Roosevelt Investments: Thoughts from our All Cap Core Equity Team

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Concerns about Fed policy dominated capital markets in the second quarter, generating volatility in stock and bond prices. Despite some hair-raising moments, U.S. equities ultimately continued their upward trajectory.

Markets / Economy

Equity markets were volatile in the last half of the second quarter, demonstrating investor sensitivity to statements from the Federal Reserve regarding the future of its quantitative easing program. In May, when Federal Reserve Chairman Ben Bernanke commented that the Fed would likely start reducing asset purchases by the end of the year, the Russell 3000 retreated approximately 5%.

However, soon after Bernanke made his comments Fed governors issued some reassuring statements, indicating that short term rates would remain low for an extended period and that asset purchases would only be reduced if the economy exhibited sign of strengthening. As a result, stocks rebounded. Ultimately, the Russell 3000 rose 2.7% in the second quarter, bringing year-to-date returns to a little over 14%.

Growing concerns about the future course of monetary policy caused unusually large changes in yields in the U.S. Treasury market. Following Bernanke's remarks, the yield on the 10-year U.S. Treasury bond increased nearly 0.4%, posting the largest weekly gain in a decade. At the end of June, the 10-year Treasury note was yielding nearly 2.5%, up sharply from 1.62% at the beginning of May.

U.S. markets were not the only ones to experience swings over the past month. Foreign exchange markets also experienced fluctuations, particularly certain emerging markets, where currencies have substantially weakened. We believe this volatility stems from the unwinding of certain trades.

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Previously, investors took advantage of unusually low U.S. interest rates to borrow money and invest in riskier assets, including emerging market stocks and bonds. As rates started to rise, some investors appear to have sold off their holdings, triggering weakness in some overseas equity, currency, and fixed income markets.

Meanwhile, as domestic and international capital markets faced a bout of volatility, the U.S. economy continued to sputter along. The latest revision to first quarter GDP indicated a meager 1.8 percent expansion, demonstrating that while the economy continues to grow it is doing so at levels below the historical average. Nevertheless, even with this slow growth environment, consumers remained optimistic. The Conference Board's June consumer confidence figure reached its highest level since the beginning of 2008. Additionally, the housing market continued to perform well. New home sales in May hit five-year highs with prices continuing to move higher.

Looking Ahead

We are cautious on the near-term outlook for the U.S. market. Over the past few months, we argued that the extraordinary amounts of liquidity being pumped into the global financial system would support equities. Now, with the Fed indicating that it is poised to reduce asset purchases should the economic data justify it, we are growing concerned about the global capital markets' ability to weather such a shift. Over the last several weeks, the specter alone of monetary tightening sent shockwaves throughout capital markets both here and abroad. Therefore, we believe that the potential for further market volatility has increased as we presumably approach the beginning of the end of the Fed's quantitative easing program.

Despite this increased level of near-term caution, we continue to see solid prospects for stocks over the longer term.

In addition to our concerns about domestic monetary policy, we are also paying attention to trends in the global economy. The Chinese economy continues to deteriorate, while other emerging markets also face difficulties. Added to this is lingering weakness in the Eurozone region.

Japan, however, offers a bright spot in our opinion. Given recent data out of Tokyo, we remain optimistic about the prospect for Japanese equities, which gained 10% in the second quarter. In addition, industrial production came in well ahead of expectations and retail sales continued to grow. Also, inflation rose for the first time in 6 months, indicating that the Japanese central bank's efforts to combat deflation may be starting to take hold.

Portfolio Positioning

We continue to believe that U.S. stocks can move higher even if interest rates rise, so long as the increases follow a moderate pace. However, the speed at which rates have increased over the last several weeks has been disconcerting, with implications across asset classes and geographic regions. As a result, we have made some changes to our clients' portfolios to reflect our more cautious view on equities. While we are not bearish on the market, we have modestly added to our risk tools in order to help preserve capital should stocks correct. We have also reduced our exposure to the housing market given its sensitivity to interest rates. That being said, absolute rates are still quite low and even with the recent increase the home affordability index is still near historically high levels.

Finally, despite this increased level of near-term caution, we continue to see solid prospects for stocks over the longer term. The Federal Reserve has taken extraordinary measures in recent years to support the economy and financial markets, and therefore the normalization process will likely be quite complex and inherently risky.

The fact that policy makers are examining exit strategies implies that the economy might be able to stand on its own in the not too distant future.

It is conceivable that unforeseen consequences will occur, making the near term challenging for equity investors. But the fact that policy makers are examining exit strategies implies that the economy might be able to stand on its own in the not too distant future. While capital markets might need time to adjust to this new reality, we believe that if the economy proves capable of growing on its own volition, stocks will ultimately benefit.

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Risk Tools: Cash, Zero-Coupon Treasury ETFs, TIPS ETFs, Inverse/Leveraged Inverse ETFs and Precious Metal related securities are used as needed.

Inverse/Leveraged Inverse ETFs - Leveraged ETFs are securities that attempt to replicate multiples of the performance of an underlying financial index. Inverse ETFs are designed to replicate the opposite direction of these same indices, often at a multiple. These ETFs often use a combination of futures, swaps, short sales, and other derivatives to achieve these objectives. Most leveraged and inverse ETFs are designed to achieve these results on a daily basis only. This means that over periods longer than a trading day, the value of these ETFs can and usually do deviate from the performance of the index they are designed to track. Over longer periods of time or in situations of high volatility, these deviations can be substantial.

Precious Metals - The value of precious metals may be affected by various and often unpredictable factors, including, but not limited to, the economic, financial, social and political conditions globally and in particular countries. A precious metal's market price and the liquidity and trading values of precious metals may be affected by, retail markups, safekeeping charges, shipping costs, the actions of sovereign governments that may directly or indirectly impact the price of a precious metal. Precious Metals markets are subject to temporary distortions or other disruptions due to various factors, including the lack of liquidity in the markets, the participation of speculators and government regulations and intervention. In addition, U.S. futures exchanges and some non-U.S. exchanges have regulations that limit the amount of fluctuation in futures contract prices that may occur during a single business day. These limits are generally referred to as “daily price fluctuation limits” and the maximum or minimum price on a contract on any given day as a result of these limits is referred to as a “limit price”. Once the limit price has been reached in a particular contract, no trades may be made at a different price. Limit prices have the effect of precluding trading in a particular contract or forcing the liquidation of contracts at disadvantageous times or prices.

TIPS - Treasury Inflation Protected Securities.

Zero-Coupon Treasury - U.S. Treasury debt security that does not pay interest (coupon) but is issued at a discount.

Themes assigned as per Roosevelt Investments' evaluation.

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