Actuarial Consulting Group

Quarterly Update & Economic Commentary - March 31, 2014

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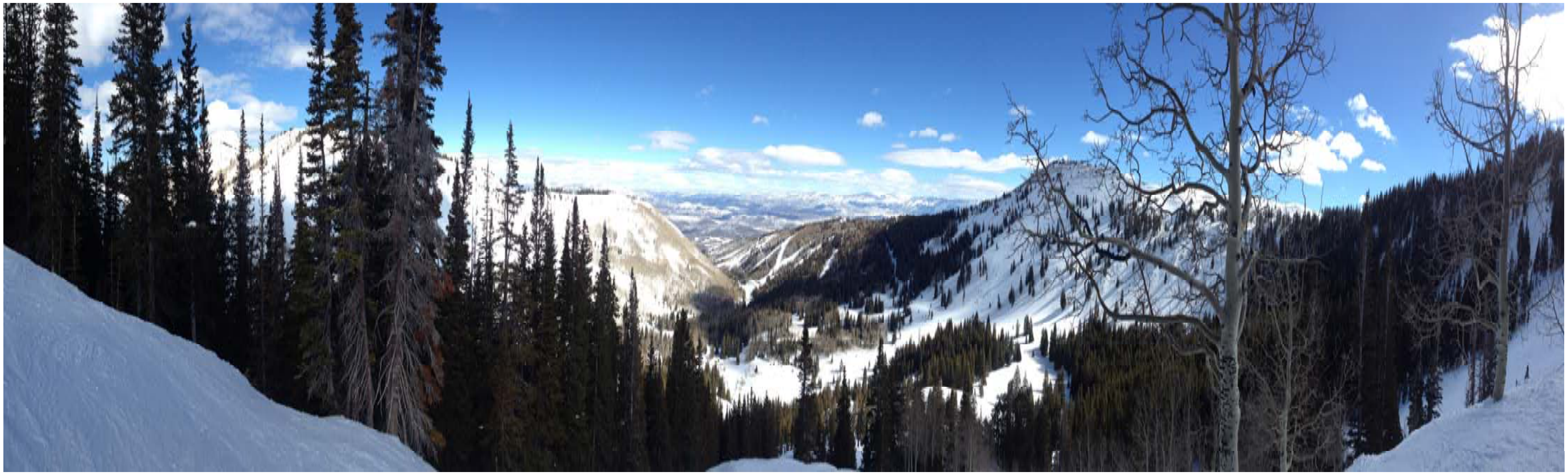
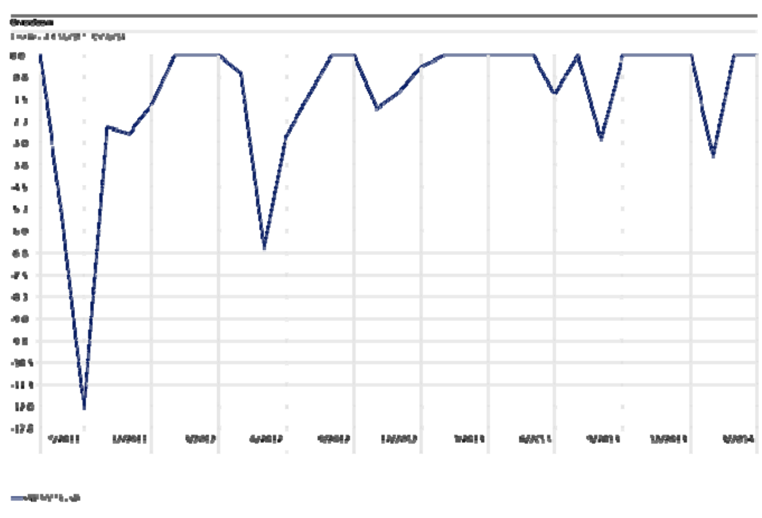


