Equity Market Update

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To begin the year, we wrote the market was near fair value, in our opinion, and volatility would be greater than 2013. With the end of the 1st quarter behind us, it appears our outlook was correct. Geopolitical events in Turkey, Ukraine, and Russia heightened the debate that a slowdown in emerging markets was likely. Add-in an unusually cold winter crimping consumer activity, along with further tapering from the Federal Reserve, and the first three months of the year made for a bumpy ride.

The S&P 500 returned 0.84% for March and finished the quarter up 1.81%. Year-to-date, mid-cap is up 3.03%, along with small-cap up 1.13%. Both small and mid-cap fared worse than large companies in the month of March as investors debated whether the PE premium carried by mid and small-size companies versus large-cap was too big.

Through the first three months of 2014, American stocks continue to outperform international markets. Year-to-date, the EAFE index for developed international economies is up 0.84%, and emerging markets are in red territory again, down 0.53%. However, emerging markets saw a large reversal in March advancing 3.08% as investors moved funds into these economies on the belief their underperformance versus the US the past three years had been too severe.

On a sector basis, leadership was mixed this quarter. Utilities were the best performing (+9.0%), followed by Healthcare (+5.4%). Cyclical sectors such as Materials, Financials, and Technology also outperformed the overall market. The worse sector, by far, was Consumer Discretionary (-3.2%). Our overweight positions in Technology and Healthcare benefited client portfolios, along with our underweight exposure to Consumer Discretionary.

The upcoming 1st quarter earnings season will receive much attention. With the equity markets still near all-time highs and valuations either in-line or slightly above historical averages, investors will be looking for signs the overall economy is still on its growth trajectory. Earnings growth estimates have been trimmed for the 1st quarter due to the unseasonably cold winter, but many still believe economic growth will reaccelerate in coming quarters.

Given the pullback in interest rates in the first quarter, along with economic data showing the recovery is still intact, we remain overweight Technology, Energy, and Industrials. Our stock selection continues to favor medium duration stocks that carry larger weights in the index and have the ability to reward shareholders through increased dividend payments and buybacks. The economic data is not too robust or too anemic to justify large holdings in either high (i.e. momentum) or short (i.e. high dividend yield) duration plays. We continue to underweight the consumer discretionary sector due to stretched valuations.

Finally, our outlook for equities remains positive relative to fixed income. We believe the volatility witnessed thus far in 2014 will continue since stock valuations are no longer below historical averages. This puts increased emphasis on economic data points and corporate earnings to propel the overall market and our strategy higher.

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