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April 2014

The Nebraska Quarter

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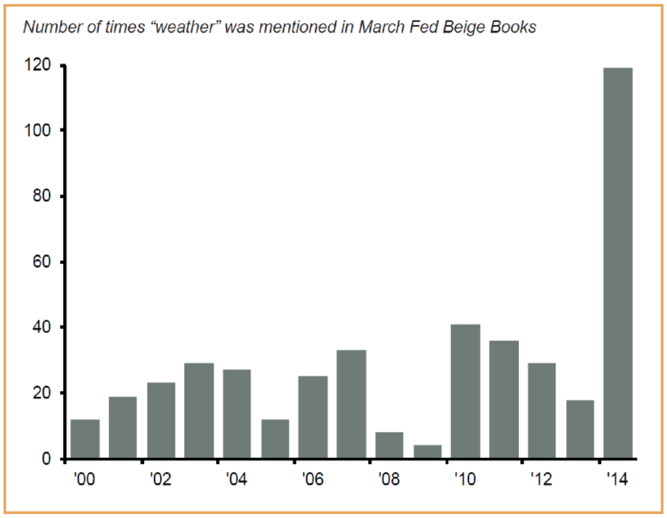
Coming on the heels of a relatively poor year for bonds and a great year for developed market stocks punctuated by double digit gains in the fourth quarter, investors were wise to anticipate a change in the investment climate in 2014. They did not have to wait long as Stocks softened right out of the gate in January and Bonds rallied. Volatility picked up a bit, but did not reach overly stressful levels and most markets recovered from their January declines. With a fairly uneventful three months in the capital markets, difficult weather in the U.S. was one of the biggest stories during the quarter. By the end of March, the best way to summarize the recent economic and market themes was that they were like Nebraska in the winter – Cold and Flat.

How flat? For the quarter, U.S. Large Cap stocks were at breakeven with only a few days to go but rallied at the very end of March to finish up around 1.8%. Small caps did a tad better. Looking at non-U.S. markets, major developed country stock averages managed a small gain of 0.8% while Emerging Market stocks rebounded from a 6.5% decline in January but still fell short of breakeven, posting a small decline. Emerging Market stocks continue to be one of THE stories as they finished the quarter trailing U.S. markets by 23% over 12 months and by 17% annualized for three years. Global Real Estate was one of the few standouts, with the most widely used benchmark advancing almost 10% for the quarter.

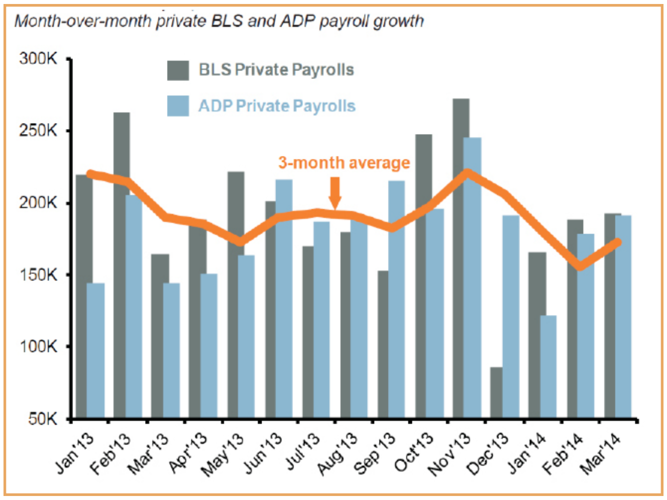
With most analysts predicting full year returns of 2.0% - 3.5% for the asset class, perhaps the biggest surprise of the first quarter was Core Bonds – returning 1.8% in only three months as the yield on 10 year U.S. Treasuries declined from 3.0% to 2.7%, boosting bond prices across the board. That this was accomplished in the face of continued "tapering" by the Federal Reserve made it even more curious. The most obvious explanation is that the demand for high quality bonds was a nod to traditional diversification – they typically shine in the face of stock market weakness. A flight to safety and quality in a time of heightened geopolitical risk was probably another important contributing factor. Within the bond market, high yield corporate bonds continued to lead the pack. Municipal bonds rewarded patient investors who suffered through last summer's headline induced volatility by outperforming their taxable bond peers in the first quarter.

In line with their traditional counterparts, many Alternative strategies posted returns close to zero for the quarter. However, trend following strategies, many of which performed well during 2013's relatively smooth markets, were whipsawed somewhat in January and February and posted moderate declines. These strategies follow and adjust to trends in both directions (taking both long and short positions) and thus can provide uniquely useful diversification in down markets, especially if both stocks and bonds decline simultaneously (a real risk nowadays). They can be unproductive during moderately choppy markets that produce "head fakes" and no consistent direction. As a result, their role in portfolios, while small, is to act as a form of necessary insurance (with a deductible) against larger drawdowns.

As far as the cold…How cold was it? Since most of our clients experienced it firsthand, and our readers on the West Coast were keenly aware as they drove to their yoga classes with their sunglasses on and the top down, I don't need to go into details about the brutal Polar Vortex that froze two thirds of the country. But it was a story, and not just socially, as it did impact the Economy. The Federal Reserve felt it was important enough to mention the weather 120 times in the March Fed Beige Book. As you can see in the chart below, this was about 3x the previous high of the last 14 years.


Number of times "weather" was mentioned in March Fed Beige Books

No MBA or PhD in Economics is needed to know that economic activity will be muted if we're all hibernating in our houses due to historically cold weather and record snowfalls. But a picture and some data is always helpful to illustrate a point and confirm a theory. The chart below shows the impact on hiring and payroll growth as the employment renaissance of 2013's 4th quarter was stopped in its tracks in January and February.


