Wealth Health
Personal Wealth Management

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5 Becker Farm Road
Roseland, NJ 07068

Tel: 973.535.9577
Fax: 866.734.4227

www.wealthhealthllc.com
info@wealthhealthllc.com

Market Review

One thing that stands out about the past quarter amidst the record-setting highs of the S&P 500 and the positive performance across all major asset classes as shown in the chart below is the very low stock market volatility. By late June (6/19/14), the VIX, a volatility index that measures expected 30-day volatility of the S&P 500, had dropped to 10.6, a level last seen in February 2007.

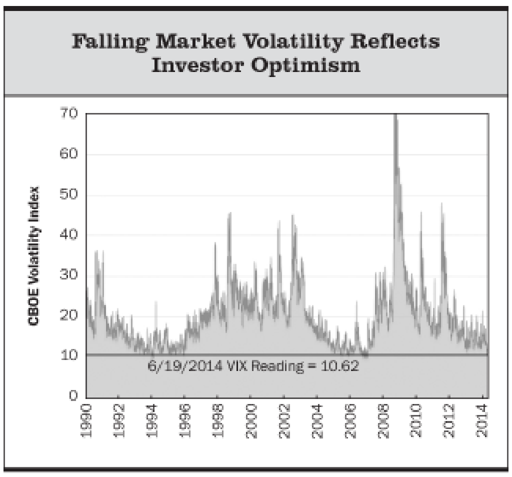
While low volatility and high stock prices reflect the market's apparent lack of concern about risk—likely buttressed by a belief that the Federal Reserve will continue to support financial markets with accommodative monetary policy—this seeming complacency is causing us some near-term concern because it suggests a market more vulnerable to negative surprises.

Index Returns *Through 6/30/2014*

			Annualized Returns		
Index	**QTD**	**YTD**	**1-Year**	**3-Year**	**5-Year**
S&P 500	5.23%	7.14%	24.61%	16.58%	18.83%
Russell 2000	2.05%	3.19%	23.64%	14.57%	20.21%
MSCI EAFE	4.09%	4.78%	23.57%	8.10%	11.77%
MSCI All Country World Index	4.81%	6.24%	23.42%	10.37%	14.79%
MSCI Emerging Markets Index	6.60%	6.14%	14.31%	-0.39%	9.24%
Barclay Capital US Aggregate Bond	2.04%	3.93%	4.37%	3.66%	4.85%
Barclay Capital Municipals	2.59%	6.00%	6.14%	5.35%	5.81%
Dow Jones UBS Commodity	0.08%	7.08%	8.21%	-5.17%	1.99%
HFRI Fund of Funds Composite Index	1.60%	2.17%	7.69%	3.33%	4.26%

The more investors are expecting and positioning portfolios for a benign or optimistic environment—using leverage and pouring money into riskier and/or less liquid assets to ramp up their near-term returns—the more likely it is that there will be a negative shock relative to these market expectations, and the more disruptive it will likely be if and when the shock happens.

This shorter-term concern about potential market vulnerability is also consistent with what continues to be our longer-term view that stock market valuations in aggregate are discounting too optimistic an outlook. In sum, our view is that markets continue to be too dependent on central bank largesse, too short-term focused, and too complacent about the risks and imbalances that remain in the global economy in the aftermath of the financial crisis.



Data as of 6/19/14. Source: CBOE.

But what might disrupt the market's calm? Unfortunately, geopolitical shocks are always a risk and one that we don't try to anticipate. But even with this year's events in Ukraine and the sectarian violence in Iraq (to name just two), markets in general have remained relatively calm (except for some short-term, temporary stock-market declines).

Asset classes across the board rose in the second quarter despite lackluster global economic growth, an uncertain outlook for global monetary policy, and geopolitical tensions in Ukraine and Iraq.

U.S. GDP growth was revised further downward for the first quarter, but expectations are for growth to rebound in the second quarter.

After a poor first quarter, emerging-markets stocks rallied strongly in the second quarter.

Investment-grade bonds earned nearly 2% as Treasury prices rose and bond yields continued to fall, a surprise to many investors.

Overall, our macro view and assessment of the risks and returns across the major asset classes has not changed meaningfully since last quarter. We continue to see the U.S. and global economies on a slow path of recovery from the 2008 financial crisis.

We continue to view the markets as too dependent on central bank largesse.

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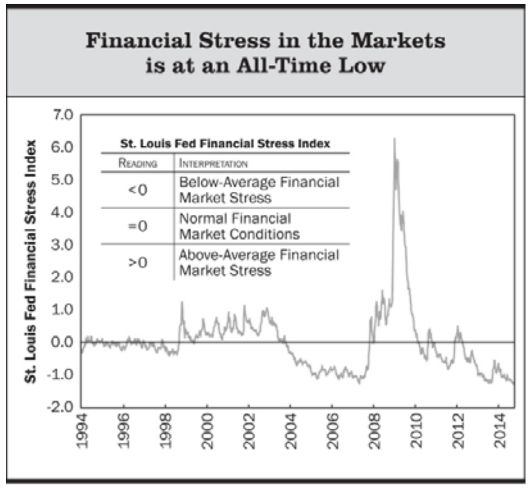
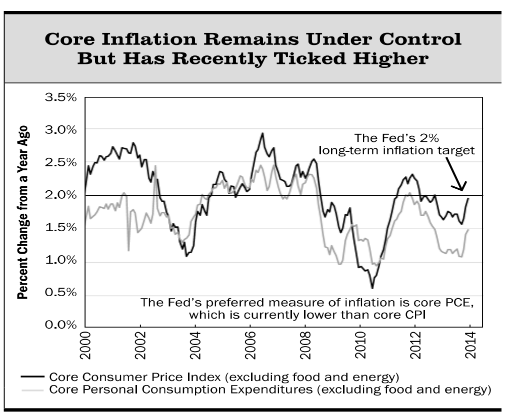
Inflation vs. Deflation

