Q2 2014 ECONOMIC OUTLOOK

BY ROBERT BENSON

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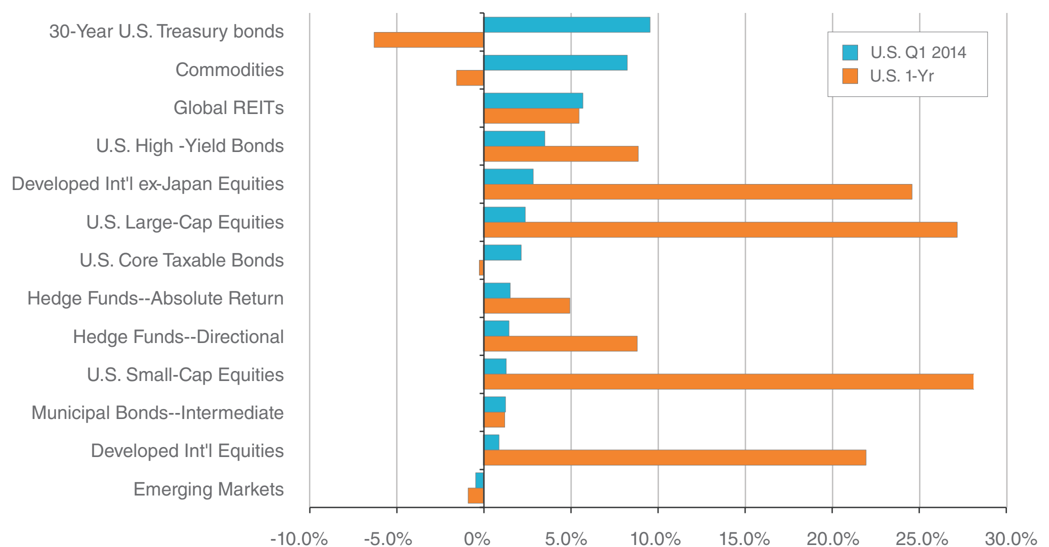
RUNNING THE LONG RACE

Investors had to navigate the equivalent of an obstacle course in first-quarter 2014. As we had predicted near the end of last year, volatility in the capital markets did pick up in 2014 on profit-taking and as fundamentals play catch-up with last year's run up in prices. A severe East Coast winter and Russia's foray into Crimea added to the set of obstacles. In response, many investors appear to have tripped all over themselves chasing returns or running from short-term risks, as evidenced by first-quarter mutual fund flows.

The resulting volatility was unnerving at times. In January, global stock prices ended down significantly (-4%), as investors shifted into less-volatile asset classes in response to civil unrest in Ukraine and concerns about a weaker U.S. economy. The situation largely reversed in February, pushing the global stock market (MSCI AC World Index) nearly 5% higher. By the end of the quarter, most major asset classes were sporting positive returns, to the benefit of long-term investors who had endured the many shifts and turns in the obstacle course.

Q1 2014 AND 1-YEAR TOTAL RETURNS: MOSTLY POSITIVE
(As of March 31, 2014)

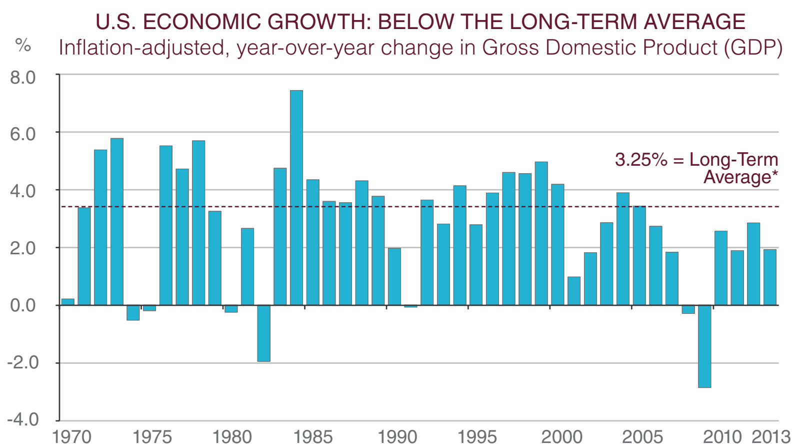


SOURCE OF DATA: Morgan Stanley, Barclays Capital, Russell Indices, and Bank of America Merrill Lynch, Dow Jones UBS, Bloomberg, U.S. Treasury.

