Van Hulzen Asset Management

QUARTER IN REVIEW

JULY | 2014

ASSET CLASS RESULTS

US equity market valuations ticked higher in the second quarter as the economy bounced back from a cold weather slowdown and stocks rose. Despite concerns over a reduction in Federal Reserve bond purchases, equities rewarded investors with solid gains. Robust merger activity and strong corporate earnings overshadowed any short-term concerns.

Similarly, interest rates remained subdued. Credit spreads on corporate debt continued to tighten and low interest rates propelled further aggregate investment into commercial real estate and several other asset classes. Investors who maintained allocations to income investments into 2014 have been rewarded with better than anticipated results.

Real estate values continued higher in most categories. Commercial properties and most income-producing real estate properties have appreciated considerably in the first half of 2014.

After five years of appreciation in asset prices, complacency toward risks can become an easy state of mind. Several “fear” indicators suggest that investors have a “casual” outlook toward future risks. The so-called volatility index (VIX) is near all-time lows, tight credit spreads suggest a willingness to accept lower than normal rates of return presumably in response to a general complacency toward future risks and cap rates on real property have hit all-time lows in several market categories.

HISTORY AS A GUIDE

By historic standards, US equity markets could be classified as moderately-overvalued suggesting the possibility of below-average returns in the coming years. Similar concerns for bond returns surround the possibility of interest rates continuing to rise in the near future.

The Total Market Capitalization of the US markets relative to GDP stands at 124%. By comparison, the stock market was at 148% of GDP at the market peak in 2007 and dropped to 57% of GDP at the market low in 2009. A ratio of 75% to 90% is considered fairly valued. One year ago, this indicator was at 102%, only slightly above normal.

Interest rates stood at 2.53% (US 10 yr) at quarter end, which is still low / accommodative relative to a 10-year average of 3.5% and a 20-year average of 4.3%.

With this as backdrop, it is valuable to look at timeliness of various investments and asset classes. In the following section, investing is compared to farming in a simple comparative illustration.

CROP CYCLES AND ASSET CLASS TIMELINESS

Successful farming is an involved, dedicated, year-long process. It takes daily monitoring and hard work. No matter what the season or time of year, a farmer always has something to do. The main stages of a farming cycle can be distilled down to six time periods: cultivation, sowing, fertilization, growth, harvesting, and storage. Environmental inputs such as weather and insects are also major factors in the outcome of the process. Each crop is unique and many have different times for growth and times for harvest. Geography and weather are just a few factors that determine when different crops should be planted and when they should be harvested.

The same is true for investing. The economic cycle, geography, and interest rates are a few of the major influences on investment assets. Growing a portfolio requires constant work and attention, has various stages and often produces an unknown results. Employing principles of risk management can improve both crop and portfolio yield outcomes.

The Investment Farming Cycle:

Cultivation: a time to research and perform due diligence.

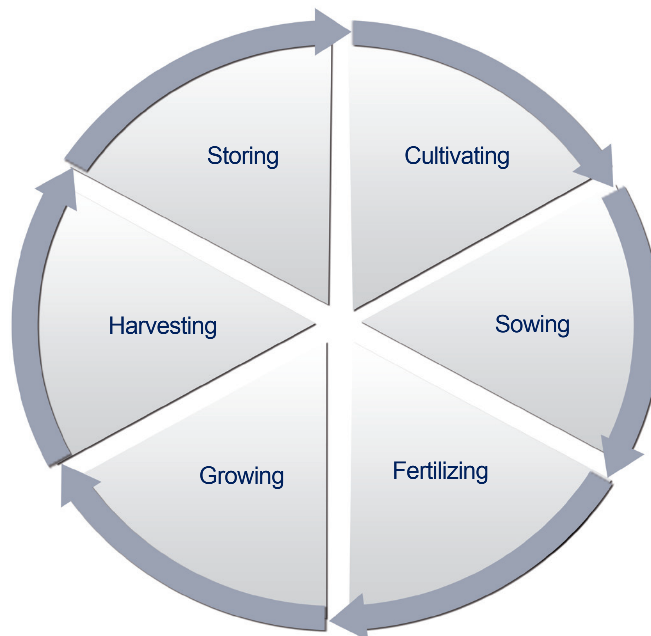
Sowing: a time to make initial investment purchases and to allocate capital.