Away from the geopolitical realm, a deflationary or inflationary surprise could be disruptive. In Europe, core inflation fell to a low year-over-year rate of 0.7% in May (headline inflation, which includes food and energy, was only 0.5%). Several smaller European countries are in outright deflation. However, the markets have been worried about European deflation for a while now, and the latest CPI number was in line with consensus expectations. Meanwhile in June, the European Central Bank initiated new monetary policies in an attempt to help reflate the economy, and also signaled that it would act more aggressively, if necessary, to prevent a deflationary shock in Europe from happening. (This echoed its actions in late July 2012, when ECB President Mario Draghi assured the markets it would "do whatever it takes" to prevent a breakup of the European monetary union, triggering a huge rally in European stock and bond markets).



Data as of 6/13/14. Source: Federal Reserve Bank of St. Louis.

In the U.S. economy, deflationary and inflationary risks are more balanced. While inflation, and importantly, inflation *expectations* remain under control, it has recently been ticking higher. Core CPI hit 2% on a year-over-year basis in May. The inflation measure the Fed focuses on, the core personal consumption expenditures price index, rose to 1.5% in May, which is still below the Fed's long-term inflation target of 2%. In her most recent policy statement, Federal Reserve Chair Janet Yellen expressed little concern about the recent uptick, referring to the short-term inflation data as "noisy." But several economists have pointed to the acceleration in the inflation rate over the past year as a potential harbinger of higher inflation to come. For example, core CPI has increased at a 2.8% annualized rate in the past three months, compared to the 2% trailing 12-month rate. Inflation obviously bears watching, and no one is watching it more closely than the central banks.



Data as of 5/31/14. Source: U.S. Bureau of Economic Analysis and U.S. Bureau of Labor Statistics.

But that doesn't mean the financial markets will necessarily agree with central bankers' assessment of the inflation risks or that the central banks' assessment will be correct. Central bank policies have been a huge driver of financial market returns in recent years, e.g., driving down bond yields and pushing up stock market valuations. Monetary policy remains a key uncertainty, and its impact—both intended and unintended—on the markets and the economy must be taken into account in managing investment portfolios.

Update on our Macroeconomic Outlook

Overall, our macro view and assessment of the risks and returns across the major asset classes has not changed meaningfully since last quarter. We continue to see the U.S. economy—and the global economy more broadly—on a slow path of recovery from the 2008 financial crisis. Private sector balance sheets continue to strengthen (reflecting the U.S. household and financial system deleveraging that has occurred since 2009).

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This lessens the odds of another financial crisis and is a key support for the recent increase in our estimate of fair value for the stock market as we discounted a less stressed macro environment. Risks remain, however. We've touched on a couple specific big-picture topics concerning global central bank policy and European deflation. Another is a disruptive unwinding of China's credit bubble. More recently, we are becoming more sensitive to inflation risk, given the uptick we have seen in the United States over the past quarter and the strengthening (although still not strong) labor market, which at some point should start pressuring wages higher. Improved wage growth should be beneficial for consumer spending and the overall economy (and Yellen has explicitly said she wants to see higher wage inflation), but it would also likely put pressure on corporate profit margins and therefore earnings, which are a key component of our asset class valuation framework.

Based on Fed statements and behavior, we continue to see the risk of the Fed overshooting in terms of accommodative monetary policy, keeping rates "lower for longer," and allowing inflation to move above their 2% long-term target. This strikes us as a bigger risk than the Fed tightening too soon and snuffing out the tepid economic recovery. But it isn't clear how or when the markets will react if the Fed remains accommodative in the face of a sustained rise in inflation above 2%. And the markets' reaction will almost certainly influence the Fed's behavior as well. Fed credibility has been critical to market stability, and markets have reacted positively (or at least neutrally) to the most recent Fed statements and actions. But that credibility may be increasingly called into question if the market perceives the Fed is remaining inactive in the face of inflation or other potentially worrisome economic indicators.

Our Portfolio Positioning

In the meantime though, the music is playing, the punch bowl is out, and the equity markets are dancing to the central banks' tune. This party may continue for several more months or quarters. But we don't think relying on central bank generosity is a sound investment strategy over the longer term. While we think inflation risk has increased at the margin, we have not made any portfolio changes because we don't view the change in inflation risk as significant enough, nor is our conviction that an inflationary scenario will play out high relative to other potential macro scenarios we consider.

Overall, our portfolios are somewhat defensively positioned, with a moderate underweight to stocks and equity risk (primarily U.S. stocks and smaller caps due to their unattractive valuations) and a significant underweight to core bonds and interest-rate risk, relative to our long-term strategic allocations. These tactical allocation decisions are based on our asset-class risk and return estimates, which in turn are driven by our assessment and analysis of economic fundamentals and market valuations.

Closing Thoughts

As we consider the range of potential outcomes, we are comfortable with our positioning and the risk and return trade-offs we are making. In the current low-volatility, low-yield, high-P/E environment where investors aren't getting much in return potential for taking on risk, we don't see any asset classes offering compelling fat-pitch returns relative to their risk. Instead, our tactical positioning is more on the defensive, risk-management side. We remain in a period in which patience and discipline are particularly critical, even if over the shorter term it may not seem so as markets continue to hit new highs. There is a powerful behavioral inclination to chase markets and asset classes that have already performed strongly. In contrast, our investment process and discipline is forward looking—based on longer-term analysis of fundamentals and valuations across multiple scenarios, informed by economic and financial market history and cycles, yet with a recognition that history does not exactly repeat.