Looking out into 2014, we remain optimistic regarding the global economy as well as the capital markets. In equities, we look for positive (if somewhat modest) single-digit gains for the year. Although global economic growth is likely to be well below historical levels, we are seeing signs of moderately stronger expansion around the globe, even with the recent downward revisions for emerging-market economies. In fixed income, we look for U.S. interest rates to trend higher by year-end, with increased volatility. We have positioned LNWM client portfolios to capitalize on these expectations.

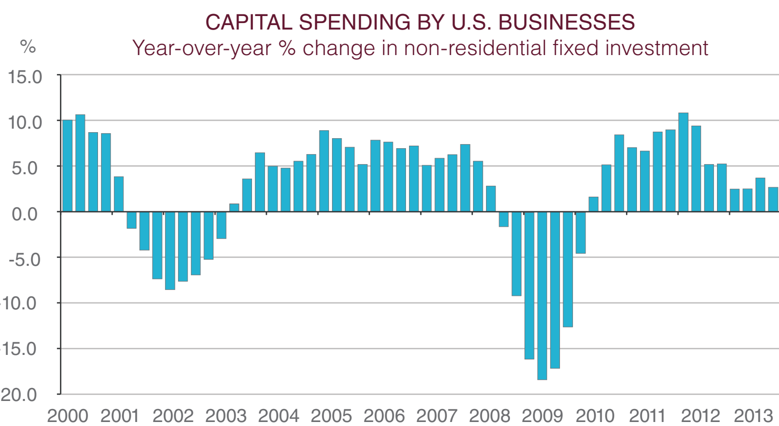
DEVELOPED ECONOMIES AND EQUITIES

LNWM remains confident that the U.S. economy will grow at a higher rate than in 2013. Unfortunately, some of our optimism stems from the fact that last year is relatively easy to beat. Gross domestic product (GDP) expanded by only 1.9% in 2013 — a third slower than the growth rate experienced in 2012, and well below the 3.2% annual average since 1948. For 2014, we expect U.S. GDP growth to be slightly less than a 3%.



*From 1948 through 2013.

SOURCE OF DATA: Bureau of Economic Analysis; Annual time series.

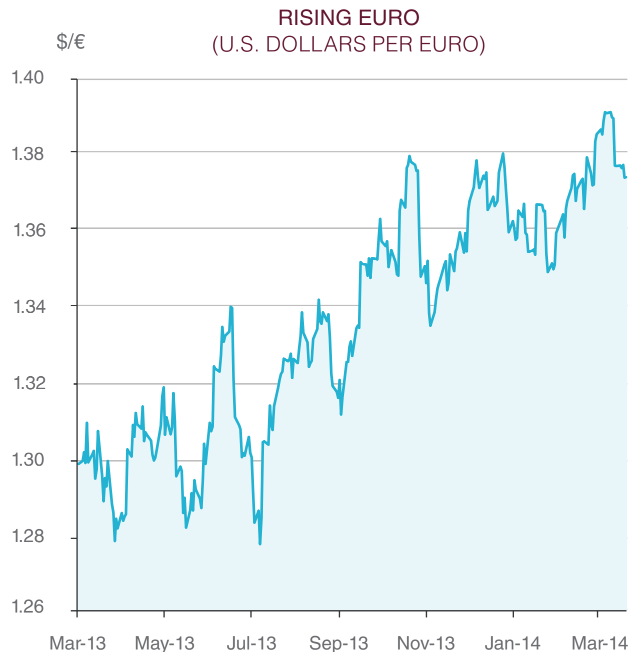


SOURCE OF DATA: Bureau of Economic Analysis.

