JANICZEK & COMPANY, LTD.
WEALTH MANAGEMENT

Portfolio Matters

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MIDYEAR UPDATE

Correction? Likely. Recession? Not.

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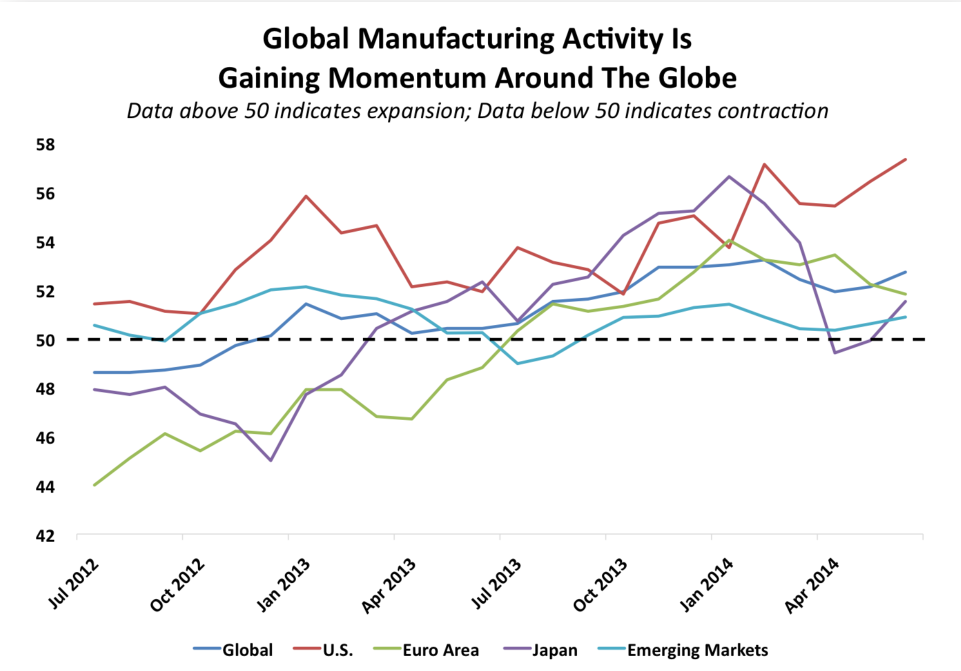
On July 1st, the U.S. soccer team's surprising 2014 World Cup run came to an end. Of course, their final game versus Belgium was never supposed to have occurred in the first place, given the overwhelming consensus view that the U.S. would be eliminated much earlier. In fact, the U.S. wasn't supposed to win even 1 match, according to most experts. They were the underdog in all 4 World Cup games, however, they won their first match and tied their second. In their final game, it took a very good Belgium team extra time (i.e., "overtime") to finally oust the Americans 2-1.

This story provides several lessons for and parallels to the investment world. First and foremost is that the consensus view is rarely the best way to make investment decisions. Psychologically, it's the most comfortable approach, buying or selling when everyone else does. So if the U.S. soccer team were a stock, it was clearly very undervalued entering the World Cup tournament. Only by ignoring the popular view and performing one's own due diligence could someone have taken advantage of the opportunity. (And I'm sure someone in Las Vegas probably did!)

Throughout 2014 we've witnessed an increasing consensus view that the stock market is overvalued and overdue for a meaningful correction. Interestingly, we don't disagree, but not because of the popularity of the opinion. Taking this popular view as a foregone conclusion, one would have likely sold or reduced equities earlier this year ... missing out on some very nice gains. We take a different and more robust approach, relying not on the communication skills of TV orators but rather the information provided by the market.



BOTTOM LINE

- The economy is still expanding despite lower expectations for 2014
- Nearly all asset classes gained in the second quarter
- Continue to watch for a pullback in stocks, but recent trends are still positive
- Tactical moves in bonds and alternative investments also remain on deck

Economy

As we wrote last quarter, the first three months of the year were marred by poor weather across the U.S. We now know that Q1 GDP was a negative 2.9% (revised down from the original estimate of negative 1.0%). As such, most economists lowered U.S. GDP expectations for 2014 from about 2.9% to 2.1% range. Global GDP growth is still expected to be around 3.7% this year, implying some strengthening growth outside the U.S. We agree with the lower economic growth expectations for the U.S. this year, however, we remain confident in our conclusion that our economy is growing and will provide a healthy environment in which investors can succeed.

