Argent Wealth Management, LLC

Investment Outlook

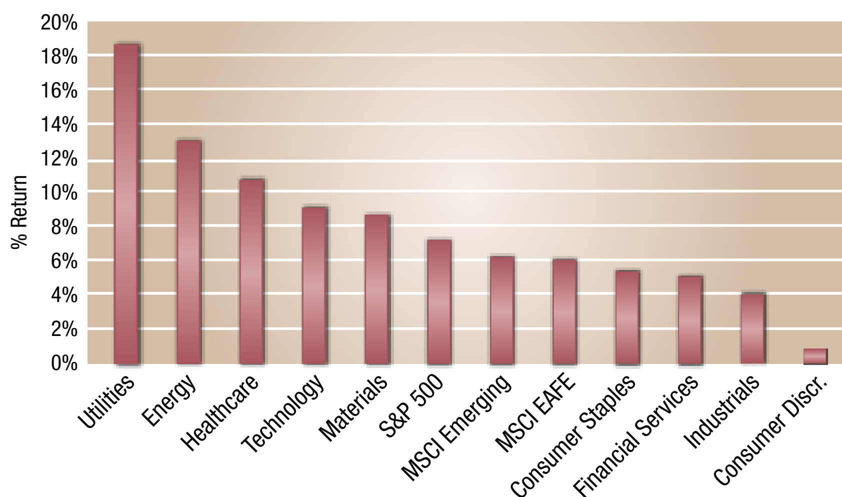
SUMMER 2014

Third Quarter 2014 Investment Outlook | First Half 2014 Review

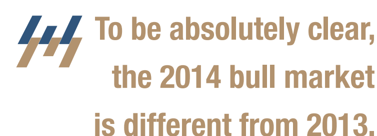
The Goldilocks Market Still Lives….For Now

We must admit as to being surprised by the broad-based market advances and exceptionally low volatility that characterized the first half of 2014. As noted in our last outlook, we continue to expect more-normal market volatility; although we would not be so presumptuous as to suggest the precise timing or the catalyst.

Fortunately, our strategies and our clients' portfolios continued to prosper. While we did have portfolios positioned more cautiously than at earlier points in the equity bull market, such caution did not harm returns. Higher-flying and more speculative areas of equity markets trailed market averages, so underweights here helped. Many of our most-favored market sectors did deliver superior returns, such as Preferred Equity, Commodities and Real Estate.



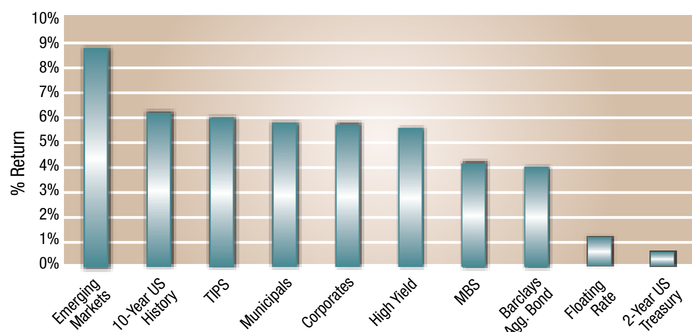
To be absolutely clear, the 2014 bull market is different from 2013. Last year it was all about risk or, technically speaking, "beta." The more risk taken, the greater the reward. Within equity markets, the top performers were concentrated in the riskiest and most volatile sectors, with U.S. Smaller Capitalization Growth stocks leading the pack.



Such a single-dimension market as 2013 is difficult to manage within our framework of constructing broadly diversified portfolios. Any attempts to diversify exposures and to manage risk will reduce portfolio returns. While diversification works exceptionally well over a full market cycle, it can seem frustrating when the most volatile sectors rise to the top of the pack.

So far, 2014 has very much rewarded broadly balanced portfolios. It has also been a great environment for managing the overall level of risk and finding attractively valued assets that are not in the mainstream of equity or bond indices. On the equity side of markets, all of the most successful sectors have been driven by a favorable starting valuation (cheapness), by high level of dividend yield and/or by superior quality (balance sheet strength and earnings predictability). Those are precisely the characteristics upon which our favored equity managers focused.

Year-to-Date Bond Returns



Within fixed income, success was also characterized by getting away from the assets that are concentrated in the Barclays Aggregate Bond Index. While the index itself did produce a respectable return, far better returns were found in income-oriented assets such as Preferred Equity, High Yield and Distressed Debt.

Can the Goldilocks Market Continue?

Yes, such a market can continue for longer than seems reasonable or rational. Market participants can stay complacent as long as economic fundamentals remain balanced and there is no shock to the system. Such environments can become "self-reinforcing" in the short run. In these cases, investors perpetuate the current market patterns by, for example, buying even small market dips in a rising equity market.

