuel asset prices.

With the financial crisis and Great Recession still fresh in most investor's minds, we are constantly on the lookout for overarching warning signs. One we have noted is investor complacency. The chart to the right, courtesy of David Wilson's "Visual Guide to Financial Markets," shows the market volatility index, (aka VIX)



VIXO Index (CBOE OEX VOLATILITY INDX) VXO (a/k/a "Old VIX") Weekly 14SEP2008-24J
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hitting low levels only seen twice before in the past 30 years, both prior to market corrections. The VIX is typically referred to as the market's "fear gauge," and the low level suggests that investors aren't afraid today. We take notice of that type of extreme sanguinity.

Why Not the Dow?

When we discuss US equity markets we typically reference the performance of the Standard & Poor's 500 ("S&P 500" or "S&P"). On more than one occasion we have been asked "why don't you use the Dow instead?" The "Dow" of course refers to the Dow Jones Industrial Average, the most famous market index in the world. Without becoming too esoteric, the Dow typically doesn't meet the requirements of an index to be used for portfolio comparison purposes. Because it is price weighted, as opposed to the market cap weighting of the S&P 500, the Dow is virtually impossible to replicate in an actual portfolio.

In a price weighted index like the Dow, the stock with the highest price per share dominates the index. If a stock in the Dow were to split two for one, it would have roughly half of its prior weighting in the index unless an adjustment was made. In the case of the Dow, an adjustment is made to factor for splits, dividends, and other corporate actions. This adjustment is extremely difficult to accomplish in an actual portfolio and typically not additive to investment returns. Overall, this methodology isn't logical in a portfolio context. Therefore, we use the S&P as our equity index.

The Economy

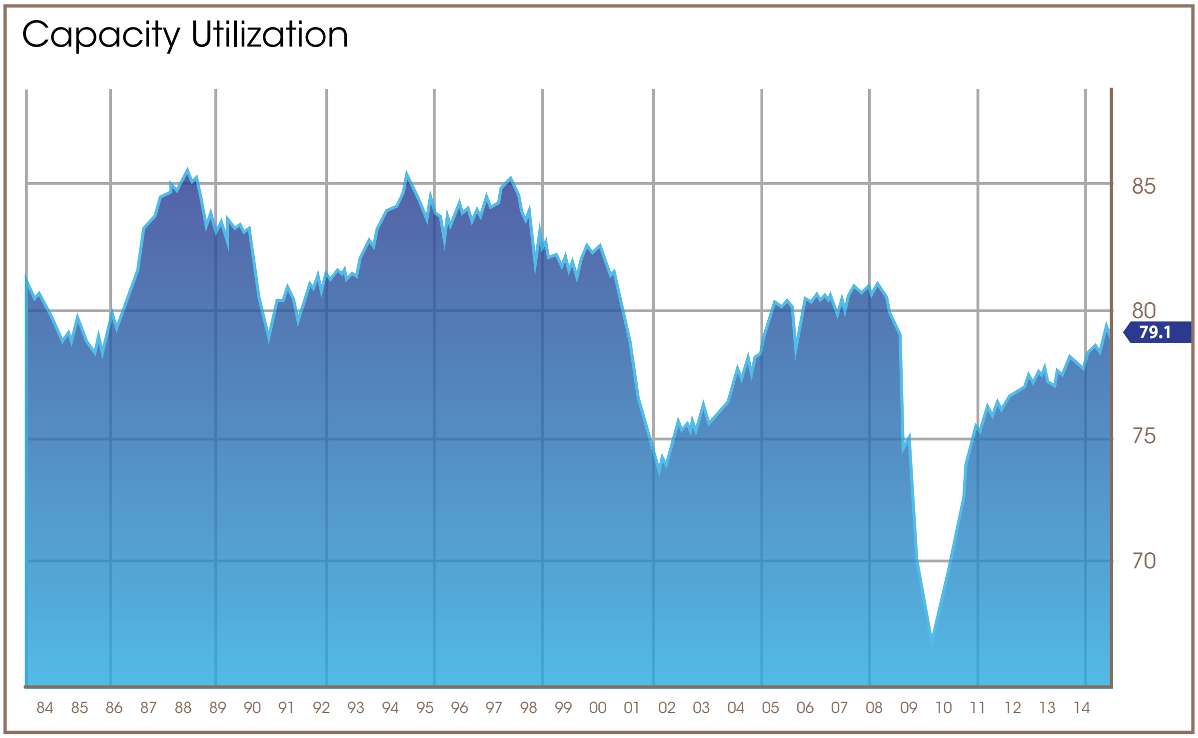
Something happened along the way to economic recovery: a really bad quarter. First quarter GDP came in at a startlingly weak -2.9%. While many expected soft results as much of the Midwest and East Coast experienced horrific weather, the results were dramatically weaker than anyone anticipated and the worst performance by the US economy since the first quarter of 2009. While we agree with most pundits that much of what ailed the economy was temporary in nature, we found the magnitude of the decline quite shocking.