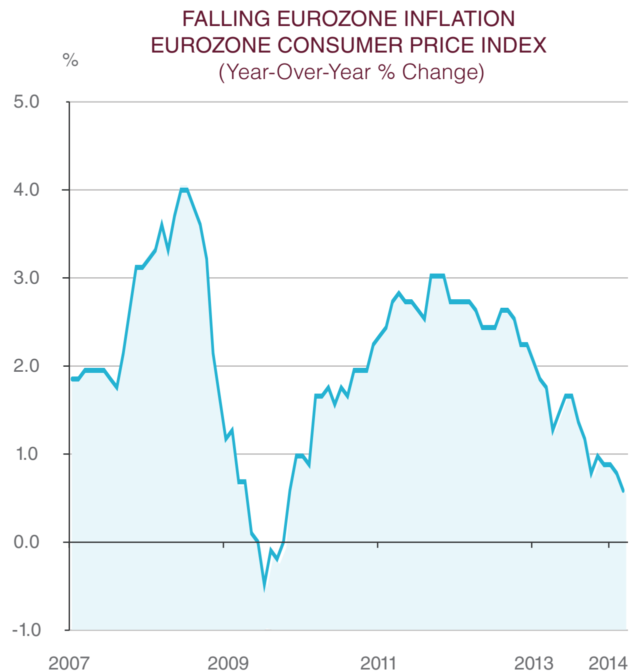
Just as a runner slows in muddy conditions, the U.S. economy continues to endure slippery footing from the weak employment situation, the slowing pace of commercial and industrial loans, and upward pressure on interest rates. Therefore, we do not anticipate the U.S. growth rate to be higher than 3% — the long-term trend — for several more years.

Still, we look for U.S. stocks to move higher in 2014, due to these factors: a pick-up in business investment; solid consumer spending; and record-high household wealth and corporate profits. Much of U.S. GDP growth in 2013 came from higher consumer spending, mainly due to the rebound in stock and real estate prices, although we are also starting to see some increase in wages. This was offset by slower gains in spending by businesses.

In fact, "non-residential fixed investment" – a measure of capital expenditure by businesses – rose only 2.7% in 2013, down dramatically from the 7.2% average for each of the previous two years. In 2014, we expect U.S. businesses to respond to consumer demand by increasing their rate of investment-related spending closer to 5.7%, the average for the past four years.



SOURCE OF DATA: Eurostat.



SOURCE OF DATA: Eurostat.

In Europe, we anticipate growth will continue to lag that of the U.S., with troublingly low inflation. Deflation (falling prices) is a serious concern for the European Union (EU) and is driven in part by recent appreciation in the euro. Deflation is already evident in several peripheral EU economies: five out of 18 nations comprising the Euro area have seen falling prices. This drives both consumer and business spending lower and could push the region into a mild but protracted recession. With the Euro area expanding only 0.3% in the first quarter, it would not take much to push it into a recession.

Despite Europe's lackluster growth, we are not reducing exposure to European equities. Most of the European companies in our portfolios are multinationals not heavily dependent on their home markets to generate profits. Although we expect our managers to earn positive returns from European stocks this year – while providing meaningful diversification from our exposure to U.S. corporations – we continue to think that the U.S. stock market offers slightly higher return potential.

OPPORTUNITIES IN EMERGING MARKETS

LNWM's emerging-markets (EM) managers have continued to outperform their benchmark (the MSCI EM Index). Still, given that EM stocks have underperformed during the past year as well as the first quarter, LNWM recently undertook a deep review of our total allocation to the EM asset class, as well as a review of the managers we use to implement this allocation.

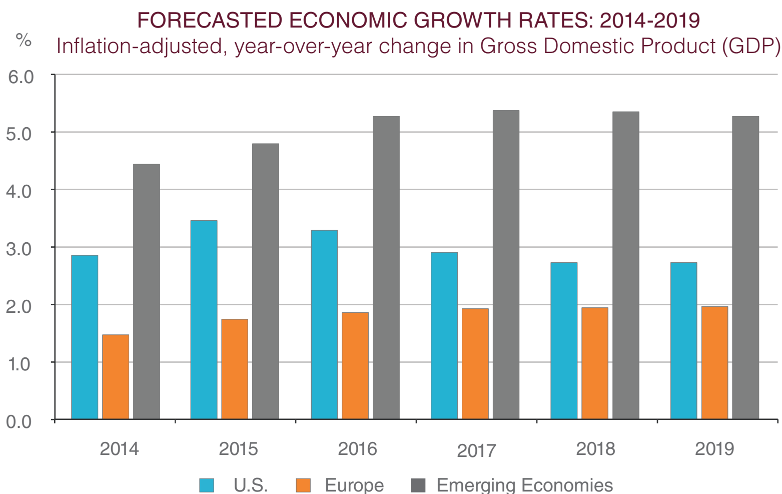
OUR FINDING: We believe today's prices for emerging-market equities suggest the potential for attractive returns. Therefore, we continue to think that LNWM's slight overweight to emerging market equities is appropriate (we are +1% to +2% relative to the MSCI All Country World Index, a global cap-weighted index).

