Perspectives and Market Commentary

U.S. Economic and Market Overview

In our last Commentary, we discussed the impact of the employment participation rate on U.S. economic conditions. We concluded that a rising equity market may encourage older workers to retire on schedule rather than continue working to make up for savings lost in 2008’s Great Recession and market melt-down. This quarter brings a combination of good, and bad, news.

On the good news front, the labor force recorded strong gains in non-farm payrolls and a continuing decline in unemployment claims. Older workers continued to leave the job market on their own schedules.1 We also saw the Institute for Supply Management’s (ISM) Purchasing Manager Index recover from the decline of this past winter—indicating a growing economy with potentially strong consumer demand in coming months.

![Purchasing Manager Index](source:Bloomberg)

Bolstering our view of potential improvement in consumer demand are the May results for ISM’s New Orders Index which gained 2% over an already strong April showing and reflects growth in new manufacturing orders for the 12th month in a row.

But there are developments which could slow what appears to be a U.S. recovery gathering steam. We are particularly concerned with developments in both Iraq and Ukraine where instability directly impacts U.S. Treasuries (as discussed below), but also may threaten the role low-priced oil has played in helping global economies recover over the last few years.

Before the current unrest, Iraq had climbed to become the second-largest producer in OPEC following significant foreign investment in the country’s infrastructure. Predictions for future Iraqi output were strong, but are now in significant jeopardy. By late June, oil prices had risen to over $107 per barrel and doom-sayers were predicting $150 prices if the situation deteriorated further. At the same time, Iran and the U.S. met and discussed the possibility of joint action to slow the advance of the Islamic State of Iraq and Syria (ISIS) insurgent group toward the oil facilities in Southern Iraq—where China has significant investments. The prospect of the U.S. and Iran working together to protect a region with Chinese petro-investments is something few observers could have predicted.

The turmoil in the Ukraine—with Russia suspending natural gas deliveries to the country and possibly to several countries in Europe—is another concern. While less of a concern than the impact of global instability on oil prices, industrial and household users of natural gas have benefited from years of low prices and will feel the impact of a possible spike in price. U.S. companies relying on export demand may feel the pinch if European customers see their gas bills soar.

Economic Conditions

The brutal 2013-2014 winter depressed GDP growth over the last two quarters with first quarter GDP registering an estimated -2.9%—the first negative quarter of GDP growth since the first quarter of 2011. Adding insult to the weather-related injury was the continuing effect of a surplus of manufacturing inventory.

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1 Bureau of Labor Statistics, June 2014
as shoppers hunkered down rather than heading to the mall. As we move into the summer months, we are finally seeing a pick-up in consumer demand and confidence which, when combined with good news on the employment front, bodes well for an uptick in forecasted GDP.

**Second Quarter Economic Highlights**

- Job growth improved dramatically during the four months ending May, with non-farm payrolls rising by some 200,000 jobs—the biggest boost in employment in some 14 years. Weekly unemployment claims during the second quarter came in at their lowest totals since 2003 and unemployment edged down in May to 6.3%.

- With some 70% of U.S. GDP attributable to consumer spending/retail sales, the strong showing in May 2014—an increase of 4.3% over the same month a year ago—was heartening news, particularly coming off the low sales figures earlier this year. The year-on-year May sales figure is within reach of the 20-year average of 4.6%.

- The Consumer Price Index (CPI) increased to 2.1% for the year ending May with the month of May recording the largest CPI increase (0.4%) in more than a year primarily due to rising food prices. With fears of deflation ebbing and CPI at levels deemed acceptable, it was no surprise that the Fed decided to continue winding down its monthly bond-buying program.

<table>
<thead>
<tr>
<th>Economic Forecasts</th>
<th>2012</th>
<th>2013</th>
<th>2014e</th>
<th>2015e</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. GDP (Y/Y Real)</td>
<td>2.8</td>
<td>1.9</td>
<td>2.6</td>
<td>2.8</td>
</tr>
<tr>
<td>CPI Inflation (Y/Y)</td>
<td>2.1</td>
<td>1.5</td>
<td>1.8</td>
<td>2.1</td>
</tr>
<tr>
<td>Unemployment</td>
<td>7.9</td>
<td>6.7</td>
<td>6.1</td>
<td>5.8</td>
</tr>
<tr>
<td>Fed Funds Target</td>
<td>0.25</td>
<td>0.25</td>
<td>0.25</td>
<td>1.00</td>
</tr>
<tr>
<td>Treasury Notes (10 yr)</td>
<td>1.76</td>
<td>3.03</td>
<td>3.00</td>
<td>3.80</td>
</tr>
<tr>
<td>S&amp;P 500 Target</td>
<td>1426</td>
<td>1848</td>
<td>2010</td>
<td>2130</td>
</tr>
</tbody>
</table>

*Source: HighMark Asset Allocation Committee*

The forecasts presented above are very near market consensus and do not meaningfully differ from Fed forecasts. Given the broad view that the economy will continue to expand at a reasonable pace and unemployment will continue to decline, we believe that the yield curve will steepen as we move through the balance of 2014. Therefore, we remain modestly cautious on bonds.