Fertilize: a time to add to investments that are unfolding as expected and to rebalance assets, selling positions that develop problems.

Growth: a time to monitor activities and take fewer actions, more time spent looking for potential risks to the crop.

Harvest: a time to begin selling and reducing an investment that has yielded good results. A time to review both portfolio and allocation decisions made during cultivation and sowing.

Storage: a time to pull exposures back more broadly, generally during a season of economic winter.

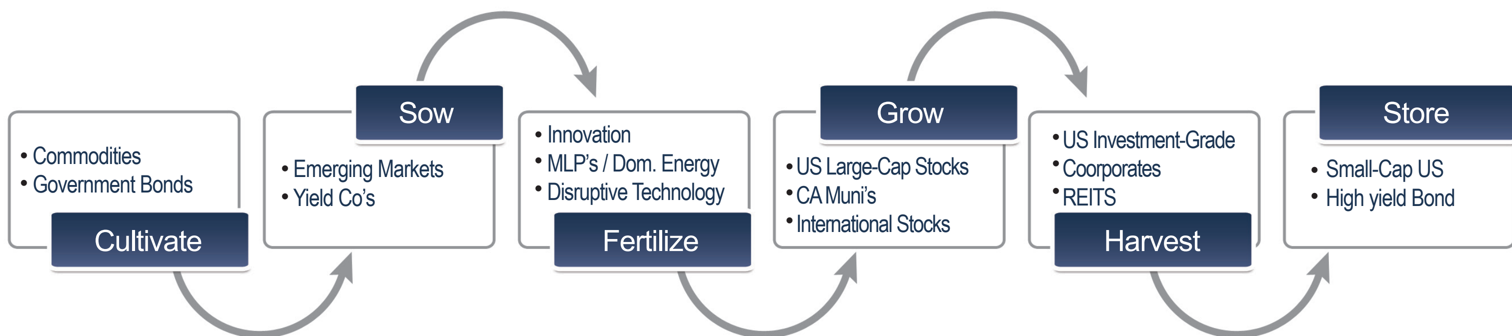


In terms of asset class investing, there can be times when certain assets (crops) should lie fallow and let the ground rest. Again, just as soil needs recovery time, asset classes sometimes go out of favor and should be avoided until they show signs of recovery.

Midway through 2014, equity markets are entering a sixth year of recovery and rally. Uninterrupted periods lasting into a sixth year are rare and would typically fall into the harvest or storage categories. Small-cap US stocks have risen dramatically since 2009 and are now in a season of late harvest and storage. Innovation and disruptive technologies will still offer opportunities in specific companies but the broader asset class in general is overvalued relative to historic prices.

Interest rates have fallen steadily for nearly thirty years creating a long growing season with plenty of time to reap better than normal results. In the mid-2010's the cycle is bottoming and harvest is approaching. In some bond categories, it is already time to be storing up and moving on to other investments. High yield bonds offer a fairly poor risk/return trade-off at current levels. Spreads have tightened and markets have priced in low levels of default risk for the category.

Below is a graphic of various asset categories plotted along the investment cycle:



CONCLUSION

This outlook on asset class timeliness takes a long-term view and assumes that an investor in equity assets has five or more years to invest in the category. Short-term fluctuations and trading ideas are not illustrated here. Trading opportunities and short-term investments can still be found within asset classes that are less timely.

Some cycles take only a few years to go from Cultivation to Harvest (small-caps) while other cycles can take decades (government bonds) to unfold. A market capitalization to GDP ratio of 124% is high by historic standards, but could continue higher as long as negative event risks remain low.

A long-standing adage says "the trend is your friend." And that has certainly continued to be true for equity investors into 2014. At the same time, it is always beneficial to look up from time to time, check the crop, and look to the horizon. And remember the farmer who is constantly preparing for the next phase of the cycle.

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