Market Commentary – Second Quarter 2014

Strong Returns despite Market Worries

In spite of a weak start to the quarter, investors were again rewarded with strong returns across stock and bond markets in the 2Q14. Growing geopolitical conflicts around the world involving Ukraine and Russia, Iraq, Syria and Egypt (to name a few) dominated news headlines though had minimal lasting impact on market returns. Large US company stocks rose +5.2%[i] in the quarter, outperforming small companies which rose +2.8%[ii] during the same time period. Market sentiment once again shifted away from momentum and high growth stocks towards larger, more established stocks paying dividends.

International stock markets also experienced strong returns rising +5.2%[iii] driven by further signs of stabilization across the Eurozone and less negative news from key emerging market economies. Though lower in absolute terms, the US bond market earned +2.0%[iv] for the quarter as interest rates once again declined benefitting longer term bond holders.

US Economic Picture Mixed but Improving

Signs of improvement across the US economy have continued to appear despite some hiccups. GDP growth for the 1Q14 was revised down to -2.9%, well below initial projections. A number of factors including weather and the impact of the new Affordable Care Act Law led businesses to delay investment and consumers to put the brakes on spending.

In the second quarter, vehicle and retail sales experienced notable improvements (along with housing) with growth also emerging across business investment and manufacturing. Employment figures continued to improve in the second quarter, with the unemployment rate dropping to 6.1% in June. Though this improvement is a welcome sign for the labor market, many challenges remain including a low labor participation rate of 62.8%, still elevated underemployment rate of 12.1% and low real wage growth. Longer term, the US economy will face a combination of challenges including higher interest rates and the effects of a historically low household format rate for 18-34 year olds, driven by low income growth rates, high levels of student loan debt, rising real estate prices and a weak job market.

We remain hopeful yet cautious that the second half of 2014 will witness a reacceleration in economic growth across the US.

US Stock Market Valuations Are Reasonable

US stock prices have continued to drift higher in the face of growing calls for a market correction, with volatility (the degree to which prices fluctuate) remaining low vs. historical levels. Stock prices have risen largely due to the expectation of continued economic growth which is expected to drive company sales and profits higher. As of 6/30/14, valuations across S&P500 companies appear reasonable and in-line with 25 year averages, albeit less enticing than a year ago.[v] Though stock market bears continue to focus on the +190% return on the S&P500 since it bottomed in 2009 as proof of an imminent market collapse, a review of current fundamentals vs. longer term trends tells a different story.

M&A activity remains robust as companies continue to take advantage of low interest rates to issue debt and seek tax inversions which entail purchasing foreign companies in order to re-incorporate a company overseas to reduce taxes. Cash balances on corporate balance sheet remain high, and cash returned to shareholders in the form of dividends and share buybacks continue to grow. Though companies will face a harder road ahead should further economic growth fail to materialize, we do not see a significant bubble forming at this time.

We are not in the business of calling market tops or bottoms, but see sufficient evidence to warrant adhering to our long term allocations to US stocks for clients.

European Growth & Inflation Weak; Investor Flows Continue

During the second quarter, the European Central Bank (ECB) again cut interest rates and began charging commercial banks to keep funds at the ECB. Both moves were directed to boost lending and stimulate growth across the European Union. Eurozone GDP grew +0.2% in the 1Q14 while inflation is expected to remain low at +0.7% in 2014 per the latest IMF estimates. The risk of deflation remains one of the most pressing concerns for Europe, and the ECB continues to emphasize its commitment to taking additional actions to support growth and boost inflation.

Despite these challenges, money has continued to flow aggressively into European stocks in advance of a projected economic recovery. Valuations have risen across European stocks and shares today trade at less of a discount to US stocks than historically present. European companies will need to see improvements in fundamentals to support current stock prices and to appreciate further.

We continue to follow developments across major European economies and markets closely. Should improving sales and profits materialize for European companies, the potential for greater returns vs. the US stock market exists.