Quarter in Review

The equity markets started off the year with higher levels of volatility than was seen in 2013 and suffered a negative return in the month of January. The volatility influenced many investors and "talking heads" to predict that the much-awaited equity correction was upon us. However, the market continued to show its resilience and bounced back with a strong February, allowing for the majority of the broad indexes to finish the quarter with positive returns. The S&P 500 closed with its fifth straight positive quarter, while the S&P MidCap 400 and S&P SmallCap 600 closed with their seventh straight positive quarter. The Dow Jones Industrial Average's streak snapped, as it lost 0.15 percent during the quarter. The MSCI EAFE, a popular international developed markets equity index, finished the quarter with a positive 0.66 percent return, which was its third straight positive quarter and its sixth positive quarter out of the last seven. The MSCI Emerging Markets Index had back-to-back monthly gains of over 3 percent in February and March, but that was not enough to make up for the losses suffered in January. The index finished the quarter with a loss of 0.43 percent.

S&P 500 Drawdowns Since August 2011



From an equity perspective, interest-sensitive investments performed well for the quarter. As interest rates fell, dividend-paying securities looked more attractive. The utility sector had a great quarter, returning approximately 10 percent. Real Estate Investment Trusts (REITs) and preferred stocks both had good quarters; the FTSE NAREIT All Equity REIT Index returned 8.5 percent, and the S&P Preferred Stock Index returned 6.9 percent for the quarter. The only S&P sector to have a negative return for the quarter was Consumer Discretionary, which lost 2.8 percent, following a sector-leading 2013 return of over 43 percent.

Fixed income indices were pretty much positive across the board for the quarter. Investors flocked to the dollar, pushing interest rates lower. As a result of the interest rate drop, longer duration bonds outperformed shorter duration bonds with similar credit risk. The Barclays US Aggregate Bond Index finished the quarter positive by 1.84 percent, and the Barclays US Corporate High Yield Index finished the quarter positive by 2.98 percent. The best performing fixed income investments during the first quarter were those with a longer duration and a lower credit quality.

Most commodity prices increased during the first three months of the year. Coffee was a top performing commodity, rising by over 60 percent according the S&P GSCI Coffee Spot Index. Agriculture also had a strong quarter, posting a 16 percent increase in price. Gold rebounded almost 7 percent during the first quarter, after suffering a 9 percent drop during the fourth quarter of 2013. Gold prices are still down almost 20 percent over the last 12 months. Oil has seemed to be in a relatively tight trading range over the last several quarters, as traders continue to monitor geopolitical issues abroad and concerns over slowing global growth, mainly in China.

The first quarter ended up being a great quarter, when you consider the growing anticipation of a pullback following such strong equity market returns over the last two years. In addition to the belief that reversion to the mean was necessary, additional risks either resurfaced, or were introduced that could have provided the catalyst for a correction. The market was resilient, however, and most asset prices increased in value.

Fourth quarter earnings - released during the first quarter - were strong, and the S&P 500 operating earnings set a new record. Unfortunately, investors care more about forward-looking guidance which was generally negative. According to Factset, of the 111 companies in the S&P 500 that provided guidance, 84 percent (93 companies) issued negative Earnings per Share (EPS) guidance, the second highest number since FactSet began keeping track in 2006. In addition to the disappointing guidance, revenues were also lacking. A majority of earnings growth came from margin expansion.

United States economic news throughout the first quarter was disappointing. The question on everybody's mind was whether the economy's slow start was a result of weakening consumer and business fundamentals, or a result of extreme winter weather conditions across much of the country. We believe the weather undoubtedly impacted many of these numbers. New orders for durable goods fell in both December and January, while February's reading was an improvement, some weakness is still visible. The employment numbers showed signs of weakness through the quarter, with a bright spot near quarter-end, when the four-week moving average of initial claims dropped to its lowest reading since September. The Gross Domestic Product (GDP) reading for the fourth quarter was a relatively good number, even though the market got spooked and felt some downward pressure when the reading was revised downward from its initial reading of 3.2 to 2.4 percent after the second estimate. The final revision for the fourth quarter was 2.6 percent, a solid reading following the third quarter's increase of 4.1 percent.