We expect U.S. economic growth to accelerate in the third quarter as the inventory hang-over is absorbed, production increases to meet retail investor demand, in part as a result of wider employment, and easy monetary policy continues.

**Fixed Income Outlook**

By David Wines

The Federal Open Market Committee (FOMC) continued to reduce monthly asset purchases by $10 billion (to $35 billion from $45 billion) following their June 18th meeting. They have now reduced purchases by $10 billion at each of their prior four meetings, and June’s meeting included the announcement that the Fed plans to end purchases this fall; perhaps at the October or December meeting.

Despite a reduction in forecasted 2014 U.S. growth from 2.1% to 2.3%—versus the 2.8% to 3.0% listed at the March meeting—Fed Chairwoman Janet Yellen said in late June that the brisk recovery from a tough winter—as evidenced by improving employment, business investment and household spending—supported the continued demise of QE II. Further clarity as to the Fed’s timing to raise rates in 2015 was not forthcoming; and the forecasted Fed Funds benchmark rate—1.2% by the end of 2015—changed only slightly from the March meeting.

We continue to believe that the Fed will tighten over the second half of 2015 and that the decline in asset purchases over the balance of the year will continue to place upward pressure on interest rates as asset demand on the part of the Fed diminishes.

However, there are two possible sources of emerging demand which may take the place of the Federal Government and, depending upon their appetite for U.S. Government debt, might continue to result in less than heartening yields for investors.

The first potential source, and the most obvious, is a flight to quality U.S. debt securities resulting from continued unrest in the Ukraine and, particularly, Iraq and the Middle East. We have already seen the results of a mini-flight to quality following Russia’s annexation of Crimea when the 10-year Treasury yield fell to just over 3%. In the context of global risk, events in Iraq may be even greater than continued upheaval in the Ukraine and may lead to a continued decoupling of bond prices and yields from underlying economic fundamentals.

**Will Pension Funds “De-Risk”?**

The other possible source of increasing demand for, longer-dated Treasuries in particular comes from the pension fund community. Two possible trends are behind this: the first is continued “de-risking” of corporate defined benefit retirement plans. General Motors (GM) was among the first to “de-risk” by exchanging its
portfolio of stocks, bonds and alternative investments for a $26 billion annuity to shift pension liability away from GM to Prudential Insurance, the annuity provider. The portfolio Prudential uses to manage this risk is heavily invested in U.S. Treasuries. Despite low rates, many corporations continue to follow GM’s example—trading in their traditional pension portfolios for annuities backed by Treasury-focused insurance general accounts.

Also, over the last 20 plus years, pension funds have reduced bond holdings—particularly U.S. Government Securities both in absolute terms (as shown in the exhibit below) and as a percentage of fund portfolios. Asset classes such as direct real estate, international and domestic equities, alternatives and emerging markets have benefitted from the allocation away from debt.

Generally speaking, with a few noticeable bumps along the road, this “risk-on” strategy has proved successful: as the exhibit below indicates, the largest U.S. pension plans have now funded 93% of their future retiree liabilities and this figure is expected to continue to improve in 2014. The question remains whether pension funds re-allocate away from risk assets like equities and back to bonds to preserve equity market gains that have helped restore funded status above long-term averages. In a period when the S&P 500 dips in and out of record territory on a near-daily basis, it would not be surprising to see demand for Treasuries increase—with rates, perhaps, less of a concern to pension fund CIOs than the effect of a market.