Emerging Opportunity in Emerging Markets

Low valuations and falling interest rates globally have pushed many investors back into the emerging markets since the start of the year. Despite strong relative returns for the emerging markets this year, we have continued to remain cautious and limited direct client exposure to this area of the market. We need only to look back at the selloff across these markets last year to realize the sensitivity of these markets to changes in interest rate policies in the developed world.

Risks to China's economy remain our greatest concern given the high levels of public debt and deflating real estate market. Our research continues to highlight the challenge faced by the Chinese government to balance a comprehensive reform agenda and long term growth targets. Chinese 2Q14 GDP figures demonstrated a pickup in economic growth driven by stimulus focused on social housing and infrastructure projects.

We continue to favor indirect exposure to emerging market economies via large multinational companies based in the US and developed international markets. However, we remain open to opportunities that may develop to tactically allocate to the emerging markets given the growing attractiveness of valuations vs. developed markets.

Interest Rates Fall . . . Again

Yields on bonds continued to fall during the second quarter to the surprise of many. Falling yields have been more a function of central bank intervention, pension plan rebalancing, short covering and falling US deficits leading to lower bond issuances than an indication of economic reality. Typically, improvements in economic growth would lead to rising bond yields but this trend has yet to materialize in the US and abroad.

The search for yield across the globe continued in the second quarter, with bond substitutes such as utilities and REITs (which pay high dividends) producing some of the highest returns. US dollar-denominated Emerging Market debt also experienced strong returns as investors returned to higher risk bonds.

Recent statements from Janet Yellen and the Federal Reserve remain cautious but optimistic highlighting the potential for earlier than expected interest rate increases. Though the Fed has maintained its commitment to a highly accommodative monetary policy for the foreseeable future, we continue to sense complacency among some bond market investors who are willing to pay any price for income.

Current Portfolio Positioning & Outlook

- We continue to maintain stock and bond allocations in-line with long term asset allocation targets.
- Favoring large company stocks in the US. We have taken some profits in mid and small company stock investments due to current valuations.
- International stock exposure remains broadly diversified but weighted towards high quality European companies.
- Bond investments remain concentrated in short and intermediate term bonds with a mix of investment grade and high yield.
- We continue to research and employ opportunities across alternative investment fund strategies that can add diversification to portfolios.
- We see interesting opportunities in global healthcare and life sciences due to emerging demographic and industry trends.

Market Return Data for 2Q2014

Broad Market Benchmarks	2Q2014
S&P500	5.23%
DJIA	2.83%
Russell 2000	2.05%
FTSE Global All-Cap ex-US	5.21%
MSCI Emerging Markets	6.60%
Barclays US Aggregate Bond Index	2.04%
Barclays US Treasury Bill 1-3 Months	0.01%
Bloomberg Commodity Index	0.08%
CBOE Interest Rate 10 Yr Treasury	2.52%
Consumer Price Index (CPI-U) 12 Month	2.10%
TWM Client Benchmarks	**2Q2014**
Aggressive Growth Strategy	5.23%
Capital Appreciation Strategy	4.59%
Balanced Return Strategy	3.85%

Did You Know?

- The SEC is considering new regulations for money market funds. In an effort to address issues which arose during the 2008 market crisis, the SEC is proposing that institutional money market funds begin to implement floating Net Asset Values meaning the value of each share can fluctuate above or below \$1. We continue to follow this proposal closely.
- The SEC is considering moves to make pricing on corporate and municipal bonds more available to retail investors. We fully support these actions which will provide greater transparency for the investing public.
- Only three companies in the US continue to maintain an AAA credit rating (the highest credit rating assigned a company). A high credit rating doesn't just mean a lower chance of default. During times of market stress, highly rated bonds can provide better liquidity meaning they can be sold easier.

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[i] S&P500 Index Total Return
[ii] Russell 2000 Index Total Return
[iii] FTSE Global All-Cap ex-Us Index Total Return
[iv] Barclays US Aggregate Bond Index Total Return
[v] JPM 3Q2014 Guide To The Markets, S&P, FactSet