KayneCast

A Podcast Series by Kayne Anderson Rudnick

Episode 3

A Market Review of the First 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 today to give a market review of the first quarter of 2014, as well as his outlook for the rest of the year. Hey Doug, thanks for joining us today.

Doug: Oh hello, Len. Thanks for having me.

Len: So Doug, let's get right into it. The first quarter of 2014 is in the books. Can you tell us what happened to the stock market this past quarter and in particular to equities?

Doug: Well Len, domestic equities generated modestly positive returns in the first quarter, and this is on the heels of last year's extraordinary 30% plus returns in the equity market. Now despite the fact the market was very strong the last year, historically speaking, markets are sort of long overdue for a correction of 10% or more, and so far equities have only experienced a modest pullback, roughly less than 6% in the first part of the quarter, roughly the first five weeks. And for the full quarter, the S&P 500 Index of large-cap stocks actually managed to advance 1.81% while small stocks lagged a little bit, but still eked out a gain of 1.12%.

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

Doug: Well, bond yields fell during the quarter. The 10-year in particular surprised people by falling in yields from 3% plus down to about 2.7% in the quarter, and this was in response to a lot weaker-than-expected economic data that we saw during the first quarter.

So the Barclays U.S. Aggregate Bond Index actually gained 1.84%, which offset not all but most of last year's loss. High-yield bonds, municipal bonds, and emerging-market debt, which are the most credit sensitive parts of the bond market were very strong performers within fixed income, dramatically outperforming the Barclays U.S. Aggregate Bond Index for the quarter.

Len: Okay, so Doug we all know that 2013 was an atypically strong year in terms of returns for the market, but beyond that, what do you think is the main reason behind why returns so far this year have been comparatively modest?

Doug: I think equity investors reacted negatively to a slew of somewhat disappointing economic data in the first part of the first quarter. This is largely we believe in response to poor weather, and as the quarter progressed, it became clear to most investors that the winter storms in many parts of the country were distorting many of the economic indicators that were coming in. So as a lot of states began to unthaw during the end of the quarter, the economic data started to pick up. Today we saw jobless claims down to the 300,000 level, which is the lowest it has been in the last seven years. Well before the financial crisis it wasn't even as low as this. So even in the labor market you're starting to see - after a period of poor winter stats - some pickup in economic data.

Len: OK, so pretty modest growth in the U.S. Did we see the same kind of progress around the world?

Doug: Well, emerging-market stocks - which had a very rough 2013 - they actually declined in value as many investors liquidated emerging stock holdings due to the rise in interest rates in the U.S. which had a negative impact on interest rates in numerous emerging markets. That combined with some chaos abroad that we've seen resulted in negative returns for the emerging markets in the last year. They also modestly declined in the first quarter. They were down about 0.43%, so a little bit less than 1%. So emerging markets to us seem to be bottoming out and are actually starting to improve.

From a global perspective, events around the world also contributed to the volatility that we experienced in emerging markets in the first quarter. Obviously the Crimean vote to secede from the Ukraine and join Russia, as well as Russian troops massing on the border of Ukraine, has impacted European consumer confidence and put some shivers in many people's outlook for the European economy.

There were also concerns during the quarter about China's growth rate. In the months of January and February in particular, many economic statistics were weaker than expected, particularly industrial production in China. And rising labor costs and weak commodity prices in many of these emerging markets have also challenged governments and their ability to maintain peace in their respective countries.

On a positive note, low levels of inflation and very slack labor markets around the globe give central banks a lot of ability to continue their stimulative policies. Even Germany, which historically has been the most hypersensitive in terms of inflation, is starting to become more concerned about deflation than they have been historically.

Len: Well, thanks Doug. That certainly helps us understand what happened in the first quarter. What's your outlook going forward? Do you think we'll continue to see this same kind of progress for the rest of 2014?

Doug: Despite "Mother Nature" throwing a short-term monkey wrench into our economic growth in the first couple months of this year, I think as the country begins to unthaw during the next few months, you're going to see material improvement in economic growth rates probably from the one, one-and-a-half percent rate in the first quarter up to 3% to 4% by the third quarter, and maybe stronger than that by the fourth quarter. So we think as the year unfolds, we're going to see accelerated growth. We just think it has been delayed, not derailed in terms of the growth that we were expecting from the end of 2013. The growth will result from gains in consumer spending, less government austerity this year, and a good monetary backdrop. Janet Yellen has made it fairly clear that until the slack labor market and inflation pick up dramatically, they will continue to be extremely accommodative in their monetary policy.

Len: So Doug this sounds pretty positive. Are you saying we can expect pretty smooth sailing here for a while, or at least as far as equities are concerned?

Doug: Well, I think the year has already been very choppy despite the fact that the indices overall haven't moved much. There has been a lot of carnage below the surface. There has been a lot of rotation out of high growth areas, for instance, lately and into areas like utilities and energy. There have been rotations out of domestic equity stocks recently and into some emerging market stocks, which have been beaten down. So we think the year is going to be characterized by a lot of choppiness and a lot of rotation, unlike last year which was pretty much a straight up year without many corrections and without much rotation underneath the surface in 2013. So we do think it's going to be choppier than usual and certainly choppier than last year which was unusual in its lack of volatility.

So expect more volatility, but we think at the end of the day equity returns will end up being positive, probably up mid to high single digit for the year. We're not expecting a repeat of 2013 returns. That would be highly unusual for that to happen. And we think that one of the biggest risk factors to our forecast going forward—that is positive—is that China has a hard landing as opposed to being able to sustain a growth rate that is positive and particularly north of 7%, which we're fairly comfortable they'll be able to do given their financial flexibility, but that I think is the biggest risk factor going forward. If we're correct in our assessment that the economic growth will accelerate as the year unfolds from here, then we would expect bond yields to start to rise somewhat, probably back to the 3% or slightly higher level.

Len: Thank you for your insight and your time Doug. That was really helpful. 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 and subscribing to the KayneCast feed via iTunes, or by just listening to the KayneCast player on our website.