Making Sense of Finance

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Second Quarter Review

STOCK MARKET

The second quarter of 2014 showed an improvement for all three major U.S. stock market indexes. The Nasdaq Composite led the way with a gain of 5.0% followed closely by the S & P 500 index increase of 4.7%. The Dow Jones Industrial Average (DJIA) again was the weakest performer for the quarter, however this time posting a gain of 2.2%. Although the conflict still continues in the Ukraine, that story is no longer making frequent headlines in the business news; the recent unrest in northern Iraq has grabbed some attention, particularly in relation to the energy sector. With continued ongoing tensions around the world, though, the stock market indexes prevailed higher, as the DJIA and S & P 500 closed at record highs in June (one of 11 record highs for the DJIA and 16 for the S & P 500 in the second quarter). Investors may ask how can this be?

Corporate earnings in the aggregate are still increasing enough that the valuations are not that stretched, especially given the relatively low interest rate environment. The trailing 12 month P/E ratio for the S & P 500 has risen only 5%, yet the value of the index rose 22% over the last 12 months. Part of the rise in earnings per share may be attributed to the large increase in stock buyback programs over the last year which has resulted in a lower share count for many companies that has pushed up earnings per share meaningfully. Also merger and acquisition announced deals were at the highest level last quarter since the second quarter of 2007. This has driven some prices higher as companies look to spend their huge cash balances and employ their higher priced stock as currency too.

Energy stocks, in particular oil and gas exploration companies, had the best performance last quarter as oil prices rose, partially due to the above mentioned Iraqi situation and the decision made by the Obama administration to allow for the first export of non-refined oil from the U.S. in a very long time. Utility stocks had another decent quarter (+7%) after a very good first quarter in part because long term bond yields did not rise as expected so far this year which made their stock dividend yields still attractive. All of the

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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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major S & P 500 stock sectors had positive returns for the second quarter but some lagged the overall market. These laggards were financial and telecomm stocks.

In the aggregate, foreign stocks did not perform as well as U.S. stocks in the second quarter as measured by the MSCI EAFE index (U.S. dollar based) which rose 3%. However, some emerging market stock markets far outpaced the U.S. stock market last quarter. Amongst these were India and Argentina which had double-digit percentage gains for the quarter. Among the developed country markets, Canada, Japan and Spain made some of the biggest gains. Greece and Portugal were among the countries with the worst performing stocks in the second quarter as economic worries in these countries still persist.

BOND MARKET

The bond market continued its rally in the second quarter in all categories with yields decreasing (bond prices move inversely to yields). Last quarter began with a 10 Year Treasury yielding 2.73% and finished with a yield of 2.53%. Average junk bond yields hit an all-time low of 4.8% in June. These historically low yields have spurred a rise in below investment grade bond issuances this year. In the first six months, junk bond issuance was $286 billion. Investors seeking the higher yields of riskier emerging markets have also caused those bond prices to rise last quarter. Investment grade corporate bonds and municipal bonds continued to rise as they did earlier this year. In general, longer term bonds outperformed their shorter term counterparts last quarter which has led to a flattening of the yield curve.

The Federal Reserve continues their bond buying tapering program, which so far has not driven interest rates noticeably higher. Everyone is still focused on when the Fed Fund rate (currently 0%) will be allowed to rise and drive short term interest rates higher. The consensus opinion is for an increase in the third quarter of 2015 which is still way off in the distance. In the meantime, these abnormally low rates for short-term Treasuries will continue to hold back bank deposit and money market rates which continue to pay way less than the current inflation rate (latest CPI rate is 2.1%).

OUTLOOK

An abundance of capital outside the stock market and a weak economy actually positions the market well on the upside, in our view. While a pull-back is very possible, we do not have any concerns about irrationally inflated prices in stocks. Bonds overall, are more at risk, in our opinion, as more people chase higher yields that are issued from companies with lower credit quality. Over the past few years, the market has continued to rise due to corporate profits, stock buyback, and a shift of funds into stocks, in general; but economic growth continues to be anemic. A more robust economy and all the other factors we mentioned above could lead to continued gains in the stock market.

Record highs in the stock market bear little indication of its future direction. While Dow 17,000 sounds high, so did Dow 10,000 more than 15 years ago. Indeed, we expect Dow 20,000 and Dow 50,000 in the future (under no time frame); otherwise, what is the point of investing in the stock market. Plus, with our money management models, we hope to do better than the market over time. What we are weary of are record growth rates and record valuations; two things that are unsustainable. A great example of this is the recent closure of all Crumbs Bake Shop (OTC:CRMB) stores, a popular chain that grew too fast too soon and now recently filed for bankruptcy protection. The Internet boom of the 1990s was an example of highly inflated assets. Companies with miniscule sales and huge losses were still valued at billions of dollars. The market currently, as we see it, bears no resemblance to this. While an eventual correction (10% decline or more) is inevitable, more often, it should be looked upon as a buying opportunity, not a reason to cash out. Even then, having a balanced portfolio should mitigate some of the stock market declines.

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