However, at some point, these patterns do change — and often abruptly.

We believe it is critical to understand there are no certainties with respect to a market forecast. Rather, there is a range of potential outcomes. Each outcome has a certain probability and an associated set of consequences for a portfolio. While a portfolio should be constructed to benefit from the most likely market scenario, other less probable outcomes should be considered. A prudently constructed portfolio should hold at least some assets that prosper during these less probable outcomes.

While the Goldilocks market can continue for some time, we believe that an increase in volatility to more normal levels is more probable. More importantly, the "payoff" for positioning a portfolio for the Goldilocks scenario appears to be modest. More and more areas of both equity and fixed income markets are expensively priced, suggesting limited additional appreciation in these sectors.

The most likely outcome that this scenario would suggest is a continuation of the recent past — markets that grind higher and relatively broad-based market participation. We believe our portfolios would do just fine in this scenario (although it is not our preferred outcome) as long as the market continues to pay attention to valuation.

The "melt-up" scenario, or a return to highly speculative areas of equity markets leading all other sectors, is where our portfolios would be at risk of lagging their respective benchmarks. While possible, the probability is low. These more aggressive sectors are already priced more expensively than other sectors by a substantial margin. While high starting valuation does not eliminate the probability of this scenario, it makes it a risky proposition.

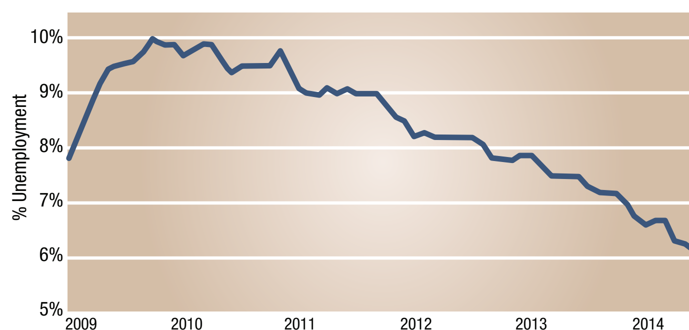
Economic Acceleration: the Fed Takes Away the Punch Bowl

In our view, the most likely scenario involves a moderate acceleration in economic growth and healthy market correction. In fact, the probability of this scenario has been steadily increasing based upon a number of recent developments both at home and abroad.

In the United States, our economy appears to be rebounding from an unexpectedly weak first quarter. Recent employment reports have been solid. Credit markets are flush with liquidity, and corporations have been tapping cheap capital funding. Home prices (and real estate in general) have continued to improve, suggesting the consumer is in better shape and has the capacity to spend.

Outside of the United States, more indicators point to better growth as well. India overwhelmingly elected a pro-growth leader and for the first time in many decades has a ruling coalition with a mandate for economic growth. China appears to have managed its slowdown reasonably well and appears to be getting stronger.

Unemployment Since 2009



The European Central Bank (ECB) has turned up the volume on its monetary stimulus and has taken a page from our own Fed with respect to nontraditional measures. With European inflation rates still well below targets, we expect the ECB to keep the monetary spigots on full blast for some time to come.

Most importantly, central banks have a huge incentive to promote faster growth and higher inflation. Such is the path to be able to pay for the accumulated debt from the past credit cycle. It is also the path to better employment conditions in the short run. While this scenario is far from a certainty, we would not want to underestimate the power of coordinated central bank policy.

We believe our Fed would take away the monetary punch bowl, perhaps sooner than markets currently anticipate. The remaining parts of the asset purchasing program (QE) would most certainly be unwound, on schedule. That would suggest the conclusion of this program in November, with the stage now set for an increase in shorter-term interest rates.

An increase in the Fed Funds rate could occur, under the economic acceleration scenario, as soon as the second quarter of 2015! But what really matters to markets is when market participants start to worry about the Fed changing policy. That could happen at any time if the markets begin to anticipate the potential for faster growth or any deterioration in inflationary expectations.

We expect a healthy correction (not collapse) in equity markets, and market participants anticipate higher interest rates. This scenario also suggests a firmer path of earnings growth, so it is not unambiguously negative for equity markets. More critically, we would not expect such an equity correction to be evenly distributed, with the most highly valued and most speculative sectors going down more sharply than steadier, more quality-centric sectors.

Interest rates would likely rise, but also not necessarily evenly or dramatically. There are several key reasons that would likely keep the rise in interest rates more contained than would otherwise be the case: 1) Interest rates on the base Treasury yield curve are already up substantially from cycle lows. The “yield curve” is already quite steep. In other words, the markets already anticipate and have priced in a certain amount of Fed action. 2) International interest rates are extremely low and have gone even lower recently. There is a limit to how much our interest rates can rise above other countries’ interest rates. 3) Any major spike in interest rates would slow economic activity, such as housing. That slowdown would relieve some inflationary pressure and would moderate the amount that rates can rise.