Although there's always something to worry about, we like what we see in the global economy. The related chart, purportedly a favorite of former Fed Chair Ben Bernanke, shows the increased participation in manufacturing expansion around the world. Coupled with other cyclical factors that are also headed higher, we maintain a positive outlook for both our domestic and global economy. Let's examine the U.S. economy further.

A key economic milestone that was (finally) realized during the quarter was related to employment. We have now recovered all of the 8.8 million jobs lost from the 2009 recession. It was the slowest jobs recovery in the post-WWII period, but the current trend remains positive and is further supported by the most recent data. The June jobs report showed a monthly gain of 262,000 private jobs resulting in a higher 3-month average gain of 254,600 jobs added. In fact, June was the 5th consecutive month of 200,000-plus jobs gains, something we haven't seen since January 2000. The data show that U.S. companies continue to add jobs, the unemployment rate continues to fall, and initial jobless claims continue to decline. Although slower than previous recoveries, the employment growth story looks to be a positive one going forward.

Improving strength in the jobs market comes with the growing risk of inflation. Past periods of debilitating inflation all occurred not only with low unemployment, but more importantly, strong wage growth. Although currently not a red flag, wage growth is one indicator we'll be watching closely.

Why is wage inflation such bad news? When more people have more money to spend, they bid up the prices of all assets. But with wage inflation, higher prices don't lead to less demand since the supply of wages is growing, fueling even more demand. This is the kind of inflation that can spiral out of control and lead to severe recessions.

One potential surprise we envision is the Fed raising rates earlier than the market expects. The general market view is that Fed Chair Janet Yellen's perspective is much like former Chair Ben Bernanke: "doveish", or soft on inflation concerns. However, Bernanke operated in one of the worst job markets on record, with wage growth nowhere in sight. Yellen took over when the jobs picture had improved, and the risk of wage inflation going forward is far more real.

Secondly, the Fed's own expectations of interest rates over time provide another cause for concern, in our view. In their latest disclosures, the Fed shows their expectations of the benchmark Fed Funds rate (currently less than 0.25%) to be 1.13% in 2015, 2.50% in 2016, and then a "long-run" expectation of 3.75%. This gap between 2016 and long-run is striking, and we believe it signals the following: 1) Higher interest rate risk will develop gradually over time, but 2) the risk that the Fed changes their own expectations sooner is significant.

For these reasons, we've dipped a toe in the water with some of our portfolio holdings, and we stand ready with a long list of remedies should the surprise scenario play out. Unfortunately, we doubt most investors have thought this through in managing their bond portfolios.

Overseas, the second quarter brought some interesting developments in Europe. The European Central Bank (ECB) made history (ominously) by reducing their benchmark deposit rate to negative 0.10%. This means that European banks must pay the ECB interest on funds held at the central bank and not loaned out. ECB President Mario Draghi also stated that the bank may consider an asset purchase program similar to what the Fed and the Bank of England have been doing. Unlike the U.S., Europe still faces the possibility of deflation, an ugly scenario in which no one wants to lend or invest, cash hoarding goes to extreme levels, prices fall from nonexistent demand, and the economy tumbles into recession.

We don't expect such a recession in Europe, and we'll look for opportunities when the market gets too fearful. As a reminder, we don't invest in GDP. We buy the debt of or equity in companies. Long term investors capitalize on discounted asset prices, setting up for above average returns. Short-term, emotion-driven investors succumb to the "noise" and sell, often at the worst times.