There have certainly been some positive economic indicators that would indicate a rebound in second quarter GDP; however, at CitizensTrust, we are looking a bit longer term to see how sustainable a rebound will be, assuming it occurs at all. The inflation measures, including forward expectations for inflation, have been increasing, which is good for the Fed even though it is bad for the consumer. The logic behind pushing inflation is that eventually rising prices will result in rising wages and allow cheaper dollars to be used to pay back the outstanding debt of both the government and individuals.

Slow economic growth combined with inflation gives us pause as we vaguely remember the stagflation that occurred during the Carter years. Stagflation is a difficult economic condition to combat because the theoretical remedies for slow growth exacerbate the inflation problem. Of all the potential economic outlooks, this is the one that truly gives us concern.

According to the National Association of Realtors sales of previously owned homes in the U.S. increased 4.9% last month, reaching an annualized rate of 4.89 million, the biggest one-month gain since August 2011. The median price rose 5.1% compared with May 2013, while the number of homes on the market increased 6%. The increase in inventory available for sale is certainly a sign of pent up selling demand and should help to moderate price increases going forward.

Capacity utilization, the measure of how much of total production capacity is being utilized, has been rising steadily since late 2010 (see Bloomberg chart below). The most recent reading puts the measure at 79.1%, just below the level where we typically see robust hiring, wage increases, and capital spending take place. Should the economy recover from Q1s weak performance, the US economy could finally be at the cusp of a private sector-driven recovery for the first time since the financial crisis!



As we mentioned earlier, inflation continues to be both a worry and a goal. For manufacturers and consumers, inflation is a concern; for the Fed, inflation is a goal. A first quarter survey by the National Association for Business Economics found that US companies are starting to feel the effects of rising costs. Among respondents, 35% report higher wages, up from 23% in Q4. Meanwhile, 31% of respondents say material costs have increased, up from 15%.

The Fed and Fixed Income

The Fed began cutting back on its asset purchases (aka Quantitative Easing) last year, yet rates haven't moved in either direction since the cut began. Many clients continue to ask why rates didn't reverse in response to the Fed's reduction, and the answer is in the math.

At one point the Treasury was issuing over $150 billion per month in new debt (on average) with the Fed purchasing $85 billion in treasury and mortgage debt each month, $58 billion in treasuries or roughly 1/3 of new issuance. Due to better tax collections, reduced spending from the sequestration, and the 2013 government shutdown, the budget deficit has improved from an annual rate of roughly $1.3 trillion to $550 billion. Even though the Fed is now purchasing a smaller dollar value of treasuries each month, they are purchasing a larger percentage of the new issuance than they were prior. This is a significant driver to lower rates.

Our concern with the Fed's responses is that they seem to be looking at current data and not looking ahead. In their most recent missive the Fed observed that economic activity had improved, which, after a -2.9% quarter could only mean they were looking at April and May data, a short data set indeed. We hope that their crystal ball includes a bit broader view and perspective, but history hasn't supported that wish.

Both Janet Yellen and Ben Bernanke must be feeling like Arthur Burns, the Fed chief in the 1970s. The US has been experiencing a slowing productivity rate similar to 1970s as food and energy prices absorbed an ever-increasing portion of discretionary income. Since the recession ended, our productivity rate has only increased at a pace of 1.4% as compared to 1.5% in the 1970s and the long term US average of 2.5%. Slower productivity growth means higher input costs (i.e., inflation) gets passed through to consumers in the form of price increases, but the benefits don't get passed along in the form of higher wages to employees.

