

What We Are Telling Clients

By James F. Dykstal, CFA, Portfolio Manager, October 2013

Below is a summary of our views on the economy and markets, which we are sharing with discretionary clients. In essence, we view that the risk in risk assets is underappreciated – especially in domestic small cap stocks. Some sectors have already corrected and we view those more favorably in the longer term.

Economic Outlook

- The pace of GDP growth in 2013 has been modest so far at below 2%. We expect GDP growth to remain between 1.0% to 2.0% into 2014.
- Inflation will continue to remain modest despite the Fed's efforts to bring inflation up. Unemployment will remain above longer term averages and wage growth will continue to be stagnant. The Fed will try to begin tapering in 2014 contingent upon inflation and employment indicators.
- The pace of the recovery in residential real estate will slow slightly in response to an increase in longer term interest rates.
- The European economy appears to be slowly recovering from recession, but risks remain. Growth is at a pace less than U.S. growth. The U.S. dollar will be relatively stable versus the euro and the yen. The Japanese will continue with its aggressive quantitative easing program.
- Growth in emerging markets will lead developed markets, even with slowing GDP growth in China, as consumers in emerging market countries continue to increase their percentage of global consumption.

Strategic Market Outlook

- Larger cap and higher quality U.S. equities offer relative safety versus other equity classes. Emerging market stocks, while more volatile, will benefit from stronger economic growth in those countries and below average valuation.
- The downside risk of the stock market is increasing as the market appears to be fully valued. P/E ratios may contract slightly if interest rates increase with small cap stocks most at risk.
- Stock volatility will be strongly influenced by global macro events such as the Federal Reserve's "tapering" decision, economic slowing in China or a new sovereign debt crisis in Europe.
- U.S. Treasury bond yields will trend slightly higher. Investors will continue to invest in higher yielding corporate bonds. High yield bonds and bank loans offer an attractive risk/return tradeoff.
- Commercial real estate offers compelling value when income returns are compared to investment grade bonds.

Current DMS Tactical Positions

- Equity exposure remains underweight in favor of lower volatility fixed income assets.
- Within equities, the focus is on lower beta stocks of large, high quality, dividend paying companies.
- Within equities, holdings of small cap stocks remain underweight.
- International stocks remain underweight due to concerns of European debt troubles and the prospect of lackluster economic growth. However, incremental funds were invested to take advantage of low relative P/E multiples.
- Among international equities, emerging markets stocks are relatively attractive as those countries lead in global economic growth. Asian markets are favored relative to Europe.
- Within fixed income, credit is overweight compared to Treasuries. High yield is viewed favorably.
- Commercial real estate is viewed as attractive as a yield alternative to bonds.

If you are interested in more information, please call Tom Woolwine, President, at (913) 981-1345 or email, twoolwine@dms-demarche.com.