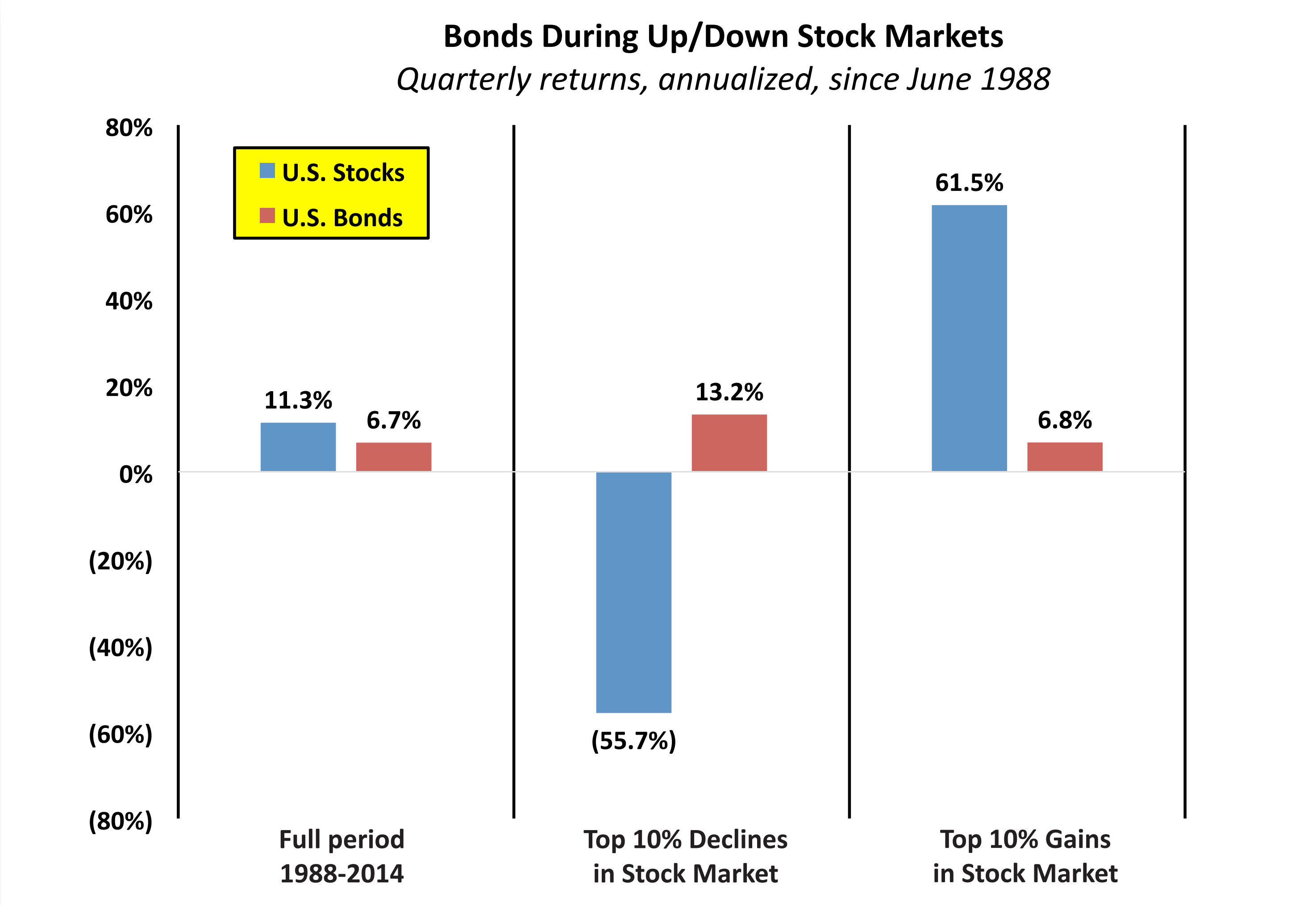
Finally, emerging markets appear to be weathering their current economic soft patch. Russia's economy benefited from subsiding fears in the Ukrainian conflict, while India's election saw a new pro-business regime take hold. China's 7.4% GDP growth in the first quarter was the lowest in six quarters, however, policymakers have adopted less of a tightening posture recently, an incremental positive for the world's second largest economy. Elsewhere, oil-exporters benefitted from a rise in oil prices as Middle East tensions escalated. In all, we remain interested in the economic potential of emerging markets, and believe the overall economic outlook is improving.

