DMS

Discretionary **M**anagement **S**ervices, LLC

What We Are Telling Clients

By James F. Dykstal, CFA, Portfolio Manager, July 2014

Below is a summary of our views on the economy and markets, which we are sharing with discretionary clients.

Economic Outlook

- GDP growth should rebound from a dismal first quarter and settle in at a modest 2%. Growth is constrained as personal consumption remains constrained (approximately 2%). Personal income growth remains below longer term trends due to current slack in labor markets.
- Inflation is expected to remain muted. However, some recent improvements in job growth will allow for the Fed to finish the "tapering" of quantitative easing.
- The yield on the ten year Treasury fell during the quarter from above 3% to approximately 2.75%. Upward pressure on rates will appear despite any short term "flight to quality" due to an increase in stock market volatility.
- International economies will continue their slow recovery throughout 2014. Both the European Central Bank and the Bank of Japan will continue with quantitative easing in attempts to spur GDP growth. The U.S. dollar will strengthen versus the euro and the yen due to the removal of Fed stimulus.
- Growth in emerging markets will be higher than developed markets, even with slowing GDP growth in China. Consumers in emerging market countries continue to increase their percentage of global consumption.

Strategic Market Outlook and Tactical Allocations

Fixed Income: The trend toward higher interest rates should continue, but expect "flight to quality" events as the markets readjust to more volatility in the equity markets.

- High yield should outperform in a rising rate environment despite current tight credit spreads. Credit is overweighted versus Treasuries, and duration is tilted shorter than benchmarks.
- Commercial real estate is viewed as an attractive yield alternative to bonds; however, queues can delay additions to positions, and an increase in interest rates could damper valuation improvements.
- International bonds are viewed as an attractive complement to domestic bonds, due to a mismatch in interest rate cycles.
- Emerging market debt provides diversification and yield potential. Central banks in countries such as Brazil, India, and Turkey have increased interest rates, and currencies have stabilized as a result.
- Hedge funds with a non-directional (or absolute return focus) are viewed as an attractive uncorrelated option.

Equities: The domestic stock market looks to be fully valued as earnings growth slows. We expect more volatility in domestic equity markets as companies' earnings momentum slows. International developed stocks appear to be undervalued relative to domestic stocks despite continued slow growth in those countries. Emerging market stocks are viewed favorably, due to stronger economic growth and attractive valuations relative to developed nations.

- Small cap stocks are more underweighted than large cap stocks, due to above average P/E multiples. Equities are tilted toward lower beta, higher dividend stocks to reduce volatility and to generate income.
- Stock allocations in developed markets lean toward international stocks, as they appear to be undervalued relative to domestic stocks. The relative attractiveness takes into account the lackluster economic growth in Europe and Japan. The ECB and the Bank of Japan will continue their quantitative easing programs.
- Within international equities, emerging markets stocks, comparatively attractive due to their low relative P/E multiples, are equally weighted to target. Unfavorable economic news has been priced into valuations.