Making Sense of Finance

Karagosian Financial Services 4/21/2015 Volume 18, Issue 2

First Quarter Review

STOCK MARKET

January was not a very auspicious start to 2015 when all major U.S. indices began the year with declines. However, in February the market rebounded sufficiently so that the first quarter ended in positive territory for two out of three of the major stock indices. The minimal gain of 0.44% for the S & P 500 last quarter made it the ninth consecutive quarterly gain in this widely followed index. This index had only three other stretches that long since World War II. Among the other familiar indices, the Nasdaq gained 3.48% and the Dow Jones Industrial average lost 0.26% year to date.

The market may be anticipating weakened earnings growth for many companies in the first quarter. After the aggregate S & P 500 companies reported mid-single digit earnings growth for the fourth quarter of 2014, current estimates call for a year over year decline of 2% for the first quarter of 2015. This is primarily due to large double digit percentage declines anticipated for the energy sector's earnings. If energy is excluded, a 5% gain in the first quarter is predicted for the remaining companies in the index. This is still positive but not up to previous levels of growth. The stronger dollar has been given as reason for lower growth in many instances, as almost half of the revenue for companies in the S & P 500 is derived overseas. This reduces the value of profits earned abroad when translated into U.S. dollars, as well as makes goods produced in the U.S. more expensive for foreign buyers.

Healthcare stocks were again among the top performing sector last quarter. So far the industry's fear of mandatory health insurance has in reality worked to their benefit. Consumer discretionary stocks also outperformed the broader market. Utility stocks were the biggest laggard in the first quarter after posting a big year in 2014. Most investors buy these stocks for their dividend yields so they have been attractive in a very low yielding bond scenario. However, the continued fears of rising interest rates have deemed these stocks less attractive in comparison. Energy stocks also continued to lag as oil prices continued to decline in the first quarter, albeit at a slower rate than last year.

Making Sense of Finance

•••

Everyone and their neighbors have 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 geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

Contributors:

Seaver T. Wang

Christine Terry

315 Fifth Avenue 704B

New York, NY 10016

www.toinvest.com

The returns in foreign equity markets were better than the U.S. last quarter. The MSCI EAFE index which is a measure of developed markets worldwide increased 5% in U.S. dollar terms. Stock indices in Germany, France and Japan had double digit percentage returns in the first quarter of 2015. However, when translated into U.S. dollars, the returns in Europe were lower than the returns in the local currency due to the 11% drop in the value of the Euro versus the U.S. dollar in that three month period. Among emerging markets, Russia rebounded from last year's very poor performance. Chinese and Indian stock markets also gained in the first quarter while the Greek market was the worst performer, amid ongoing concerns over the country's bailout status.

BOND MARKET

All major U.S. bond sectors had gains last quarter. The Barclays U.S. Bond Aggregate Index of investment grade bonds returned 1.6%. Corporate bonds had the best total returns for the period, both investment grade and below investment grade bonds gained over 2%. Municipal bonds, after being the best performing bond sector in 2014, continued to make gains last quarter with a slight gain of 1.3%.

Although the threat of rising interest rates by the Federal Reserve (many say may start to increase in the third quarter) hangs over both the stock and bond markets, interest rates on U.S. Treasuries continued to decline last quarter. The yield on a 10 Year Treasury declined from 2.17% at the start of the year to the current level of 1.94%. If you feel like your bonds are not giving much in return on an inflation adjusted basis, you would be correct. Historically, the average 10 Year Treasury yield is 6.24% (since 1958) and inflation adjusted the average real historical yield is 2.48%. This inflation adjusted yield pales in comparison to today's real yield of only 0.25%. Eventually this bull market in bonds will come to an end.

OUTLOOK

Students of the stock market have no doubt observed increased volatility. Essentially, there is no consensus on what the future will hold, but this should not affect long-term investors. As long as we believe that corporate profits will increase in the future, then one should invest. After a strong recovery from 2008, securities with good value have become scarce, but like in most cases, volatility is our friend. REITs (Real Estate Investment Trusts) have come off their highs in the first quarter, as have many oil related stocks. As of April 21, 2015, oil prices have come off their recent lows, from the mid $40s to over $57 today. On the flip side, the Shanghai Index of stocks has increased over 100% year-over-year. While impressive, this has occurred during a period where China's GDP has been decelerating the past three years. This is a perfect example of a volatile market we don't want to be involved in where asset prices are disconnected from economic reality. Given the challenging interest rate environment, we prefer shorter duration bonds. The threat of rising interest rates has been front headline news for six years, and is no reason to panic, in our view. In our experience, markets can adjust to difficult environments in an orderly fashion, but they react erratically when surprised.

Tepid economic growth in the U.S. and a stronger dollar will likely continue providing headwinds for most of the companies we invest in. We would expect companies to meet earnings per share expectations due to share buybacks which can be funded by very strong balance sheets, and for sales growth to disappoint a bit due to weakness in international markets and the negative translation from a strong U.S. Dollar. But we remain somewhat optimistic that the world will catch up to the U.S. Our view is that the U.S. is the place to be, albeit from anecdotal evidence. Consider that the top two foreign buyers of New York real estate are from Russia and China and that the Japanese and Chinese are heavy buyers of U.S. debt; yet the U.S. has plenty of wealthy individuals, but we hear nothing of them buying Chinese , Russian or Japanese assets. Ironically, it has been reported that Chinese companies owe U.S. investors nearly $1 Trillion in debt, which represents a greater risk to individual companies, in our view. We conclude that despite a mildly dysfunctional government, no other country has our breadth of investments, financial strength, liquidity, and transparency.