Asset Allocation

To put it bluntly, just about all investments rose during the quarter. In fact, J.P Morgan stated that, by one measurement, it was the first time since at least the 1980s that such broad-based investment returns were realized. Of course, this market action is exactly what the Fed intended with its quantitative easing efforts.

Global equities rose 5.2%, while global bonds posted a return of 2.5%. Notably, emerging markets rallied strongly in the second quarter, with both their bond and stock markets outperforming their developed market counterparts.

Our current tactical asset allocation continues to add value to our client portfolios. We remain 10% overweight our equity targets across all client portfolios, while we are also 10% underweight fixed income. Since we put this tactical tilt



in place last October, U.S. stocks have broadly risen about 17%, international stocks 7%, and bonds about 4%. Of course, we believe that a comparison against one's complete financial plan (not a market index) will determine one's success or failure.

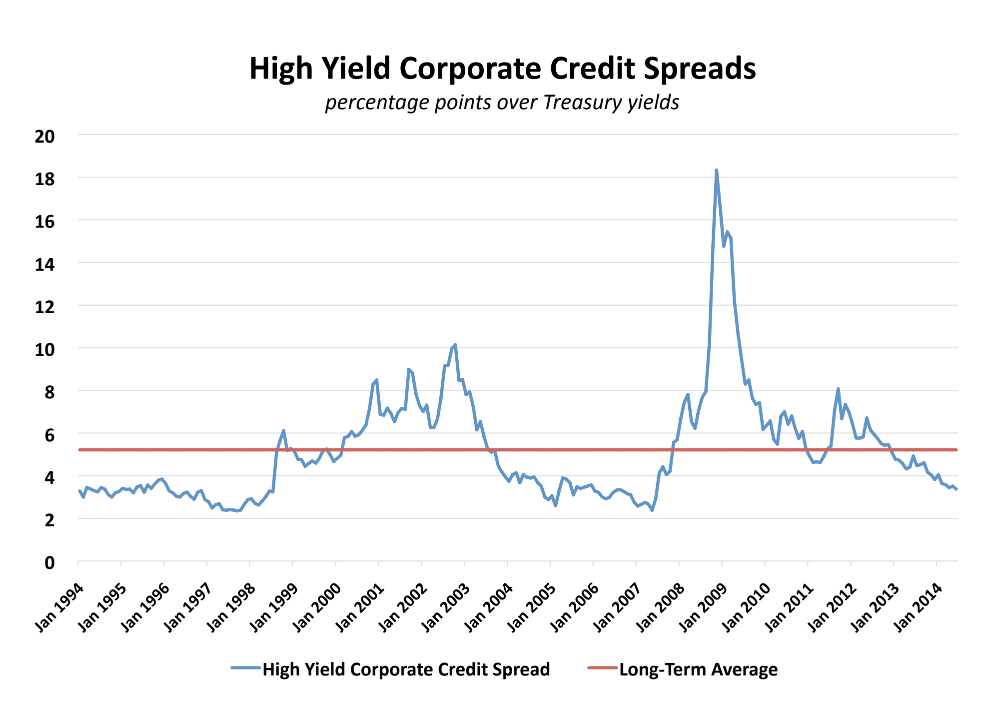
We're often asked how both stocks and bonds could be moving higher at the same time. After all, bonds often gain when stocks stumble, hence the benefits of diversification. But history shows that bonds don't typically *fall* when stocks gain. In fact, since 1988, quarterly data show that when stocks post positive returns, bonds gain 80% of the time, delivering an average annual return of 6.6%. The big benefits of a diversified stock/bond portfolio come when stocks fall. In those negative stock return markets, bonds gain 75% of the time, with an average annual return of 6.9%. The chart above underscores the point, showing bond performance during stock market extremes.

The real surprise has been the decline in bond yields, which has provided support for healthy returns in bonds. In January, we wrote that "we expect the 10-year Treasury yield, currently at 3.0%, to rise to 3.5% in 2014." The Fed has followed through on its reduced bond buying, however, yields have fallen back to 2.5%. We're not too concerned with our predictions, however, because our investment management process checks our "crystal ball" skills with technical indicators. As we've said before, we look at what *should be happening* (i.e., rising interest rates over time) with what is *actually happening* (falling interest rates).