The U.S. Initial Public Offering (IPO) market has been hot. According to Renaissance Capital, the IPO market has shown more activity in the first quarter than any other first quarter since 2000 - right before the Internet bubble. During the first quarter, 64 companies went public and raised $10.6 billion, which is more than double the amount of companies that went public during the first quarter of 2013. The activity has been driven by biotech and health care companies, which have accounted for nearly half of all IPOs.

In addition to some weak economic news coming out of the U.S. economy, the first quarter saw a plethora of headline news from outside the U.S. January's rocky start for the equity market was aided by concerns of significant currency devaluation in emerging market countries like Brazil, Turkey, India and South Africa. During 2013, interest rates in the U.S. rose as expectations increased that the Federal Reserve would begin reducing monthly bond purchases. These higher rates were attractive to many investors, most notably the investors that purchased sovereign debt of these emerging market countries that had higher rates. As capital left these countries, their currencies saw significant declines. Central banks from these countries blamed the U.S. for their policies, but these countries failed to prepare for the inevitable time when capital would leave their countries as rates increase in more stable countries, like the United States. The capital flows into the United States was a main contributor of U.S. rates falling during the first quarter.

The Winter Olympics also occurred in the first quarter, and aside from unfinished hotel rooms for the media and poorly-built half pipe for snowboarders, the Olympics went off without any major issues. However, shortly following the end of the games, Russia intervened in the crisis in Ukraine which ultimately led to the annexation of the city of Crimea. The crisis had, and continues to have, global markets on watch; however, fears of further action seemed to dissipate towards the end of the quarter.

China, the world's second largest economy, continues to show signs that its economy is slowing. Although their economy grew at an annual rate of 7.7 percent in the fourth quarter, it fell slightly from the 7.8 percent seen in the third quarter. A corporate Chinese firm, Shanghai Chaori Solar Energy Science and Technology, defaulted in March. This is the first corporate bond default in China's history. On one hand, this could be a sign of an economic weakness; but on the other hand, it is a good sign that China has allowed the free markets to play out and allow the failure. No matter how much investors hate defaults, they are an important component of the healthiest and most trusted exchanges in the world. Because of this, it might be more of a positive than a negative.

A Look at the Numbers

Index	1st Quarter 2014 (%)	Year to Date (%)
DJ Industrial Average TR USD	-0.15	-0.15
S&P 500 TR USD	1.81	1.81
S&P MidCap 400 TR	3.04	3.04
S&P SmallCap 600 TR USD	1.13	1.13
NASDAQ Composite TR USD	0.83	0.83
MSCI EAFE NR USD	0.66	0.66
Barclays US Agg Bond TR USD	1.84	1.84
Wilshire US REIT TR USD	10.13	10.13
US 30-Day Treasury Bill TR USD	0.01	0.01

Forecast in Brief

We are happy to say that winter is over and spring is upon us. The brutally cold and seemingly endless winter not only caused havoc with school schedules and travel arrangements, but it also impacted the economy. The second quarter will be an important quarter for determining whether the weaker data reports seen during the first quarter were weather-related or early signs of a deteriorating economy.

We expect the housing market to pick up during the second quarter as the same drivers that influenced previous year's growth are still present today. Inventories are low, interest rates remain at historically low levels, demand is high, and banks are more able and willing to lend than over the last few years. Because of these factors, home prices are rising which could benefit current homeowners, but will limit the market for a segment of potential buyers. This will be an issue in the future, but is not expected to hurt the market this year. Most cities have enough credible buyers to support the rising prices in the short term. Another industry impacted by the harsh winter was auto sales, but like housing, we expect to see consumers upgrading their vehicles once the weather begins to improve.

