Monthly Commentary

SELECTOR
Real-Time Money Management

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"Good investors gather information, put that information into current and historical context, then make sound decisions."

The last four weeks have been marginally constructive for most major market equity indexes. The best news is that market volatility has declined once again. The general pattern has been five good days followed by one sharp kick back. (There is a Latin dance like that, but I don't recall the name.) Progress has been painstakingly slow for equities, as the primary trading pattern remains sideways, a.k.a. trading range bound.

The exception to this action has been small cap equities, which are dealing with their own little demons. Small cap equities dropped quite sharply during the January correction, averaging a -8.5% decline versus the larger cap's -7.5% pullback. The small cap recovery was very rambunctious, however, with a +13% rebound that very quickly (four weeks) took them to new all-time highs by March 1st. This was a case of too much sugar all at once, and like too much cotton candy at county fair, there were consequences. We liked the small cap sector after it had declined about eight percent from those new highs. Unfortunately, the tummy ache lasted a few more weeks and the declines took small cap indexes down another five percent.

When a market sector takes on a direction that is not in sync with the general market, it is called a divergence. Normally, a divergence is not a big issue, especially when it involves a particular industrial sector, like energy or technology. But when the diverging sector involves an entire capitalization sector, such as large cap or mid cap or small cap, it can become a big deal. Eventually, market capitalization divergences always are corrected. The question is, will the diverging sector create a pull on the rest of the market, or will it return to the flock? We are attentively waiting to see how this is resolved. We do have an exposure to small cap equities and they are not contributing to the bottom line. Practically every other position is contributing, so we are tolerating their divergence, for now.

The market scorecard is more positive than last month. The S&P 500 is now up +2.80% YTD. The S&P MidCap 400 Index is up +1.82% YTD. Meanwhile, the Russell 2000 SmallCap Index is down -4.80% YTD. International equities have now taken the lead over domestic equities. The MSCI Europe 350 is up +4.83% YTD, while the MSCI Emerging Markets Index is up +4.02% YTD. The broader MSCI EAFE Index is up +2.17% YTD. The poorest performing single country stock indexes are Russia, down -10% YTD, Japan, down -8% YTD, and China, down -6% YTD.

The best performing industry sector continues to be real estate. The Dow Jones U.S. Real Estate Index is now up a handsome +14.29% on the year. It is interesting that there is also an international interest in real estate securities, with multiple overseas real estate indexes also showing double digit returns YTD. The utilities sector also is prominent on the leader board despite slipping nearly -5% in the last couple of weeks. The Dow Jones U.S. Utilities Index is now up +9.95% YTD. Pharmaceutical and health care sectors have popped back nicely the past month, along with energy, basic materials and technology sectors. It is also interesting that despite the institutional interest in commercial real estate securities, there is a marked decline in home construction. The Dow Jones U.S. Select Home Construction Index now stands down -6.39% for the year.

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Bond markets continue to be strong thus far in 2014. In fact, every bond index that we follow is in positive territory. The best performing bonds have been long-term, led by U.S. Treasuries and U.S. Government bonds. The Barclays U.S. 20+ Year Treasury Bond Index is now up +11.95%, the Barclays U.S. Utility Bond Index is up +6.67%, and the S&P National Municipal Bond Index is up +5.80%. TIPs, investment grade corporate bonds, and high yield bonds also continue to advance with very acceptable returns. The Barclays TIPs Index is up +4.58% YTD, the Barclays U.S. Corporate Investment Grade Index is up +4.19%, and the Markit iBoxx USD Liquid High Yield Index is up +3.83% YTD. These bond returns are every bit as surprising as last year's equity gains, especially given the extremely low interest rate environment that exists and projects for the next several quarters.

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Sources: Bloomberg, Marketwatch.com, StockCharts.com.