When the inevitable stock market correction comes, we expect interest rates to temporarily fall even lower. In such a correction, bonds will likely serve portfolios well. Once the correction has concluded, however, the long term prospects for investors still favor equities over traditional bonds.

Fixed Income

Emerging market debt led the global fixed income world, but the quarter was a strong one across the board. Emerging market bonds rose 4.5%, while non-U.S. developed market bonds gained 2.7%. In the U.S., bonds returned 2.0% while municipal bonds delivered 2.2%. The Fed further reduced (as expected) its asset purchases by another $10 billion per month, the 5th consecutive reduction. The original $85 billion monthly purchase program has now shrunk by 59% to $35



billion per month. The program is likely to end this October, however, we don't expect the fed to begin raising rates until June 2015.

Interestingly, the second quarter saw the Fed's stimulus reduction efforts (upward pressure on yields) more than offset by other factors, including a "flight to safety" (downward pressure on yields, especially in higher quality bonds). Concerns such as fighting in Iraq and bank solvency in Portugal pushed yields lower throughout the quarter. In hindsight, the decline through the first half of the year simply returned the 10-year Treasury yield to the lower end of its recent 2.4% to 3.0% trading range.

To provide some further perspective, the current 10-year Treasury yield of 2.5% remains comfortably above its 1.6% level of May 2013, when the Fed announced it would begin pulling back on its purchase program (beginning the so-called "taper tantrum" decline in bonds.) The same holds true for mortgage-backed securities, which were at 3.4% in May 2013 compared to their current 4.2% level.

The point is that yields have surprised many by declining in 2014, but they remain higher now that the Fed has tapered its stimulus efforts, and we see the case for even higher yields over time.

For the remainder of 2014, however, our research indicates that there may be more declines in yields and more gains for bond investors. The 10-year Treasury yield could easily challenge 2.0% should any correction in the stock market materialize. The geopolitical risks in the Ukraine, Iraq, and now Portugal could also serve as catalysts for lower yields.

Our bigger concern may be the overly optimistic sentiment that we see in the bond market. If we look at credit spreads (i.e., the difference between high quality and low quality yields which shows how much more yield investors demand to take on the lower quality), we find a very healthy risk appetite. While the spread between high quality and low quality yields has averaged 3.89 percentage points since 1994, it stands at a 2.42 percentage points (37% lower) as of June 30.

Credit spreads tell a two-sided story. On the one hand, the spread has tightened (i.e., gotten too optimistic) due in large part to a 10-year Treasury yield that is up from its low of 1.4% back in July 2012. On the other hand, we know this spread is likely tight because of a yield-starved market that is probably accepting more risk to earn any level of income. During the second quarter, spread tightening came despite Treasury yields falling … indicating a higher level of risk tolerance.

So, we continue to monitor the fixed income market within our overall investment research process for signs of extremes, at which time we would adjust our clients' portfolios accordingly.

Equities

Equities headed higher during the quarter, but the story underneath is what's worth watching. In the U.S., large caps jumped 5.2% in the quarter while small caps rose a mere 2.1%. Non-U.S. stocks also delivered strong results, with developed market equities gaining 4.3% while emerging markets posted a very strong 6.7% for the quarter.

The cyclical bull market in U.S. stocks is getting long in the tooth. Globally, equities have gained 28% since 2012 and 185% since the 2009 lows. U.S. equities have performed even better, returning 38% and 242%, respectively. The second quarter's performance included 16 new all-time highs for the S&P 500 Index and marks the 6th straight quarter of positive returns, a streak that we haven't seen since 1998.

It's now been 57 months since we experienced a 10% correction (twice as long as history would suggest), and nearly 4 years since the last 20% correction (also longer than usual). We agree with the call for a correction, but we don't see any downturn in equities markets resulting in another recession. Rather, we see continued growth for equity investors for years to come. Let's examine why.

