ATR Advisors

ABSOLUTE TOTAL RETURN
FIRST QUARTER 2014 COMMENTARY

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The first quarter of 2014 saw the stock market "rotate" into many of the sectors that had actually under-performed in the previous year. For example, the Real Estate Investment Trust (REIT) sector had been one of the worst performers in the S&P 500 during 2013. It had a total-return for 2013 (represented by the Dow Jones US Real Estate Index) of *under 2%* for the entire year. Without dividends, the Real Estate Index actually had a *loss of over 2%*. However, in the first quarter of 2014, the same Real Estate Index was one of the strongest performers, with a total-return of 8.75% for the first quarter alone.

Another example was the utility sector, represented by the Exchange Traded Fund XLU, which grossly *under-performed* the general market in 2013, with a total-return almost 20 percentage points below the S&P 500 Index. The same sector grossly *out-performed* the general market in the first quarter of 2014, with a total return of over 10% for the quarter alone, compared to a total-return of the S&P 500 Index of under 2%.

This demonstrates that the strongest performers in one quarter may turn into the weakest performers in the very next quarter. The stock market is fickle in whom it chooses as its favorites.

However, we still remain relatively optimistic about the US equity market as a whole for the remainder of 2014. Although the market may well be "due" for a temporary 5-10% correction at some point, over the coming year we see continued growth in US equity prices. Both buy-side and sell-side analysts are now converging on estimates that earnings per share for the S&P 500 should grow somewhere in the range of 7 -8% year-over-year from 2013 to 2014. If we assume, for the sake of argument, that price-earnings multiples will stay the same, this means that we can expect total-return from the S&P 500 to perform in the range of 9 – 10% return for the year, including dividends.

If the US economy picks up more growth than expected, we may even get some multiple-expansion (increase in Price/Earnings ratio) on top of that.

Our favorite sectors at this point include capital goods, diversified financials, semiconductors, software, tech, real estate, and utilities. We think large-cap stocks will likely out-perform small-cap stocks. We think companies that buy back their own shares will continue to out-perform the broader market. Some of our least favorite sectors at this time include autos, consumer services, consumer durables, pharmaceuticals, biotech, health care, retailing, media and telecom.

We think medium-term and long-term interest rates will likely creep up during the remainder of 2014 and into 2015, which should put pressure on longer-duration bonds. We anticipate that the US Federal Reserve, under its new Chair Janet Yellen, will likely continue with its current plan to taper its Quantitative Easing (QE) bond purchases, and that by the end of 2014 the Fed's Quantitative Easing program will be largely completed.

Some positive factors we see at this time include rising inflows of new investments into stock mutual funds, gradually improving housing data, steady improvements in employment, easing credit conditions in the US (which tend to precede uptrends in the stock market), and rising activity in Mergers and Acquisitions.

At the same time, we do have some serious concerns about events in the world economy, and their possible effects on the US stock market. Europe continues to teeter on the edge of outright deflation, and its leaders may not have the political will to overcome that danger if it does materialize. The Russian takeover of Crimea demonstrates how easy it is for geopolitical events to cause negative shocks to the world economy. In the emerging markets, we see ongoing currency problems for vulnerable countries, as "hot money" may rapidly flow out of their economies. In addition, the rise of extremist political parties in Europe – as happened in the 1930's – remains a worry for as long as unemployment levels in some European countries remain so extraordinarily high.

Although Prime Minister Abe's "three arrows" of new economic policy ("Abenomics") in Japan appear to have had some early success in beginning to fight two decades of deflation, we still worry about the very high level of government debt in Japan. In China, the new government of President Xi Jinping and Prime Minister Li Keqiang faces a monumental task in reorienting the huge Chinese economy into a more consumer-focused economy.

While all these concerns do temper our enthusiasm for US equities, US stocks still appear to be a good bet, simply because there just are so few other decent alternatives for investment at this time.

In their majestic (2009) historical survey of centuries of financial crises, "This Time is Different," economists Carmen Reinhart and Kenneth Rogoff pointed out that economies usually do eventually heal after even very bad financial crises. And this healing may have had time to run its course in the United States. Our economy has had over five years to heal from the "Global Financial Crisis" of September 2008, and the subsequent "Great Recession" that followed in its wake.

It appears that US Federal Reserve also believes that the US economy has healed enough to begin to "take off the training wheels." This encouraged the Fed to slowly "taper" down its Quantitative Easing program beginning at the end of 2013 and throughout 2014.

This view of the US Federal Reserve is our own "base-case" view as well. Therefore we remain optimistic about the future of the US stock market.