Investment Overview April 2014 Volume 23, Issue 2

Economic & Markets Summary: 1st Quarter 2014

by Frank W. Savage, CFA, Vice President & Senior Portfolio Manager – Union Investment Management Group

The Economy

Proceeding into the second quarter, a review of U.S. economic data suggests continuing growth against a backdrop of increasing economic and geopolitical uncertainty. Economic reports and markets are exhibiting mixed signals as investors search for greater visibility in the months ahead. Fourth quarter U.S. Real GDP Growth was revised down from 3.2% to 2.6%, significantly below third quarter growth of 4.1%. Although somewhat alarming, many economists attributed the falloff in growth to isolated events including a 16-day shutdown of the government in October and an unusually severe winter that impeded December economic activity.

Growth estimates for the first quarter of 2014 are coming in below 2% on continued winter-weather weakness and a slowing housing market. In addition to poor weather, new housing starts and existing home sales are also being affected by lower home price affordability as mortgage rates are up significantly from 2013 lows and home prices continue their surge. According to the S&P/Case-Shiller Indices, national home prices increased 11.3% in 2013. On a positive note, housing pressures may be easing going into the second quarter. Both housing starts and existing home sales appear to be bottoming and data on housing permits suggest renewed growth in the latter part of 2014.

Despite expectations of a relatively weak first quarter, many economists are projecting reasonable growth through the remainder of 2014. Weak January prints of retail sales and industrial production rebounded nicely in February. Consumer spending, which accounts for roughly two-thirds of economic output, rose 3.3% in the fourth quarter, the fastest pace in three years. Corporate profitability remains robust, reaching new highs last year driven by continued gains in efficiency and cost control. Business spending was up 5.7% in the fourth quarter, a reflection that firms continue to deploy their money into equipment and other areas designed to boost output.

On the international front, markets grappled with Russia's annexation of the Ukrainian region of Crimea and the triggering of U.S. and European sanctions against senior Russian officials. Capital outflows from Russia are expected to reach as much as $70 billion by the end of the first quarter, effectively shutting down growth for the emerging economy. East-West relations are likely to remain strained in the months ahead as Russia's build up of its military presence along the Ukrainian boarder intensifies.

The European Union continues to be threatened by dangerously low inflation. Markets did response positively, however, to a late March statement from European Central Bank officials suggesting that the bank is prepared to shed a portion of its traditionally cautious approach in favor of more aggressive (and non-traditional) deflation-fighting policies.

Interest Rates

Longer-term bonds rallied throughout much of the first quarter on mixed economic data and geopolitical concerns over the Russian annexation of Crimea before retreating in the waning days of March. The 10-year Treasury bond finished the quarter yielding 2.72%, down 31 basis points from where it started the year.

The Federal Reserve's March 19th meeting may have served as a turning point for the fixed income rally as the Fed continued to cut its monthly bond purchases and indicated that the economy may be healthy enough to begin raising rates next year. Investors responded to the Fed's comments by sending the 2-year Treasury bond slightly higher. As such, the yield curve finished the first quarter with a flatter slope (higher shorter-term and lower longer-term rates) than where it finished 2013.

Short-term (1 to 3 month) Treasury yields are likely to remain at or near current levels, as the Fed remains committed to maintaining its target range for the Federal Funds Target Rate at 0 to 0.25 percent until unemployment drops below 6.5% and inflation expectations continue to remain "well-anchored".

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

	Treasury Bill	**Treasury Notes & Bonds**			
	3 mo.	2yr.	5 yr.	10 yr.	30 yr.
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%
09/30/13	0.01%	0.32%	1.38%	2.61%	3.96%

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 03/31/14)			
Barclays Capital US Aggregate	-0.10%	Merrill Lynch US High-Yield	7.53%
Merrill Lynch US Treasury Int-Term	-1.06%	Merrill Lynch US Municipal Index	0.28%
Dow Jones Corporate	-2.21%	JP Morgan EMBI Global	-1.07%

Stocks

Equities ended the first quarter relatively flat, as investors found little reason to put new money to work given that harsh winter weather has made it difficult to assess the true strength of the U.S. economy. The S&P 500 Index, following its best year since 1997, ended the quarter with a total return of 1.8%, outpacing most major indices. The tech-oriented Nasdaq Composite Index also ended the quarter in positive territory, but faced pressure in the latter half of March as investors took profits in previously highflying biotechnology and new-generation technology stocks.

Internationally, the MSCI EAFE Index finished the quarter up slightly while the MSCI Emerging Markets Index experienced a marginal loss. European stocks were hit particularly hard in early March on concerns that a Russian economic recession would further dampen demand for European exports. However, accommodative comments from ECB officials quelled fears in the closing days of the quarter. Emerging markets were hampered by manufacturing weakness out of China, but did experience a late March rally on speculation that the Chinese government may engage stimulus measures to provide economic support.

Below is a table which displays various equity index returns for the first quarter of 2014.

Equity Indices	**1st Qtr. 2014**
S&P 500	1.81%
Dow Jones Industrial	-0.15%
NASDAQ	0.84%
S&P 500 Growth	1.40%
S&P 500 Value	2.26%
Russell 2000 (small-cap)	1.12%
MSCI/EAFE (foreign)	0.84%
MSCI/EM (emerging markets)	-0.53%

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

Return by Stock Sector	**1st Qtr. 2014**
1. Utilities	9.02%
2. Health Care	5.40%
3. Materials	2.30%
4. Financials	2.15%
5. Information Technology	1.86%
6. Energy	0.19%
7. Consumer Staples	-0.16%
8. Industrials	-0.39%
9. Telecommunications	-0.73%
10. Consumer Discretionary	-3.16%

Market gains in the first quarter were led by the more economically defensive areas of the economy. The Utilities and Health Care sectors benefitted as investors rotated out of more aggressively priced stocks in the internet, media and biotechnology industries. As such, the Consumer Discretionary sector remained pressured throughout the quarter.

The potential for rising interest rates in 2015 coupled with political concerns out of Russia will weigh on investors' minds in the coming quarters. Market participants will look for data confirmation that the recent economic slowdown was indeed weather-related and to provide evidence that the U.S. expansion remains intact.

The *Investment Overview* is published quarterly by the Union Investment Management Group of Union Bank & Trust Company.
Please address correspondence to: Union Bank & Trust, Attn: UIMG, PO Box 82535, Lincoln, NE 68501-2535.