Equity Markets

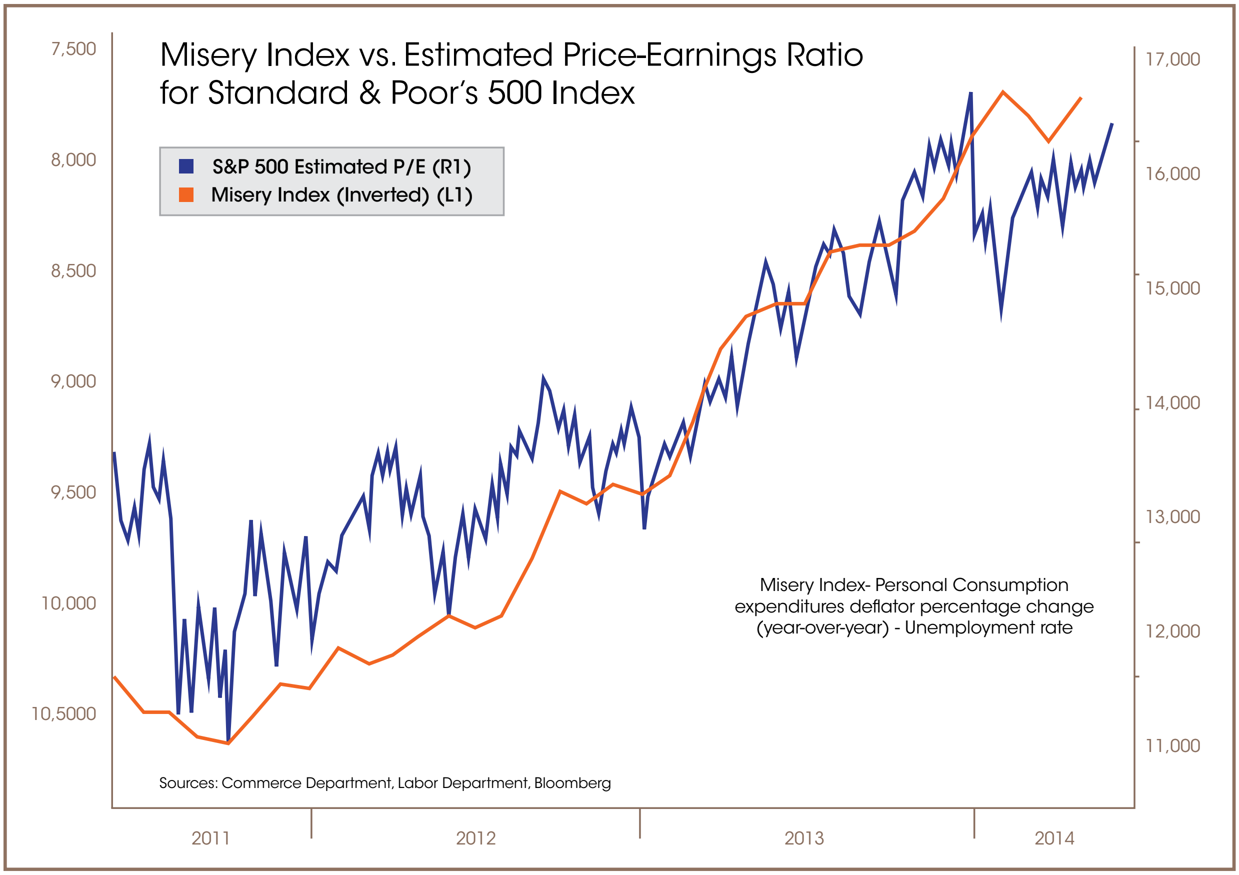
As we mentioned earlier, the S&P 500 closed the first half of 2014 at record levels, rising 7.1% YTD. Valuations continue to inch higher as earnings growth slows. The market is in an interesting position right now as it is slightly more expensive than last year and benefiting from the Fed's continued largess. There are two prescriptions for improved valuation:a market correction or higher earnings. The former is relatively unappealing to most investors due to the associated pain of opening your monthly statement and seeing a decline in market value. The latter, however, could be more devastating in the long run. We would assume that a significant increase in earnings would accompany an acceleration in economic growth. Theoretically, an acceleration in economic growth would force the Fed to finally tighten monetary policy, a trigger that has historically signaled the end of bull markets. The situation certainly makes it difficult to root for one scenario or another.

International

The geo-political environment is as dicey as we've seen since the Cold War ended. Unsettling issues have arisen in Iraq, Syria, Ukraine, Afghanistan, North Korea, and Central America. US foreign policy has been poorly defined and communicated, and the resulting tensions are creating potential hazards for both the residents of these countries and their neighbors. Old alliances are being tested, and new ones quickly formed in response. An example is a recent alliance for China to purchase energy resources from Russia. US analysts long thought such an alliance was improbable but, now that it has transpired, the benefits to both countries create additional pressure on the economic and military position of the US.

One benefit of the international turmoil has been additional demand for US Treasuries, typically viewed as the safest security in the world. In addition to the Fed purchases discussed earlier, this flight to quality is also helping to keep our borrowing rates low.

The chart below, courtesy of Bloomberg, shows that the market (blue line) has continued to rise while the Misery Index (orange line, inverted scale) has continued to decline. In other words, the worse the environment has been for consumers, the better the market has performed. This type of analysis supports what we discussed in the last paragraph, that a weak economy is better for the market right now because it ensures the Fed will remain accommodative.



Time Arbitrage and Patience

As long term investors, we feel that "time arbitrage" is a key competitive advantage in our investment philosophy. We even discuss this concept in our Policies & Procedures. Time arbitrage is the discipline that allows us to own securities that the rest of Wall Street shuns because of short term issues. Essentially we are taking advantage of Wall Street's short term horizon and leveraging our patient approach to own and buy securities that are temporarily oversold. Because we are less focused on quarter-to-quarter performance, unlike most of Wall Street, we have the ability to generate superior longer term performance by focusing on long-term value creation.

CitizensTrust Focus

At CitizensTrust we continue to focus on the long term, separating the noise surrounding the markets from the relevant data required to make good decisions. By not focusing on short term results we are able to achieve superior risk adjusted results for our clients, helping you to achieve your long term financial goals. We thank you for your business, and hope you have a wonderful summer.

"I will tell you how to become rich. Close the doors. Be fearful when others are greedy. Be greedy when others are fearful."

- Warren Buffett

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