It appears as if the Fed is committed to ending its quantitative easing program by reducing monthly treasury and mortgage-backed security purchases at its scheduled meetings — as long as the economy does not show signs of a prolonged slowdown. If the economic data continues to support a reduction of easing, we believe the market is prepared for the money printing to end in the next 12 months. Even with the Fed stopping its bond purchases, committee members continue to reassure the markets that short-term rates will be kept lower for an extended period of time. Market participants will have to continue to adapt and learn how to interpret Fed Chair Janet Yellen's comments that could provide clues to future policy decisions. We spoke of this concern in our last commentary, and believe it added to some of the volatility in the first quarter, and is expected to continue until traders are comfortable with her approach.

Considering that weather was the theme - or excuse - for many corporate CEOs, the expectations around earnings season are low. At the start of the quarter, earnings were expected to grow modestly; however, as the weather kicked in and companies lowered guidance, analysts adjusted their numbers. Some analysts now believe total earnings will decline for the second quarter of 2014. It is normal for companies to attempt to lower expectations in order to beat analyst estimates; they believe it is better to under- promise and over-deliver. Many multinational corporations, especially those with revenue and operations in the lesser developed countries, may have an additional headwind from currency devaluation.

Economic readings continue to indicate that the recovery in Europe is real. GDP in the fourth quarter grew by 0.3 percent compared to a reading of 0.1 percent in the third quarter. The unemployment rate dropped slightly to 11.9 percent in February, which is better but still dangerously high. There is a growing expectation that the European Central Bank (ECB) will introduce a new stimulus or bond-buying policy in an attempt to raise inflation. The one-currency approach is making it difficult for the weaker countries to be competitive with such an expensive currency. If quantitative easing is announced, the Euro may see a drop in value as the U.S. central bank continues to taper its bond purchases. A weaker currency could help some of the weaker countries but could exasperate Germany's trade surplus.

Japan continues their experimental policies as they look to establish sustainable growth following decades of deflation. The results will be measured in the years ahead but the story will continue to attract attention. There is a great concern over the consumption tax hike going into effect on April 1 and the potential impact it will have on economic growth. Even with the economy being restricted from higher taxes, if the currency continues to weaken as it did in 2013, export-driven corporations may still be able to grow their earnings which could drive stocks higher. The Yen, Japan's currency, tends to be a safe haven for investors during times of uncertainty and fear, but if the central bank continues its "easy money" policies and global fears are stable, the currency should weaken and the Japanese stock market can move higher. However, coupling the higher tax with a strengthening Yen would cause trouble for Japanese stocks.

After having a difficult 2013 and January, many emerging market countries saw significant rebounds and many countries are positive year-to-date after having a strong February and March. Compared to the U.S. and even some other parts of the world, the valuations of the emerging markets category look very attractive but you have to be careful. There may be a reason for the cheap valuations. Countries with weak fiscal structures, like Turkey, may struggle to keep their currency value stable as interest rates in the U.S. rise. Turkey also has additional political questions with upcoming elections and controversial technology bans being implemented. Turkey banned its citizens' access to both Twitter and YouTube ahead of elections in late March. Leadership decisions like these recent technology bans do not encourage investor confidence.

We expect to see China's growth continue to fall but we do not expect a hard landing, and we could possibly see stimulus introduced from the government to help soften the landing. Although China is attempting to be more consumer-driven, a large majority of its gross domestic product is attributed to exports. As long as Europe and the U.S. continue their economic growth, China should be able to continue its shift in economic drivers without suffering a hard landing.

This market rally, which is the most unloved in some time, has continued for another quarter; however, this ride has not been as smooth as many previous quarters. Most asset classes still managed to finish the quarter higher, and many investors continue to wait for a correction. Even given all the volatility and uncertainty, ACG's investment philosophy has not changed. We continue to believe diversification is important, and building allocations based on a client's risk tolerance and financial goals is most effective. If anything in your financial situation has changed, please let us know so we can determine whether a change in your portfolio is necessary.

— Robert Moyer, CFA, CFP®
Director of Research