Episode 8

A Market Review of the Second Quarter of 2014, and an Outlook for the Rest of the Year

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Len: Welcome to KayneCast. My name is Len Hirsh, and I am the Assistant Director of Marketing Communications for Kayne Anderson Rudnick Investment Management. Today our guest is Doug Foreman, the Chief Investment Officer of Kayne Anderson Rudnick. Doug is joining us to give a market review of the second quarter of 2014, as well as his outlook for the rest of the year. Hi Doug, thanks for joining us.

Doug: My pleasure, Len. Thanks for having me.

Len: So, Doug, if you would, tell us what happened in the stock market during the second quarter.

Doug: Well Len, domestic equity markets turned in another strong quarter with the S&P 500 returning 5.23%, and this was the sixth consecutive quarters of positive returns. This hasn't happened since the late 1990s. Although the broader indices have not experienced a long-awaited correction of 10% or more, many smaller stocks during the year have experienced material declines on the order of 20% or so. Accordingly, small-cap stocks, as measured by the Russell 2000 Index, continued to lag larger stocks year-to-date, but they still realized a positive return of 2.05% for the quarter. So, at the halfway point for the year, the S&P 500 was up 7.14%, the Russell 2000 3.19%, and the Emerging Markets Index had appreciated 6.14%.

Len: Alright, and how about fixed income, Doug?

Doug: Well the bond market has perhaps been the biggest surprise of the year. The 10-Year Treasury Bond yield, which began the year slightly above 3%, actually declined to 2.53% by mid-year instead of rising as many have expected, including ourselves. In fact, most investors thought there was going to be a significant increase in yields in 2014, but that has obviously yet to happen.

The Barclays Capital U.S. Aggregate Bond Index was up 3.93%. Real Estate Investment Trusts, which are very interest-rate sensitive, were the market leaders, up 16.14%, emerging market debt increased 8.66%, global high-yield debt was up 6.06%, and muni debt appreciated 5.69%. So, the bond market overall was very strong in the second quarter.

Len: And there was a lot of talk this past quarter about how low the GDP number was in the beginning of the year, right Doug?

Doug: Yes, Len, first quarter GDP was down a shocking 2.9% due to inclement weather throughout most of the country. The weakness in the first quarter, combined with an elongated winter which actually extended into the second quarter as well, combined with low levels of inflation, has had a favorable impact on the bond market year-to-date.

Accordingly, bonds yields fell, leading equity investors to seek out bond proxies as they looked elsewhere for yield. As a result, large dividend-paying companies, Real Estate Investment Trusts, and utilities all dramatically outperformed year-to-date. However, we still believe that 10-year yields will gradually increase from these levels despite the weather-induced delay, and if we are correct, we would expect these sectors to become less favored by yield-starved investors over the next 12 to 18 months. We should also point out that despite the weak GDP in the first quarter, corporate earnings continued to grow, which is very impressive in light of a significantly down GDP report in the first quarter.

Len: OK, and outside of the U.S., what happened around the world in Q2 that we should be aware of?

Doug: From a global perspective, Len, the ECB, the European Central Bank, finally became more concerned with deflation in Europe than inflation, and has started to ease their monetary policy much more aggressively. Meanwhile, Japan's central bank has continued a similar policy for almost a year now.

Additionally, it appears that China's growth rate has stabilized at 7% or more. After a fairly soft first quarter, the Chinese economy seems to be regaining its footing in the second quarter.

Finally, tensions overseas in the Ukraine subsided during the quarter, and many favorable election outcomes in India and a few other emerging markets were very encouraging to emerging-market investors.

Len: Well, that's a helpful review of the second quarter, Doug. So what's your outlook for the rest of the year?

Doug: Well, Len, job creation finally seems to be kicking into a higher gear, as we have now had over five straight months of 200,000 new jobs being added. This is a good sign, and it's the first time this has occurred since the late 1990s.

I think that the bond markets are increasingly likely to face headwinds over the next 12 to 18 months due to the eventual increase in short-term interest rates brought about by the Federal Reserve. As I mentioned, this headwind will probably spill into equity bond proxies such as utilities, Real Estate Investment Trusts, and high dividend-paying stocks, but as long as interest rates increase gradually as we expect, equities should continue to perform reasonably well from here.

Other things to consider are that corporate earnings are still reasonably good, merger and acquisition activity has accelerated substantially, corporate capital allocation is very sound, and equity valuations – although not cheap - are also not terribly excessive by historical standards. With all of that being said, our strategy will be to continue to invest for our clients in high-quality businesses which can do well in good and bad times.

Len: Well, thank you for your insight and your time Doug. And thank you to everyone who listened in. We hope you are enjoying the series so far, and we encourage you to get the most up-to-date episodes by either downloading a podcast app on your mobile device and subscribing to the KayneCast feed via iTunes, or by just listening to the KayneCast player on our website.