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Economic & Markets Summary: 2nd Quarter 2014

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The Economy

The most recent reading on broad economic growth in the United States of America showed an unexpectedly large decline in the first quarter of 2014. The Bureau of Economic Analysis released revised figures showing that US Gross Domestic Product (GDP) declined at a -2.9% annualized rate in the first three months of the year. According to Bloomberg, the recently released data point marks the largest downward revision since records began in 1976. Among other factors, the decline in first quarter GDP is tied to a slowdown in health care spending. Initial estimates by the Bureau of Economic Analysis reflected the assumption that the Affordable Care Act would boost spending on health care services and add 1% to growth. Instead, health spending actually slowed in the first quarter, subtracting 0.16%. Consumer spending was also weak in the first quarter, adding only 0.71% to growth compared to the previous estimate of 3.1%.

The weak reading for first quarter GDP marks a setback in what many had hoped was a steadily improving economic picture. The release follows readings of +4.1% and +2.6% in the third and fourth quarters of 2013, respectively, and while second quarter growth is expected to bounce back to +3%, growth for the entire first half of 2014 will likely only be around 0%. Consensus estimates for all of 2014 have fallen to +2.2%, down from an estimated +2.8% in January. According to BCA Research, GDP estimates are likely to fall even further given that growth would have to exceed +4% in the third and fourth quarters just to meet the current full-year target[1].

The employment picture showed evidence of continued improvement during the first half of the year. Monthly non-farm payrolls have increased by an average of 214,000 through May and the headline unemployment rate declined to 6.3%, down from 6.7% at the end of 2013. With the May jobs report, U.S. employment is now at an all-time high with the total number employed exceeding the prior peak by 98,000. However, with the unemployment rate still in excess of 6% and a large number of workers no longer seeking employment (and therefore not numbered as part of the workforce) the U.S. economy remains well below full employment.

Interest Rates

Bonds continued to rally throughout the second quarter as uneven economic performance and geopolitical unrest throughout the world have provided support for safe haven assets. The yield on the 10-year U.S. Treasury note finished the period at 2.53%, down from 2.72% at the end of the first quarter and over 3% at the end of 2013.

The FOMC met twice during the quarter, in April and June. The statement following both meetings indicated little or no change in the committee's thinking from prior meetings and affirmed that "underlying strength in the broader economy is sufficient to support ongoing improvement in labor market conditions." The FOMC did vote to reduce purchases of mortgage-backed and Treasury securities by a total of $10 billion per month at both meetings. Purchases of longer-dated securities by the Fed now amount to a total of $35 billion per month, which

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[1] *The Bank Credit Analyst*, July 2014 – Vol. 66 – No. 1. pg. 5.

is down from $85 billion at the peak of the Fed's Quantitative Easing ("QE") Program. The operating assumption is that the FOMC will continue to taper asset purchases throughout the remainder of 2014, bringing an end to QE by the end of this year.

The yield on the 2-year Treasury increased again during the second quarter, which along with the decline in the 10-year led to a further flattening of the yield curve.

Treasury yields for various maturities for the last three end of quarter dates are displayed here.

	Treasury Bill	**Treasury Notes & Bonds**			
	3 mo.	2yr.	5 yr.	10 yr.	30 yr.
06/30/14	0.02%	0.46%	1.63%	2.53%	3.36%
03/31/14	0.03%	0.42%	1.72%	2.72%	3.56%
12/31/13	0.07%	0.38%	1.74%	3.03%	3.97%

The total return numbers for various fixed income indices over the last twelve months are displayed below (data from Bloomberg).

52 Week Returns (as of 06/30/14)			
Barclays Capital US Aggregate	4.37%	Merrill Lynch US High-Yield	11.80%
Merrill Lynch US Treasury Int-Term	1.60%	Merrill Lynch US Municipal Index	6.54%
Dow Jones Corporate	3.98%	JP Morgan EMBI Global	11.05%

Stocks

Global financial assets performed well in the first half of 2014. Six of the major indices that track the performance of various markets were all positive for the first six months of the year. Through June 30th, the Dow Jones Industrial Average returned 2.7%, Gold rose 10.3%, the Dow Jones UBS Commodities index was up 7.1%, the 10-year Treasury note returned 6.4%, and both the MSCI World Index and the MSCI Emerging Markets Index returned 6.6% and 4.8%, respectively. According to the *Wall Street Journal* this is the first time since 1993 that all six have finished the first six months of the year in positive territory[2].

The Dow Jones Industrial Average and the S&P 500 Index both closed out the second quarter with solid gains, and both have chalked up respectable returns for the first half of 2014. Both indexes have repeatedly hit record highs during the quarter with the Dow posting 11 and the S&P posting 16 record closing highs in the past three months. The Russell 2000 Index of small-cap stocks ended the quarter with a gain of 2.05%, however during the quarter the index did experience a decline of just over 10% from the all-time high reached in early March. Foreign and emerging markets also performed well during the quarter.

Below is a table which displays various equity index returns for the quarter.

[2] *Wall Street Journal*, June 28-29, 2014. Pg. 1

Equity Indices	2nd Qtr. 2014
S&P 500	5.23%
Dow Jones Industrial	2.83%
NASDAQ	5.32%
S&P 500 Growth	5.82%
S&P 500 Value	4.60%
Russell 2000 (small-cap)	2.05%
MSCI/EAFE (foreign)	4.32%
MSCI/EM (emerging markets)	6.71%

The following table details S&P 500 sector returns for the quarter (price only).

Return by Stock Sector	2nd Qtr. 2014
1. Energy	11.45%
2. Utilities	6.79%
3. Information Technology	6.05%
4. Materials	5.06%
5. Health Care	4.06%
6. Consumer Staples	3.94%
7. Industrials	3.31%
8. Consumer Discretionary	3.13%
9. Telecommunications	2.50%
10. Financials	1.84%

Market gains in the second quarter were led by the Energy sector as escalating hostilities in Iraq pushed oil prices higher. The Utilities sector also continued to perform well, rising 6.8%, as investors continue to seek investments offering stable income in light of low interest rates. For the quarter, every sector finished in positive territory. Volatility was also at its lowest level since 2007 with the VIX averaging 13.8 in the first half of the year and finishing the month of June at 11.57.

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