Month-over-month private BLS and ADP payroll growth

The historic winter occurred at a rather inopportune time. You see, coming off of such an encouraging 2013, analysts were left asking if the economy could build off of its gains, if some of the strength was simply due to inventory restocking, if employment could continue to improve and if the housing recovery still had legs. Due to the weather, the answers to those questions have been postponed to the months ahead, and reading the data will be more complicated when it arrives. From our vantage point, housing is indeed continuing to rebound, the employment picture is improving, and confidence is rising at both the corporate and consumer level. Household balance sheets are in much better shape and corporate balance sheets are flush with cash.

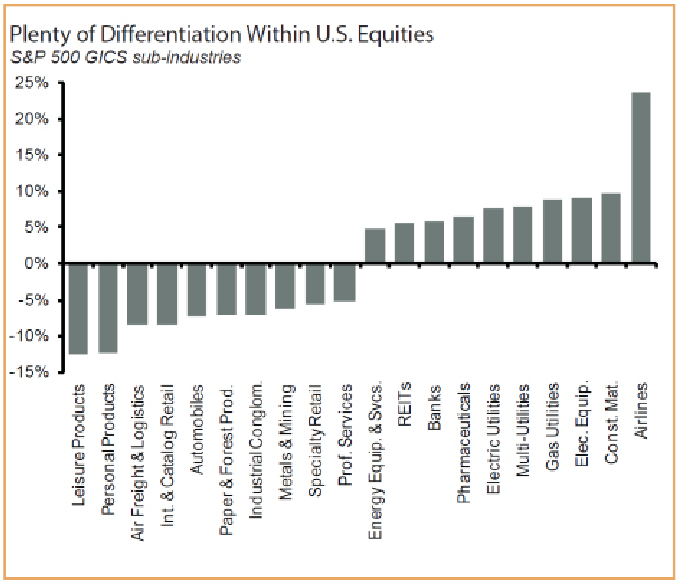
There are plenty of reasons for optimism.

But even five years after the Great Recession ended, it still doesn't feel like a robust recovery. And it's not, with GDP growth still below 3% and employment still not where anyone wants it to be. Yet we think the arguments for acceleration in economic activity remain stronger than those for weakness. We should be careful what we ask for, however, as this low growth, low inflation environment is a good one for both stocks and bonds. As we wrote last quarter, if economic results or inflationary figures come in too strong, that will flame fears of faster-than-expected interest rate increases that would be bad news for many core asset classes.

The weather wasn't the only thing Cold this quarter, as the other main story was the return of elements of the Cold War, punctuated of course by Russia's "annexation" of Crimea. Only a few weeks from the peak in tensions, I'm reminded of two things – a) How quickly and consistently the modern news cycle turns from one story to the next, and b) How integrated the global economy is. Regarding the latter, obviously there are a lot of factors at play, but the ability of the crisis to fade from headlines is likely due as much to the symbiotic relationship between Russia and Europe (which gets 30% of its Natural Gas from Russia) as it is to the lack of appetite for the U.S and our NATO allies to play geopolitical chess with Vladimir Putin. If Mr. Putin decides that he wants to keep playing, this could certainly escalate again into a serious situation, but the most likely scenario is that he will be satisfied with his easy and important victory and will not want to take further risks. Good arguments can be made that this episode might result in lower energy prices over the long-term, further supporting global economic growth, but only time will tell.

So the markets were largely flat and the brutal winter in the U.S. meant that economic data was not newsworthy.

Generally a quarter to be ignored? Perhaps, but there were some important undercurrents in the market. For one, the quarter ended with a spike in volatility, especially in internet and biotechnology stocks. There was also an unusually large number of IPOs of unprofitable companies – activity typically associated with frothy markets. And while major indices reported relatively flat total returns, the performance of individual sectors varied widely. The overall market behaved somewhat like a duck that appeared calm on the surface but was quite busy underneath. As can be seen in this chart, most sectors were either up or down 5-10%, with few being truly flat, and a handful being up or down more than 10%.



Some of the sector specific activity late in the quarter might by symptomatic of a change in market tone and leadership. We will be watching this closely over the weeks and months ahead.

Importantly, the quarter confirmed that so far investors seem quite comfortable with the transition to the new Federal Reserve Chair, Janet Yellen, and the communication from the Fed. Even though she was widely viewed as Ben Bernanke 2.0, this was no sure thing, as changes in the Fed Chair office are typically followed with heightened stock market volatility. But the moderate, deliberate schedule for tapering the Fed's "Quantitative Easing", and Yellen's strong commitment to helping the employment picture by keeping rates low for an extended period, has produced a smooth transition so far. Equally supportive policy rhetoric from Central Bankers in Europe and Japan has had a similar effect on overseas markets.

With relatively low volatility and no extreme valuation discrepancies, impatient investors looking to "do something" have been frustrated. The chorus of bears is growing a bit louder as valuation-centric analysts point to high valuations and cycle watchers argue that we are overdue for a correction. Yet history may not be as reliable a guide in an unprecedented environment of low inflation, low interest rates and high central bank support around the world. The terms "reluctantly" and "cautiously" are getting a lot of use in front of "bullish". We find ourselves with plenty of company in these camps as strong and emphatic arguments are hard to find. In times like these, we remain committed to swinging only at what we think are high probability "fat pitches" down the middle of the plate, and to maintain discipline and patience. Those same traits helped us get through this Nebraska winter and we believe will serve us and our clients well in the future.

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