In the U.S., earnings growth has justified higher stock prices since 2009. The result is a market that is fairly valued, however, as prices continue higher we believe earnings growth is struggling to keep up. Revenue growth is still growing at a low-to-mid single digit pace while profit margins are at all-time highs. An increase in economic growth could help boost revenue, but earnings estimates have gotten too rosy and will likely be revised lower during the second half of this year.

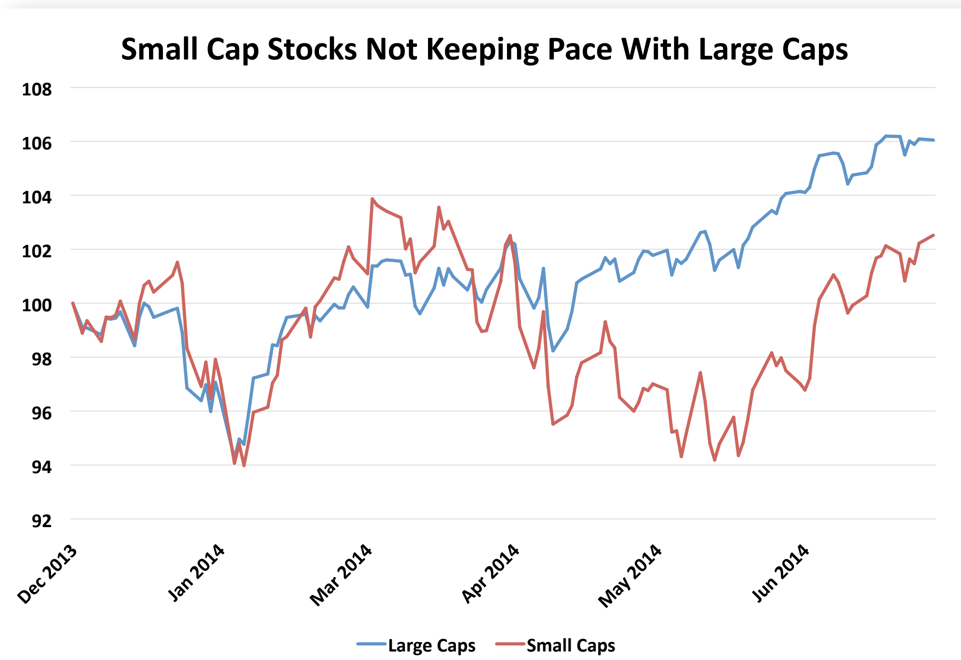
So, this fundamental view leads us to believe that the stock market runs a greater risk of overvaluation. A correction would be warranted, bringing fundamentals back to more attractive levels.

Notably, earnings growth has been less evident in Europe despite higher stock prices. In other words, we see Europe as being at an interesting crossroads: Either earnings growth (possible from further central bank easing) will justify stock prices, or any global stock market correction could be more severe for European equities.

From a technical perspective, however, stocks have reason to continue their climb. Stock market breadth (i.e., the greater number of stocks participating in gains, the better) remain at bullish levels, with over 90% of global stock markets showing upward momentum. The only technical factor flashing red is sentiment, which shows over-optimism from both institutional and retail investors. Still, in aggregate, technical indicators support further gains in stocks for now.

Another interesting undercurrent in the market is from a size perspective. Small cap stocks typically lead the way higher. In 2013, they returned 39% versus large cap stocks' 32%. However, the most recent quarter saw small caps tire out. For 2014, small caps now trail large caps with returns of 3.2% versus 7.1%, respectively.

Further, small cap valuations are unattractive and trade at a 13% premium to large caps, historically speaking. In fact, over the last 12 months, we've seen small cap stocks' earnings growth decline while large cap stocks' earnings growth has accelerated. Combined, the current environment for small cap stocks is one undercurrent we're watching to assess whether 1) the problem may be limited to small companies or 2) the coming correction in stocks may be taking hold.



When the correction comes, we have several trades on deck that will protect our clients' portfolios. For example, we could reposition our clients' portfolios *across* asset classes (trim equities, add bonds) or *within* asset classes (trim equities, buy hedged equity strategies). But until our disciplined approach to managing portfolios flashes the "sell" signal, we are comfortable in our positioning and will continue to let our profits run.