Commodities, Real Estate and other inflation-friendly assets would likely excel under this scenario. Other areas that should do relatively well would be Non-U.S. Equities, given the more supportive environment from non-U.S. central banks. We are already positioned well in these areas and would look to increase weights further as we gain greater confidence in this market pattern.

Recession Scenario: Low Probability but Very Ugly

We believe the odds of a major shock or economic recession are low, perhaps no more than 10% within the next several years. However, the consequences would be nasty, and it is difficult to prepare for such an environment.

Recessions are typically preceded by one or both of two primary conditions. The most common condition is an “inverted yield curve” as the Fed is engineering a slowdown in the economy (raising short interest rates) and ends up overdoing it. As shorter interest rates are driven higher, economic activity rolls over and accelerates to the downside. Longer bond yields actually start declining as market participants sense a slowdown coming (and a commensurate drop in anticipated inflation), setting the stage for an inversion in the yield curve.

The second typical condition preceding recessions is a major market bubble or major market shock. Examples include the collapse of Lehman Brothers and the 2000 tech bubble.

While neither of these conditions is being met or likely to be met anytime soon, the consequences would be dire. Governments are still running large deficits and debt burdens are substantial, leaving limited capacity for fiscal stimulus. Central banks are already running full tilt with respect to monetary stimulus. One wonders what action or set of actions could be taken if a crisis were to hit the system and whether these actions would actually work.

A major shock or recession would likely mean a major bear market for all kinds of “risk” assets. That would likely mean equities around the globe, with very few stocks or sectors that would not participate in the downside. It would also likely mean a major bear market for

credit markets — High Yield, Corporate Bonds, etc. These areas are expensively priced by any measure and imply near-zero default rates.

There are a few assets that would do well in this ugly scenario. At the top of the list are certain hedge-fund-type assets (e.g. Managed Futures), whereby managers can be both long- and short-risk assets. These assets did exceptionally well during the 2008 debacle and other crisis periods, which is why we hold moderate percentages within balanced portfolios.

The other primary beneficiary of this unpleasant scenario are the highest-grade bonds (U.S. Treasury bonds and AAA municipals). These are typically the "safe-haven" assets that investors flock to in times of crisis. The problem today is that interest rates are already very low and have limited capacity to go much lower. What would work well in this scenario are the longest, highest-quality bonds — and we do hold moderate positions here (a so-called "barbell" of longer and shorter bonds).

Market Correction, Yes … Collapse, No (A Repeat of Major Bear Markets of 2001 and 2008 Unlikely)

While we are indeed cautious, particularly with respect to the most speculative equity sectors, we are not implying high odds of a major bear market. There are some huge distinctions between today's relatively expensive markets and major crisis periods of 2000 and 2008.

In 2000, a huge percentage of the overall market capitalization was priced in bubble territory. Back then, it was the largest and fastest-growing companies that were at incredibly high prices (e.g. Cisco). When that bubble burst, it had huge consequences for the overall market averages and for investor wealth. Today's expensive markets are concentrated within smaller stocks and a few of the fast growers (e.g. Tesla). Fortunately, the vast majority of the large, steady, "quality" companies are quite reasonably priced.

Price/Earnings Ratio	2002	2014
Large Cap	50	18
Small Cap Growth	20	22

Data: NDR Research Group; Large Cap = S&P 100, Small Cap Growth = NDR Small Cap Growth
Chart: Argent Wealth Management, LLC © 2013

The 2008 debacle was all about a "credit contraction" of historic proportions. Credit contractions are quite unusual but can be incredibly severe. At that time, large numbers of the biggest financial institutions either collapsed or were on the verge of collapse. Credit availability dried up completely to most sectors of the economy. These types of crises feed upon themselves until the leverage within the financial system is completely unwound. That is why these periods are so serious and require such a significant response from governments and central banks to combat.

Fortunately, we do not have either the pre-conditions of the bursting of a major bubble or credit contraction. We do have very low global interest rates and highly valued markets in general. We also have pockets of speculative excesses, but these bubbles are not within huge market sectors.

A correction is well overdue. All market corrections feel uncomfortable, by definition. This one could feel particularly uncomfortable because recent market volatility has been so low and is now expected by many investors to continue. However, a properly constructed portfolio should be able to weather any correction. Most importantly, such a correction would create a number of potential opportunities that we are prepared to exploit. And that would set the stage for better returns.

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