While some EMs will continue to struggle, we see opportunities for strong returns from well-placed investments. Just as the surprisingly robust 2013 returns in developed equities have made their valuations less attractive, EMs' recent underperformance has improved their return potential. Further, we believe that the EM managers in our client portfolios are among the most capable at executing on these opportunities.

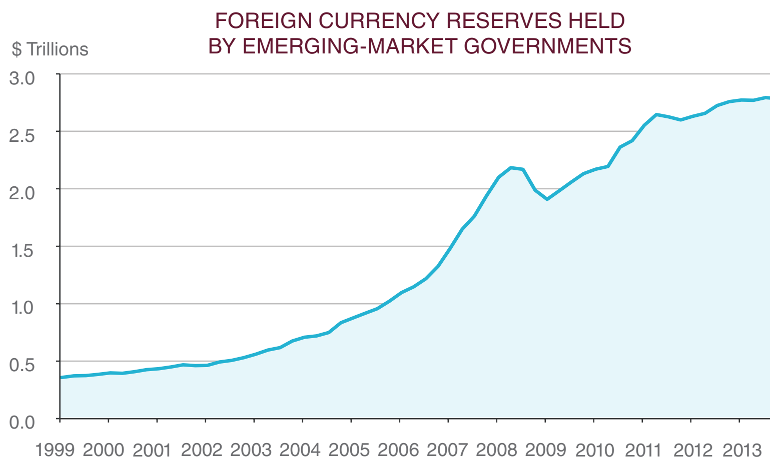
We are confident that emerging economies will continue to grow at a faster rate than developed economies. However, investors have been recently spooked by these three developments:

- Capital flows to emerging economies declined sharply
- Currencies fell due to concerns regarding rising U.S. interest rates
- Expectations for economic growth have fallen

Will a convergence of these factors lead to an EM crisis such as that of 1997-1998? This is a major fear factor for the markets. When the local currencies of several developing countries came under selling pressure starting in 1997, these nations did not have enough foreign currency on hand to ward off the pressure. So their currencies plunged and their economies fell into deep recessions.



SOURCE OF DATA: Oxford Economics.



SOURCE OF DATA: IMF COFER; Quarterly data through 9/30/2013.

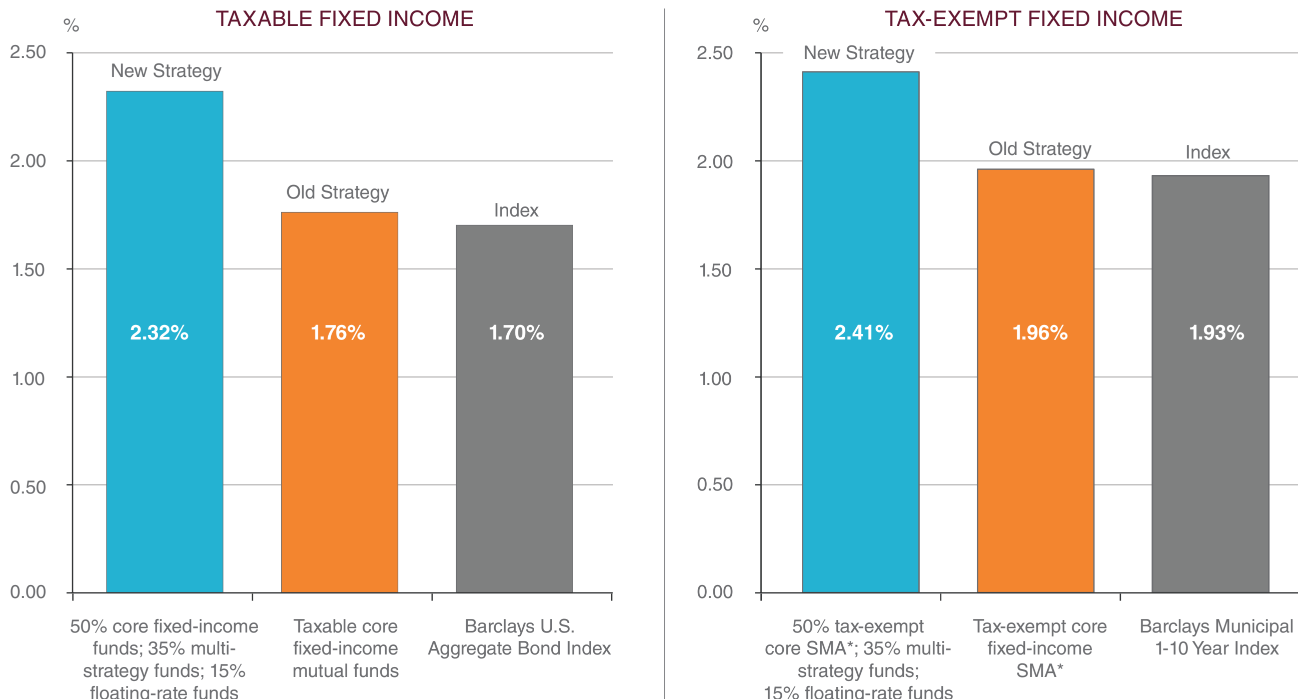
We believe a repeat of late-1990s events is unlikely for most — although not all — emerging economies. That's largely because many emerging nations learned painful lessons from past crises. Many have severed their currencies' direct link to the U.S. dollar and now have sizable and diversified foreign-currency reserves (including euros) to support their debts. While the growth in reserves has slowed over the last few quarters, EM foreign-currency reserves continue to expand. Therefore, emerging markets today are better equipped to withstand the strains of capital outflows.

