2014 August Financial Market Update

—August 31, 2014

The summary below is provided for educational purposes only. If you have any thoughts or would like to talk about any other matters, please feel free to contact me.

Rallying to New Highs

The end-of-July slide in stocks has become a distance memory after buyers stepped back in last month, sending the S&P 500 Index to a new high and above 2,000 for the first time. Although the Dow Jones Industrials was unable to flaunt a major milestone, it snuck past 17,000 and closed within 16 points of a new high (St. Louis Federal Reserve).

<table>
<thead>
<tr>
<th>Index</th>
<th>Aug Return - %</th>
<th>2014 YTD Return - %</th>
</tr>
</thead>
<tbody>
<tr>
<td>DJIA¹</td>
<td>+3.2</td>
<td>+3.2</td>
</tr>
<tr>
<td>NASDAQ Composite²</td>
<td>+4.8</td>
<td>+9.7</td>
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<tr>
<td>S&amp;P 500 Index³</td>
<td>+3.8</td>
<td>+8.4</td>
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<table>
<thead>
<tr>
<th>Bond Yields</th>
<th>Yield* - % a/o</th>
<th>Aug 29, 2014</th>
<th>Yield - % a/o Dec 31, 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>3-month T-bill</td>
<td>0.03</td>
<td>Unch</td>
<td>0.07</td>
</tr>
<tr>
<td>2-year Treasury</td>
<td>0.48</td>
<td>-0.05</td>
<td>0.38</td>
</tr>
<tr>
<td>10-year Treasury</td>
<td>2.35</td>
<td>-0.23</td>
<td>3.04</td>
</tr>
<tr>
<td>30-year Treasury</td>
<td>3.09</td>
<td>-0.23</td>
<td>3.96</td>
</tr>
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<tr>
<th>Commodities</th>
<th>Aug 29 price, monthly change</th>
<th>Year end 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil per barrel⁴</td>
<td>$95.84</td>
<td>$98.42</td>
</tr>
<tr>
<td>Gold per ounce⁵</td>
<td>$1,285.75</td>
<td>$1,201.50</td>
</tr>
</tbody>
</table>

Sources: MarketWatch, U.S. Treasury, CNBC, St. Louis Federal Reserve, Energy Information Administration
*Includes monthly change

So what’s the catalyst that leading stocks higher? A quick review of July’s commentary offers an excellent starting point.

Fundamentals still in place that support stocks—

• Low interest rates
• Rising corporate profits (Thomson Reuters)
• Stock buybacks (S&P)
• A moderately growing economy that supports corporate profits

These are all the standard “go-to” themes that have created a powerful tailwind for equities over that last couple of years.

**Junk bonds taketh and giveth back**

Another catalyst appears to have been action in the high-yield market. Note from Figure 1 that anxieties emanating from junk debt pushed yields up sharply, creating mild tremors in equities.

![Graph of Stocks and Junk Bond Yields](image)

The sharp rise in yields provided a more attractive risk-reward proposition, encouraging a flow of cash back into junk bonds, which alleviated pressure on stocks.

**European malaise**

Let me add one more catalyst that is vying for attention: the economic problems festering in Europe and European Central Bank (ECB) talk that more aggressive monetary measures are on the horizon.

Any additional initiatives that might be in the pipeline come at a time when the Fed is reducing its own monthly bond purchases.

Yes, a bond-buying program financed by freshly minted cash is controversial, and some openly fret it would not cure what ails Europe. Others argue the overly conservative ECB is behind the curve (more in a moment), as it behaves like a deer in the deflationary headlights.

Still, Europe’s problems are deep-rooted and won’t be fixed overnight. Unemployment remains at an elevated 11.5%, and its annual inflation rate has fallen to an uncomfortably low 0.3% (Eurostat).
Change in the Unemployment Rate since 2008—The euro-zone and the U.S.  Fig. 2

Source: European Central Bank Last date: July 2014

Look at Fig. 3. Industrial production in Europe remains well below its 2008 peak.

European Industrial Production  Fig. 3

Source: Eurostat
Last Date: June 2014

Euro area: the 18-nations in Europe (euro-zone) that use the common currency of the euro
EU28 – 28 nations of the European Union, including the 18 nations of the euro-zone

In contrast, the U.S. has exceeded its prior peak – see Fig. 4. Granted, we’re just 3.9% above a level seen over six years ago, but the U.S. is moving forward.
With Europe sputtering in low gear, ECB President Mario Draghi opened a key end-of-August address with a remark that was, well, very “Yellenesque” in nature—

“No one in society remains untouched by a situation of high unemployment. For the unemployed themselves, it is often a tragedy which has lasting effects on their lifetime income. For those in work, it raises job insecurity and undermines social cohesion. …but unemployment is high and social cohesion at threat, pressure on the central bank to respond invariably increases.”

Draghi is also worried about the threat of deflation, which could exacerbate economic weakness if consumers and business delay purchasing decisions in the hopes prices fall even further. In some respects, it’s a central bank’s worst nightmare because it is difficult to battle. Japan’s struggle with weak economic growth has lasted over 20 years.
Though Draghi was not specific, he suggested the ECB may soon be ready to announce more aggressive measures to combat deflation. For U.S. investors, the prospect of new cash in the financial system has been a support to stocks. In addition, the threat of deflation has sent yields across Europe to record low – see Figure 5.

It seems almost incomprehensible that investors will lend cash to both Italy and the U.S. at roughly the same rate. But capital easily crosses borders, which is helping to keep a lid on yields at home.

Wyoming’s Teton Range and Yellen’s platform

With the grandeur of the Teton Range as a backdrop, Fed Chief Janet Yellen offered up her latest thoughts on the labor market and rate hikes at the annual Economic Symposium in Jackson Hole, Wyoming last month.

Though she didn’t provide a specific interest rate timetable, there was a noticeable shift in her thinking.

“With the economy getting closer to our objectives, the (Fed’s) emphasis is naturally shifting to questions about the degree of remaining slack (in the labor market), how quickly that slack is likely to be taken up, and thereby to the question of under what conditions we should begin dialing back our extraordinary accommodation (raising interest rates),” Yellen said in her speech.

But she was quick to point out that measuring slack in the labor force is imprecise, and there is “no simple recipe” when it comes to setting a course for monetary policy.

One area that she spent much of her speech: reviewing four of the 19 indicators the Fed is using in order to determine how much slack remains in the labor market.

Her thinking is relatively straightforward. If there’s plenty of slack remaining, the Fed can hold rates low, as it hopes to speed up the economy and put people back to work.

If the number of able-bodied men and women who can work, are willing to work, and have the skills to work has dwindled, there’s little the Fed can do. Keeping rates low would likely put upward pressure on prices without doing much for the economy.

At one point she rhetorically asked, “What is a monetary policy maker to do?” Safe to say, it seemed like an honest moment as she stood among the world’s finance ministers and central bankers.

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1 The Dow Jones Industrials Average is an unmanaged index of 30 major companies which cannot be invested into directly. Past performance does not guarantee future results.

2 The NASDAQ Composite is an unmanaged index of companies which cannot be invested into directly. Past performance does not guarantee future results.

3 The S&P 500 Index is an unmanaged index of 500 larger companies which cannot be invested into directly. Past performance does not guarantee future results.

4 New York Mercantile Exchange front-month contract; Prices can and do vary; past performance does not guarantee future results.

5 London Bullion Market Association; gold fixing pricing at 3 p.m. London time; 2012/2013 year-end price fixing at 10:30 a.m. London time; Prices can and do vary; past performance does not guarantee future results.
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