In summary, the U.S. fixed income market, rather than settling into a period where economic fundamentals drive returns, may see further surprises in the months ahead.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Q3 2014 Allocation</th>
<th>Q2 2014 Allocation</th>
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</thead>
<tbody>
<tr>
<td>Municipal Bonds</td>
<td>Modest Overweight</td>
<td>Modest Overweight</td>
</tr>
<tr>
<td>U.S. and European Corporate Bonds</td>
<td>Modest Overweight</td>
<td>Modest Overweight</td>
</tr>
<tr>
<td>High-Yield Bonds</td>
<td>Neutral</td>
<td>Modest Overweight</td>
</tr>
<tr>
<td>U.S. Government Bonds</td>
<td>Underweight</td>
<td>Underweight</td>
</tr>
<tr>
<td>Mortgage Backed Securities</td>
<td>Underweight</td>
<td>Underweight</td>
</tr>
</tbody>
</table>

We recommend only slight changes to our Q2 2014 allocations; most significantly moving from a modest overweight to a neutral position in High-Yield Bonds as declining yields for this sector make its volatility and valuation less attractive. We continue to modestly overweight munis with maturities beyond 7 years and, given our discussion above regarding supply versus demand for U.S. governments, continue to underweight U.S. Governments. Corporate bonds continue to trade at spreads over Treasuries within our comfort range and so remain a modest overweight.

**Equity Outlook**

By Derek Izuel

Our Q2 Commentary mentioned that valuations for European equities looked attractive and fundamentals were improving, but not to the point that the region deserved a portfolio allocation greater than equal weighting. We think the time has come this quarter and have boosted our European stock allocation to overweight.

We believe that European stocks are cheap compared to their U.S. equivalents and offer greater potential for margin expansion. The chart on the next page, which shows 10-year rolling and cyclically-adjusted Price to Earnings ratios (or CAPE), indicates just how wide current valuations are between the two regions. Historically, European stocks generally trade at lower valuations than U.S. equities, but the current CAPE spread is as wide as it has been since before the recession.
Reinforcing our view on Europe are corporate earnings, as indicated in the chart below which plots U.S. and European earnings, showing that the earnings gap between the two markets is higher than at any point in the last 25 years. We believe that while U.S. earnings may be at their peak and the market overvalued, Europe may be at the beginning stages of an earnings rebound.

The final catalyst for our bullish view of Europe was the European Central Bank’s announcement in early June this year that it intends to keep interest rates as low as possible to stimulate growth and will consider a similar asset purchase program as the U.S. Fed has used for the U.S. economy. It goes without saying that “Quantitative Easing” as it is known has been supportive of equity valuations here in the U.S. over the last 5 years.

**Time to Jump Into the Emerging Markets Pool?**

In our last Commentary, we noted that emerging market equity underperformance versus developed markets over the trailing three years was beginning to turn around and, in fact, emerging markets have made up much of the gap we saw at the beginning of 2014 to nearly match both U.S. and non-U.S. stocks year-to-date.

We see some signs of improvement in the global industrial cycle—which benefits emerging market equities—but remain unconvinced that the time is right to overweight emerging markets versus developed market stocks. Although global consumer confidence and U.S. employment has picked up—offering a potential return to demand for emerging market goods—other signals related to European and Japanese economic activity are still flat.

We also hope that upcoming Asian trade data will indicate an improvement in the Asian exports crucial to emerging market margin expansion. Demand and stable pricing of the metals required for industrial manufacturing continues, and this benefits emerging market companies, but, on balance, these factors are not sufficient to increase emerging market allocations.

One index we follow closely as a leading indicator of potential improvement in Asian exports and emerging markets is the Baltic Dry Index. This measure of changes in pricing for shipping raw materials such as metals, grains and fossil fuels by ocean-going vessels indicates that
demand for the commodities needed for industrial production is picking up. Over the last two years, the Baltic Dry Index has averaged 1,352 and hit a low of around 850 in early June. But, as can be seen from the chart below, recent data indicates a possible upward trend in shipping demand for the raw materials needed by emerging market companies to manufacture both consumer durables and non-durables for global consumption.

![Baltic Dry Index](image)

**Equity Outlook for Q3 2014**

<table>
<thead>
<tr>
<th>Country/Region</th>
<th>Q3 2014 Allocation</th>
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</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>Modest Overweight</td>
<td>Modest Underweight</td>
</tr>
<tr>
<td>Europe</td>
<td>Overweight</td>
<td>Equal Weight</td>
</tr>
<tr>
<td>Japan</td>
<td>Equal Weight</td>
<td>Equal Weight</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>Equal Weight</td>
<td>Equal Weight</td>
</tr>
</tbody>
</table>

The major change from last quarter in terms of recommended portfolio weightings is to move from an equal weight in European stocks to an overweight for the reasons we discussed above. We continue to recommend a modest underweight in U.S. equities as valuations have only become more stretched in the last three months. We feel there is little room for U.S. stock prices to reflect improvements in company earnings that may result from the positive economic developments we discussed at the beginning of this Commentary. We are keeping an eye on Emerging Markets, particularly Asian trade developments, to find the right point at which to overweight this region.

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