However, the health of emerging economies varies widely, as will the returns of their equity markets. Many of the larger emerging markets – including Russia and Brazil — are the ones expected to struggle the most in the next 12-24 months. Therefore, we believe it's important to access EM equities through managers who can actively adjust country allocations as warranted, instead of capitalization-weighted indexes, which maintain larger exposures to the larger sized countries.

LNWM allocates to EMs in two ways: (1) through actively managed mutual funds whose managers focus on EMs; and (2) through developed international equity funds, whose managers opportunistically hold emerging market stocks. Over multi-year periods, this type of EM exposure has been a positive contributor to LNWM's portfolio performance. And we expect this to continue to be the case.

FIXED INCOME: How Are LNWM's New Strategies Performing?

LNWM's new fixed-income strategy has outperformed both the Index and our old strategy. The outperformance is seen in both taxable and tax-exempt bond portfolios (see following chart).



*SMA = Separately Managed Account.

SOURCE OF DATA: Barclay's Capital; LNWM; Morningstar.

LNWM's new fixed-income strategy, which includes fixed-income alternative strategies, was launched in October 2013. It is designed to buffer client portfolios from rising interest rates, while maintaining a competitive rate of return in a flat to moderately lower rate environment. As expected, this strategy has performed well, even though rates fell slightly in the first quarter (down 31 basis points, or 0.31%).

In her first press conference as Chair of the Federal Reserve (Fed), Janet Yellen indicated that short-term rates could increase as early as next year. While that estimate may ultimately prove premature, low inflationary pressure and a weak employment outlook suggest that the Fed will move very cautiously when the time comes to increase rates. By Yellen's own admission, many more Americans need to find employment before the economy can expand, absent a very accommodative stance by the Fed.

LNWM's view is that interest rates will rise through the remainder of the year. With the current round of quantitative easing expected to end this fall, interest rates today are lower than they normally would be, even at the current sluggish pace of economic expansion. As the U.S. economy grows, rates should climb higher. We recommend that clients continue to maintain allocations to alternative fixed-income strategies in anticipation of higher rates.

SUMMARY

LNWM remains optimistic regarding the potential for solid returns through the rest of this year. Global growth will continue to be fueled by consumer spending and international trade. Although we anticipate interest rates to rise along with U.S. economic growth, we think increased consumer and business spending will create upward momentum for stock prices.

As we noted earlier, investing is a long-term race that requires patience and good positioning. At Laird Norton Wealth Management, we believe that staying in the race for the long haul requires balancing portfolio risk and reward. The resulting equilibrium is what makes it possible to navigate through whatever hurdles or obstacles the markets put up, year after year.

Toward attaining this equilibrium, we continue to include alternative asset classes and strategies in our portfolios, where appropriate. Although the performance of some alternative asset classes has been disappointing during the past couple of years, they continue to play an important role in our approach to managing risk.

ABOUT THE AUTHOR

ROBERT BENSON is chief investment officer at Laird Norton Wealth Management. He is responsible for setting and implementing investment strategy at the firm, as well as selecting managers for our client portfolios. Bob has more than 20 years of experience in the financial industry, most recently at Russell Investments, primarily in investment strategy, asset allocation and risk management. He received his CFA designation in 1997, and he's a member of the CFA Institute as well as the CFA Society of Seattle. He has an MBA from Northwestern University. Bob has served on the boards of both startup firms and non-profit organizations.

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