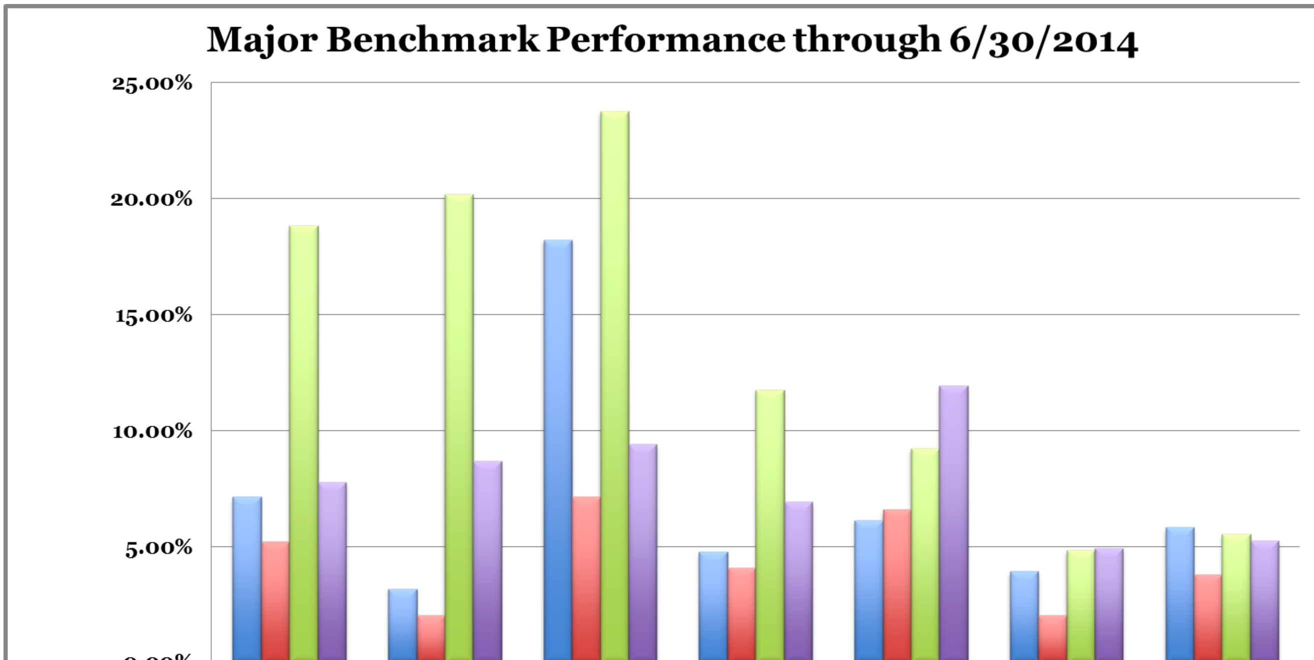
Market Summary and Outlook

2nd Quarter 2014

The stock market continues to prove that not all adages are worth following. For example, “Sell in May and Go Away”, is an old investment related saying advising investors to sell their stock holdings in May to avoid a seasonal decline in the stock market. Following such an unreliable and unproven notion would have turned out to be particularly bad advice this year, as the equity markets were up in May and even more in June. In general, we don’t agree with this mantra, as we don’t believe it is possible to time the markets, especially if a large segment of the population thinks they can profit by being in the markets between Halloween and May and out during the summer.



	S&P 500	US Small Cap	US REITs	Foreign Developed	Emerging Markets	US High Quality Bonds	TIPS
1H14	7.14%	3.19%	18.24%	4.78%	6.14%	3.93%	5.83%
2Q14	5.23%	2.05%	7.15%	4.09%	6.60%	2.04%	3.81%
5 Year (ann.)	18.83%	20.21%	23.76%	11.77%	9.24%	4.85%	5.55%
10 Year (ann.)	7.78%	8.70%	9.41%	6.93%	11.94%	4.94%	5.25%

Source: DFA

As the above table indicates, all market categories were up in the second quarter and first half of 2014.

The widely followed S&P 500 index gained 7.4% year to date, building on last year’s 32% increase. The bulk of this growth occurred in the 2nd quarter, following a modest gain of 1.3% in the 1st quarter.

Economic Trends and Factors

The harsh weather over much of the country this past winter is still having repercussions on the economy. The most recent 1Q GDP estimate was a surprising -2.9%. As a result of this lower number, many economists are lowering their full 2014 growth forecasts. In addition to the Q1 GDP estimate, there are several additional economic factors that are contributing to the lower GDP forecast:

- The housing recovery has slowed, with lower affordability and tighter lending standards.
- Inflation ticked up during the quarter although it is still well below historical averages (considering there is still $10.9 trillion cash in the economy, there is still enough of a buffer to preclude inflation becoming a problem anytime soon).
- Consumer spending remains weak and when adjusted for inflation actually declined.

While these factors reflect a slower economic recovery, that does not necessarily translate into lower market returns as there are so many other variables to consider.

On a bright note:

- The Federal Reserve continued tapering its bond purchases. The markets seemed to anticipate no interruption in the Fed's taper schedule and barely reacted. The Fed has indicated it will not increase interest rates until well into 2015. While an increase in rates negatively impacts bond prices, the Fed seems to be conscientious in its approach to show transparency and avoid nasty market surprises.
- Manufacturing data improved over the quarter and the most recent jobs report shows nationwide unemployment dropped to 6.1%. The US economy has added 200,000+ jobs per month for five consecutive months, the longest stretch since 1999. The Federal Reserve estimates full employment to be 5.4%.
- Auto sales and manufacturing orders have also picked up considerably.

Market Outlook

Equities

As we discussed in last quarter's newsletter, US equity valuations are on the high side, especially after strong returns in 2012 and 2013. However, there is not a consensus on what impact valuations will have on market returns going forward. For example,

- Robert Shiller, professor at Yale and a Nobel Prize winner (2013), sees valuations as high when compared with historical averages going back over a century.
- J.P. Morgan indicates the current price/earnings ratio is exactly at its 25 year average. David Kelly of J.P. Morgan acknowledges valuations have increased significantly for US stocks but reminds us they increased from very cheap valuations during the depths of the recession in 2008/9.

Both Shiller and Kelly recommend a cautious overweight to US stocks with the caveat there may be volatility along the way. An S&P statistic indicates on average there is a 10% correction in the S&P every 18 months. Unfortunately, volatility is a necessary part of investing. We do not recommend trying to time these potential corrections.

Both economists point out international valuations are significantly lower and that investors should diversify internationally across both fixed income and equities.

The comments of these two respected economists underscore our philosophy that despite higher valuations, we do not believe in market timing and incurring trading and tax costs to shift around asset classes.

Fixed Income

We did not expect Treasury rates to decline this year, especially considering the Fed's tapering policy that it implemented in 2013. Bond returns in 2014 have more than made up for the declines we saw in high quality bonds in 2013. Going forward, we still expect rates to increase but slowly. Some headwinds that may have pushed down US rates in early 2014 are looser monetary policy in Europe and Japan, meant to spur growth in those regions.

Looking Forward

Since we do not know when rates will rise and how quickly, nor do we know whether the stock market is primed for a correction, we continue to recommend our clients maintain their long term focus on a diversified portfolio and avoid trying to time the markets.

We thank you for your confidence in us and encourage you to call us anytime.

Janet & Barry

Sources: DFA, JP Morgan, Morningstar, WSJ, PIMCO, Payden & Rygel, BlackRock