Alternatives

The strongest returns in our client portfolios came from some of our alternative investments. MLPs were the second quarter's big winner, returning 14.2% and boosting 2014's total return to 16.4%. Positive news on energy production and consumption helped propel the MLP sector to its 8th best quarter since 1995. REITs gained 7.1%, while gold rose 3.6%. Absolute return strategies in general rose 0.5% and are now up 1.8% for the year.

As we follow our MLP investment, we can't help but take a trip down memory lane. Recall the summer of 2008, before the big decline in the stock market. Oil was at $147 per barrel and seemed to have no limit in sight. As a nation, we knew we were the largest consumers of oil in the world, importing about two-thirds of our own consumption. U.S. oil production had been in decline for decades, and many believed the world was nearing its peak level of production and would be faced with higher and higher oil prices.

Fast forward to today: The oil shale revolution has resulted in U.S. oil production growing 47% in 5 years, meeting over half of our own demand in 2013. (Note how this story provides another nice example of how consensus following can be hazardous.)

We've owned MLPs since late 2011, and we've benefitted handsomely. Since that initial purchase, our MLP manager has delivered equity-like returns while providing a largely tax-exempt yield of 5.9%. These "best-of-both-worlds" characteristics offered by MLPs should continue, in our view. For this reason, we've researched and found a second MLP manager to complement our current holding. We'll be adding this manager to our portfolios during the third quarter, and we'll provide more commentary thereafter.

Like energy, we believe real estate has some attractive qualities that should remain in place for years to come. But also like MLPs (and bonds and high dividend-paying stocks, for that matter), when interest rates rise, these income-oriented investments will face some headwinds. Bonds present the greatest risk, but other higher yielding investments that have been bid up by yield-starved investors in recent years also pose a challenge.

The challenge these investments face is mitigated by their variable income streams, which was one of the reasons for their purchase. For example, REITs that own apartment buildings can be compared to a variable rate bond, with tenant leases "resetting" every 6-12 months. Over time, as inflation and interest rates march higher, the periodic income of REITs (and MLPs and dividend-paying stocks) grows as their underlying business grows.

But, in the short-term, interest rates can spike before those income investments adjust higher. For investors, this simply means some volatility in the short-term before these investments can adjust to the new interest rate environment. If nothing else, this serves as a good reminder that long-term results should be emphasized over short-term noise.

Last, but certainly not least, we'll discuss gold. Gold remains a small position in our portfolios. The current research suggests a continued bounce from oversold levels, however, the prospects for the long-term bull market in gold remains uncertain. The bull case points to inevitable inflation, a view with which we tend to lean. However, we don't ignore the negatives, and gold has plenty of technical indicators that have been challenging. For now, gold has some improving sentiment and cash flows that are helping send its price up.

When the stock market correction comes, history show that gold may be a good place to hide. According to global research firm Ned Davis Research, gold delivers the best returns historically when the stock market is at its worst. The research firm looked back to 1968 and studied periods in which the S&P 500 Index declined 5%, 10%, 15%, and 20%. They found that gold outperformed 87% of the time, including positive average returns no matter how steep the correction in stocks. More importantly, gold's track record in delivering better performance both on a relative and absolute basis improved as stock market returns deteriorated. This historical review gives us some short-term comfort in our small gold position.

Conclusion
Much like our national soccer team, we're not taking the general consensus as fact and managing our portfolios as such. We'll allow the so-called market pundits to take a stab at the prediction game. Instead, we'll let our fundamental and technical research inform our decisions, and we'll take action when the evidence leads to a reality.

As for our clients' portfolios, we see some "undercurrents" in the stock market that warrant some caution, however, we'll maintain our overweight position until the weight of evidence justifies a change. More importantly, we continue to believe any stock market correction won't lead to a recession, and that the secular bull market for stocks will carry on.

With a dynamic and robust investment management system, investors should feel confident in their investment portfolios. But only when ones' investment system is fully integrated with one's overall wealth (including their businesses, tax strategies, multi-generational considerations, etc.) can investors thrive.