Making Sense of Finance

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Third Quarter Review

STOCK MARKET

Major U.S. stock market indices managed modest gains for the third quarter even though July and September had negative returns. The S & P 500 gained 0.6% last quarter while the Dow Jones Industrial Average and the Nasdaq Composite posted slightly better returns with increases of 1.1% and 1.9%, respectively. It was the seventh consecutive quarterly gain for the S & P 500 and the Nasdaq. Large capitalization stocks fared better than shares of smaller companies, as evidenced by the decline in the Russell 2000 Index of more than 7% in the third quarter. Public companies continue to face on-going pressure to use available cash to increase shareholder returns through cash dividends and buybacks. This has led to third quarter net dividend increases of $12.3 billion, which is an increase of almost 4% from dividend increases last quarter, and in turn has enabled the S&P 500 to sustain a yield of over 2% at the end of last quarter, even with rising stock prices. Investors typically think of large cap stocks when they think dividend yield, however the small cap stocks (as represented by the S & P 600) that do pay dividends yield just as much as the larger cap stocks, partially due to last quarter's small cap sell off.

Energy stocks were the worst performing sector in the third quarter, in contrast to the second quarter when they were the best performing sector. A factor for this decrease is that crude oil prices declined 13% in the third quarter and were at a 52 week low. Slowing growth in demand due to weak global economies and increases in supply are reasons that have been given for this price drop in oil. Utility stocks also reversed course last quarter and gave back most of their gains from the previous quarter. However, health care and technology stocks continued to add to their gains from earlier in the year, with both groups now showing double digit percentage increases on a year to date basis at the quarter end. Health care is the only sector that has recorded an increase in expected earnings growth during the last quarter.

Major foreign market indices such as the MSCI EAFE index, a measure of developed countries' markets, declined over 6% last quarter when measured in U.S. dollar terms,

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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 focuses more on making sensible and prudent choices based on logic and experience, not emotion.

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although it had a slightly positive return on a local currency basis. This is due to the appreciation of the dollar in the third quarter since foreign stocks are worth less in U.S. dollars as the dollar strengthens, all other things being equal. This divergence was also seen in the performance of MSCI EM IMI index, which is a measure of emerging market stocks, but not to the same degree. In the third quarter, the Euro and Japanese yen lost over 7% versus the U.S. dollar, while the British pound sank over 5%. Some emerging market currencies dipped even more with losses of more than 9% for the Brazilian real and Russian ruble versus the U.S. dollar. With these declines, foreign stocks in U.S. dollar terms may appear to have better value than U.S. stocks when considering P/E and dividend yield. However, as can be seen by the third quarter performance, there is always currency risk.

BOND MARKET

Bonds were generally unchanged in the third quarter as measured by the Barclays U.S. Aggregate index which had a total return of 0.2%. Municipal bonds rose while lower quality corporate bonds declined in price as did Treasury Inflation-Protected Securities amid moderating inflation expectations. The yield curve continued to flatten as long term U.S. Treasury rates declined and intermediate term rates rose slightly.

As previously announced, the Federal Reserve is due to end quantitative easing (QE) this month as the tapering off of long term bond buying ceases altogether. This round of QE had consisted of the Fed buying mortgage-backed securities and long term Treasuries. This leads to questions such as how will this discontinuation of QE affect the bond market and will there be another QE program instituted. However, the Fed Fund target rate remains at the low level of 0 to 0.25%, where it has been since Dec. 2008 with no immediate rate hike in sight. The timing of any rate increase is still subject to various economic conditions as detailed in vague terms by the Federal Reserve at their September meeting. In other words, short term rates may be around for a while longer much to the chagrin of money market and CD investors.

OUTLOOK

With the equity market in its sixth positive year, people have been wondering when the next correction will occur. We agree this is inevitable and perhaps even healthy for psychological reasons. A market correction may become a self-fulfilling event even with no clear signs of long-term weakness in corporate profits or the economy. This seems to be the case in recent media headlines that we have observed where news considered good for the market in one month is now viewed as negative. For instance, high oil prices have generally been considered a drag on the economy, but with oil prices down about 20% from the beginning of the year, many economists are citing the loss of jobs and profits which would hurt the economy. This is why we suggest ignoring the media regarding investments. This is an illustration of sentiment, not analysis. In such a case, a decline in the stock market would likely be short-term and signal a good buying opportunity for prudent investors. Let us not forget that properly diversified portfolios should have asset classes that may even benefit from a downturn in stock prices, which would mitigate some of the pain. For example, bond prices have historically had a negative correlation with stock prices. With bond yields (2.21%, 10-year T Bond as of 10/14) below the historical inflation rate of 3%-4%, the best asset class, in our view for long-term gains remains in stocks.

The bond market seems to be playing out much as we had hoped, with rates slowly and gradually moving up. Still, we remain at historically low rates which we consider favorable to the corporate environment. We think fixed income securities are best used for diversifying away risk at this time.