August 15, 2014

Geopolitics

During July some became concerned about rising geopolitical risks. We caution that such risks tend to be a matter of perception more so than economic risk. These influences can be drastic in the short-run, but they should not change the posture of true, long-term investors. It's a sad but true reality that not even a half-decade has passed in any of our lifetimes without some kind of emergent geopolitical risk-event. Today Russia has once again become the primary cause for concern, yet stock markets enjoyed some stellar performance during its many decades as our primary global foe despite specific threats against our country. Here the threat is more abstract, so if anything, it should be less of a concern than that of years past.

The start of the third quarter was much like that of the second quarter in April. Markets ended the prior quarter poking through to all-time closing highs before weakness took over. Once again, small-cap stocks were the hardest hit. However, one big difference did emerge: whereas high yield credit markets remained strong throughout the April selling fit, they weakened and led to the downside this time around. With continued downward pressure on benchmark interest rates, this brought about a widening in credit spreads for the first time in a while.

In the grand scheme of things, this is but a hiccup, though it's slightly larger in magnitude than last summer's "Taper Tantrum." While some have called this a mini Taper Tantrum, the differences between this summer's sell-off and last summer are more notable than the similarities. Last summer, the primary action was in benchmark rates, which had their largest surge since the zero interest rate policy came into effect. Coming into 2014, many expected the rise in benchmark rates to continue, meanwhile throughout the calendar year thus far, rates have declined. This decline accelerated amidst the recent spike in corporate Treasury spreads.

Many attribute this weakness in high yield credit to the potential for a more decisive retreat from the policies necessitated by the Financial Crisis by the Federal Reserve. While that may in fact be the case, we want to point out two further caveats, beyond the lack of a rise in benchmark rates.

First and foremost, as we have been saying for some time, the Fed will not take a more hawkish stance unless and until the economy shows signs of tangible and sustainable improvement. To that end, our theme of the economy outpacing the stock market in 2014 took a turn towards the more correct in the past month. Reported economic data continued to improve, and the back half of this year is poised for the strongest economy since before the Great Recession. It is becoming clearer by the day that the first quarter's decline in GDP was an aberration. This accelerating strength is something to be celebrated, not feared, for the return of normality bodes increasingly well for the lives of all Americans and financial markets alike.

Second, high yield suffers from its own unique problem in this zero interest rate world. Rates are so low in this space relative to the long-term risk profile of the sector that value investors will be sidelined until there are substantially better opportunities. With this the case, when selling flows through this asset class it takes the rebalancing effect in order to bring in a new bids, thus making the process of finding a floor a more uncertain process.

The situation in high yield stocks is similar, but distinctly different from that in equities. Taken as a whole, July seems like a much-needed cooling off month for equity markets. Over the past few months, the divergence between small and large cap stocks became pronounced with some increasingly aggressive valuations in subsets of the small cap complex getting smacked back down to reality. As a result, while the S&P continued its march into uncharted territory, the Russell 2000 has been confined to a rather volatile range.

With the calendar now open to the month of August, it is also time for us to say goodbye to our Summer Analyst, Jonathan Davis. Jonathan will be starting his junior year at Cornell. Over the course of the

summer, the greatest opportunity set appeared in the retail space and Jonathan was a huge help in advancing our research on this sector. He contributed tremendously in our effort to distill which companies were merely victims of disruption in sales and distribution from those that truly do something different, better and with considerably more value than the rest. Jonathan's contributed to both our qualitative and quantitative analysis, with information that was both actionable today and long-lived whereby its value will continue to accrue to our research efforts over time. We want to both thank Jonathan for his meaningful contribution to our research this summer and wish him well as he starts the second half of his college life.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

Jason Gilbert, CPA/PFS, CFF
Managing Director
O: (516) 665-7800
D: (516) 665-1940
M: (917) 536-3066
jason@rgaia.com

Elliot Turner, Esq.
Managing Director
O: (516) 665-7800
D: (516) 665-1942
M: (516) 729-5174
elliot@rgaia.com

Past performance is not necessarily indicative of future results. The views expressed above are those of RGA Investment Advisors LLC (RGA). These views are subject to change at any time based on market and other conditions, and RGA disclaims any responsibility to update such views. Past performance is no guarantee of future results. No forecasts can be guaranteed. These views may not be relied upon as investment advice. The investment process may change over time. The characteristics set forth above are intended as a general illustration of some of the criteria the team considers in selecting securities for the portfolio. Not all investments meet such criteria. In the event that a recommendation for the purchase or sale of any security is presented herein, RGA shall furnish to any person upon request a tabular presentation of: (i) The total number of shares or other units of the security held by RGA or its investment adviser representatives for its own account or for the account of officers, directors, trustees, partners or affiliates of RGA or for discretionary accounts of RGA or its investment adviser representatives, as maintained for clients. (ii) The price or price range at which the securities listed