

## What We Are Telling Clients

By James F. Dykstal, CFA, Portfolio Manager, April 2014

Below is a summary of our views on the economy and markets, which we are sharing with discretionary clients. In essence, we believe that the risk in risk assets is underappreciated – especially in domestic small cap stocks. Some sectors have already corrected, and we view those more favorably in the longer term.

### Economic Outlook

- GDP growth of 2% should be constrained as growth in personal consumption remains slow (approximately 2%). Personal income growth remains below longer term trends due to continued slack in labor markets.
- Inflation is expected to remain muted through 2014. However, improvements in job growth will give room for the Fed to maintain the “tapering” of quantitative easing.
- The yield on the ten year Treasury fell during the quarter from above 3% to approximately 2.75%. The continuation of the “taper” will put upward pressure on rates despite any short term “flight to quality” due to stock market volatility.
- International economies will continue their slow recovery throughout 2014. Both the European Central Bank and the Bank of Japan will continue with quantitative easing in attempts to spur GDP growth. The U.S. dollar will strengthen versus the euro and the yen due to the removal of Fed stimulus.
- Growth in emerging markets will be higher than developed markets, even with slowing GDP growth in China. Consumers in emerging market countries continue to increase their percentage of global consumption.

### Strategic Market Outlook and Tactical Allocations

- **Strategic Outlook – Fixed Income:** The trend toward higher interest rates should continue, but expect “flight to quality” events as the markets readjust to more volatility in the equity markets.
  - **Tactical positions:**
    - High yield should outperform in a rising rate environment despite current tight credit spreads. Credit is overweight versus Treasuries and duration is tilted shorter than benchmarks.
    - Commercial real estate is viewed as attractive as a yield alternative to bonds, however, queues can delay additions to positions and an increase in interest rates could dampen valuation improvements.
    - International bonds are viewed as an attractive complement to domestic bonds due to a mismatch in interest rate cycles.
    - Emerging market debt provides diversification and yield potential. Central banks in countries such as Brazil, India and Turkey have increased interest rates and currencies have stabilized as a result.
    - Hedge funds with a non-directional (or absolute return focus) are viewed as an attractive uncorrelated option.
- **Strategic Outlook - Equities:** The domestic stock market looks to be fully valued as earnings growth slows. We expect more volatility in domestic equity markets as companies’ earnings momentum slows. International developed stocks appear to be undervalued relative to domestic stocks despite already slow growth in those countries. Emerging market stocks are viewed favorably due to stronger economic growth and attractive valuations relative to developed nations.
  - **Tactical positions:**
    - Small cap stocks are more underweighted than large cap stocks due to above average P/E multiples. Equities are tilted toward lower beta, higher dividend stocks to reduce volatility and generate income.
    - Stock allocations in developed markets lean toward international stocks as they appear to be undervalued relative to domestic stocks. The relative attractiveness takes into account the lackluster economic growth in Europe and Japan. The ECB and the Bank of Japan will continue their quantitative easing programs.
    - Within international equities, emerging markets stocks, comparatively attractive due to their low relative P/E multiples, are equally weighted to target. Unfavorable economic news has been priced into valuations.

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