// Making Sense of Finance

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Making Sense of Finance

Second Quarter Review

STOCK MARKET

All U.S. stock market major indices increased in the second quarter although it may not have felt that way since the market sold off in the month of June. The U.S. stock market had risen seven months straight prior to last month. The S & P 500 and the Dow Jones Industrial Average rose 2.4% and 2.3% last quarter, respectively. Although not a repeat of the double digit percentage gains of the first three months of the year, it still was a worthy performance. The Nasdaq Composite did even better, increasing 4.2% in the second quarter (helped by a 20% increase in the "anti-Apple" stock, Microsoft) after lagging earlier in the year.

The best performing sectors for the second quarter were financials and consumer discretionary (ex. automobiles) stocks as companies in these sectors in general showed improving fundamentals. Utility stocks were the laggards last quarter losing as a group almost 4%. Due to their debt laden balance sheets and high dividend payouts, utility stocks tend to perform better when interest rates are declining which wasn't the case the past few months. Materials stocks (ex. metal mining) also had negative returns in the quarter as metal prices including gold declined. Gold prices fell 23% last quarter, which was the largest quarterly loss for gold since 1974 when gold futures contracts began trading.

Foreign stocks for the most part fell last quarter. Among developed markets only Japan's market performed better than the U.S. stock indices. After being on a tear the first four and a half months this year, in mid-May the Nikkei declined 20% in a three week time period only to bounce back the latter part of June. Overall the Dow Jones Japan index in U.S. dollar terms rose over 3% last quarter, however in local currency terms it was up almost 9% as the yen declined in value versus the U.S. dollar. Notably emerging markets posted poor stock market performances in the second quarter especially in U.S. dollar terms. Brazil and Turkey were the largest of the emerging markets to fall prey to fear of rising interest rates and internal political unrest as their respective DJ Global indices lost 18% and 16% in the June quarter.

BOND MARKET

After a benign performance in the first quarter this year, bonds took a notable downturn in the second quarter. Federal Reserve Chairman Ben Bernanke stated before Congress in mid-May that the Fed could taper its bond buying program known as quantitative easing (QE) by the end of the year. Although this was just a reiteration of the Fed's comments from an earlier date, somehow this now got everyone's attention. The result was the beginning of the long

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Everybody and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is more about making sensible and prudent choices based on logic and experience, and not on emotion.

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anticipated rise in yields (decline in bond prices). The U.S. 10 Year Treasury yield which started off the second quarter at 1.86% and actually declined to 1.66% by May 2nd did a complete turnaround. By May 22nd it broke 2% and has since never returned to under that level. The press conference given by the Fed Chairman after the FOMC meeting in June also echoed the previous months' sentiments about decreasing the $85 billion per month in mortgage backed securities and Treasury security purchases. The knee jerk reaction to these pronouncements is to sell before the Fed stops buying. However, the Federal government does not do things in a hurry and if the scenario happens as they forecast, it actually means that our economy is in better shape which should be good for all of us. The result though was by the end of June, the 10 year Treasury yield was at 2.52%. In addition to the decline in intermediate and long term Treasuries last quarter, Treasury Inflation-Protected Securities (TIPS) had losses of about 7% in that time period.

Municipal bonds were also among the worst performers in the bond market. The Barclays Municipal Bond Index declined 3% on a total return basis (includes interest paid) in the second quarter. Even though fundamentals generally are improving for municipalities with increases in tax receipts, bond fund investors withdrew a record $4.5 billion out of muni bond funds in the week ending June 25th.

Risky emerging market bonds, which had provided stellar returns in the past, also had a difficult quarter. After peaking in mid-May at record highs, the J.P. Morgan Emerging Bond Markets Index lost 9.5% of its value and ended with a second quarter total return of a negative 6.3% driven by fears of the prospect of Fed tapering off its bond purchases. Lesser losses occurred in other bond sectors, such as investment grade and high yield corporate bonds due to similar reasoning.

Market Outlook

The past quarter is a good example of investor psychology causing volatility. In general, while the past seven months in the stock market were positive, people feared of stock prices going over a cliff and plummeting in value. This did not happen. However, in the month of June, it seemed that all markets took a break, with gold, stocks AND bonds all declining in value. While disconcerting, it does occasionally happen causing headlines in the news, which we encourage everyone to ignore. And yet, at the end of the June quarter, the stock market was still up for the year and fundamentally, little has changed in the world. This is why we attribute recent fluctuations to psychological reasons. Investors were nervous when the market was up, and they got nervous when the markets declined, albeit marginally but abruptly.

We would like to remind everyone, that markets do not go up or down in a straight line and investors must be willing to accept the downside risks if they also want to participate in the upside rewards. Just as the New York Yankees have the best players in baseball, they can still lose games on any given day. Our methodology of diversifying into different asset classes minimizes these ups and downs, but DOES NOT eliminate this.

After all is said and done, U.S. equities (stocks) remain the most attractive asset class for longer-term horizons, in our opinion. Stock valuations remain modest (S&P 500 forward P/E of 14.6x) with the economy still in recovery mode. We also expect some relief from Europe which is likely near an economic bottom, by our estimation. For short-term time horizons, bonds will continue do what they are intended, for the most part; that is, pay interest and return par value at maturity. For longer-term bond holders (10-years plus), there will likely be pressure on bond prices, due to eventual rising interest rates. Investors should also be aware that barring a default; regardless of interest rates, individual bonds remain a good tool for capital preservation **IF** held to maturity. One caveat, however, is that bond funds that actively trade individual securities are more at risk of principal loss.

We remain optimistic about the coming 12 months. There has been tepid growth overall in the U.S. economy and even pockets of strength, but no meaningful recovery, which explains the continual discomfort by investors. Five years after the financial collapse in 2008, the economy is solidly in a better place, but hardly near a top. There remains a chance of GDP floating back into negative territory, but this would likely be less dramatic than what we saw in 2008. Data indicates that corporate America is in the best financial shape in decades, but, as a whole, no one will pull the trigger on new investments that would create jobs and grow the economy. In the 1980s it was the real estate boom, the 1990s was personal computing and the Internet, and again real estate in the 2000s. What will be the next big thing?

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