CAPTRUST

Consulting Research Group

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Capital markets continue to wobble as February begins, and today's volatility across global stocks, bonds, currencies, and commodities demonstrate heightened investor worries. Concerns have shifted from a few emerging market countries with currency fluctuations (including Brazil, India, and Hungary) to questions over China's growth rate and now the focus is on the U.S. and whether economic momentum remains in its favor. While we remain optimistic about the global economy's potential, capital markets have been relatively complacent about risks. We see the proverbial glass as still "half full," albeit a little less full than from our vantage point at the end of 2013, irrespective of recent market movements.

We wrote ten days ago that if our views changed on the issues that seemed to concern investors, we would let you know, and this communique reflects some changes to our views. We remind readers that a tangible difference exists between capital markets and economics; just because economic growth is rising or falling does not mean that assets like stocks, bonds, commodities, or currencies will necessarily follow suit. Several factors impact asset prices, including valuation and investor sentiment, so we will discuss some of those factors when explaining why our views have changed at the margin.

Let's take a step back and assess the global capital market environment. Over the past several years, asset price growth has been fueled, at least in part, by very accommodative central bank policies that have stressed low borrowing rates and high liquidity fueled by government bond buying programs. As colleague Hunter Brackett and I have highlighted in recent *Strategic Research Reports*, central banks are now operating less in concert with one another relative to their coordinated pro-growth policies immediately following the 2008-09 financial crisis. While Japan remains in full accommodative mode, the U.S. and UK have eased off the gas pedal while Brazil, India, and Turkey have applied brakes in the form of higher interest rates targeting adverse currency and capital flight movements. Economic growth has been uneven in the wake of less aggregate central bank involvement and the anticipation that the most significant liquidity provider, the U.S. Federal Reserve, will wind down its bond buying program sometime in mid-2014.

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From an asset price perspective, U.S., European, Japanese, and select emerging market stock markets had strong 2013 performance, again responsive to solid corporate profits, productivity gains, but most importantly increased liquidity from central banks and governments. Inflation was relatively benign and unemployment, while still challenging, improved, as did home prices. In aggregate, consumers were enticed to spend and companies benefited, justifying flows to equities and other traditionally riskier asset classes. Those flows have pushed riskier asset class valuations to, in some cases, full levels, requiring: 1) additional liquidity, 2) a continued favorable macroeconomic backdrop of high growth with manageable inflation, or both.

On the liquidity front, the U.S. Federal Reserve announced further cuts to its bond buying program last week, and unless the European Central Bank changes course this week, it will remain on the sidelines. Japan is bracing for a consumption tax increase this April, so further liquidity measures may await consumers' response. As highlighted earlier, many developing economies are actually increasing interest rates to curtail capital movements, concurrently draining capital. These developments suggest liquidity is falling, not rising.

Examining economic growth, data from China over the weekend revealed manufacturing slowed to its lowest level since the summer and its service sector, a long-awaited potential growth engine, sputtered at its lowest growth rate in five years. While European data released this morning appeared to show some improvement, a U.S. manufacturing report indicated that new orders fell the most in three decades, likely impacted by cold weather but still disappointing. Late last week, U.S. consumer data showed very little income growth while inflation readings revealed a mild increase in prices at both consumer and producer levels. The confluence of negative news was too much for investors to bypass, and markets reacted with selling across most risk assets.

We continue to see positive developments across the global economy and the potential for a solid year across diversified portfolios, and as we have noted in the past, short-term volatility is usually a hallmark of any capital market environment. Riskier asset classes may accept less liquidity with steady or accelerating growth, but should growth require liquidity from central banks that seem reticent to provide it, capital market ups and downs may be more frequent than recent experience suggests. The recent selloff (U.S. equities are down ~7 percent from peak levels a mere three weeks ago) has provided some potentially rewarding long-term opportunities, but we expect capital markets to continue to assess the liquidity and growth dynamics surrounding recent price weakness, so do not be surprised to see further volatility from here. Irrespective, the glass remains half full after this latest spilling, albeit more balanced than the start of this year. If you have questions regarding recent developments and how they relate to your unique situation, please let us know.

Onward-

Eric