# OVERVIEW

Economic Analysis and Market Review

Q1—2014

**A LOOK AT Q1**

- The Cold War redux
- Crisis in Crimea
- US economy continues regardless

The year began on a rocky note and got rockier as the quarter progressed with considerable help from Russia. Russian President Vladimir Putin must have missed the glory days of the Cold War — he once said that the breakup of the Soviet Union was "one of the greatest calamities of the 20th Century" — so he's doing his best to bring them back. The first quarter of 2014 was all about Russia's machinations to annex Crimea, a part of Ukraine and creating the worst crisis between Russia and the NATO countries since the fall of the Iron Curtain in 1989. This will be a continuing problem for the West and for global markets so a review of the issues here is relevant to any discussion of the economic environment.

Domestically, the U.S. economy continues to progress positively albeit at a snail's pace. The Fed feels sanguine about the economic recovery to continue its "tapering" of their quantitative easing program by $10 billion a month. The Employment Report for March was just shy of forecasts but showed the strongest job growth in three months. According to the Labor Department those filing for unemployment benefits hit a 7-yeaar low and they stated that all the jobs lost in the financial crisis have now been recouped. Housing continues its recovery as tight supply and strong demand are driving more construction. Interest rates are at historic lows and corporate profits and business investment are at all-time highs. In addition, our domestic oil renaissance is in full swing leading the U.S. closer and closer to total energy independence but more on this game-changing event next quarter. Will the crisis in Crimea impact our economic recovery? Not likely as Russia only accounts for about 2% of our trade.

The crisis in Crimea, a semi-autonomous region in the south of Ukraine, began with months of protests in Kiev, the capital, against President Yanukovych's plan to abandon an agreement bringing the country closer to the European Union. They were days within signing the agreement. The protesters took to the streets after any hope of negotiations was lost. On February 22, Yanukovych fled the capital after government troops attacked and killed 82 protesters in the city of Kiev. With the ouster of Yanukovych, Crimean militiamen took over Ukrainian military bases and demanded to secede from Ukraine as most of the region is ethnic Russian. A Kremlin-backed referendum was held and 97% of the registered voters voted to return to Russian control. The results of this vote are disputed.

The White House and European Union have declared the referendum a violation of international law and have enacted economic and political sanctions against Russia. The effectiveness of these sanctions remains to be seen. Russia's economy, suffering from sagging growth, a weakened currency and capital flight, is vulnerable and this will be a setback to their recovery. Already there are large outflows of capital.  A catch is that about

### LOOKING AHEAD

- Jittery markets will continue for now
- Putin problem not going away as long as he has territorial ambitions
- Improving economies will provide support for the markets

20% of Europe's natural gas comes from Russia, the world's largest oil producer, via pipelines through Ukraine. This is a concern for the EU. On the other hand, Russia can't afford to cut off the supply as 10% of its gross domestic product (GDP) comes from the sale of oil and natural gas. There's no win there. The best that can be hoped for at this point is that Russia backs off and pulls its troops away from Ukraine's borders and eases tensions across the region. Angela Merkel, Germany's Prime Minister, said, "I have the impression that a process of reflection has begun in Russia. We would also like to have Russia closer to Europe if it plays by the rules." Putin and Merkel are in discussions to stabilize the situation as are Secretary of State John Kerry and his Russian counterpart, Sergei Lavrov.

Of course, world tensions like this roil the capital markets and early gains in the global stock markets this year were quickly dashed. The S&P 500 fell 1000 points to 1740 in February and only slightly recovered by the end of the quarter gaining 1.8%. As investors fled the stock market, they poured into safe havens like the bond market driving yields down and boosting prices to a 1.84% gain, considerably better than last quarter's -0.14% showing.

The Putin Problem isn't going to go away soon so the markets will remain nervous and sometime in the next 12 months we may experience the much anticipated 10% drop. The market has gone way too long without a correction. One possible cause for this correction would be if the stock market grinds lower resulting in forced selling due to margin calls. In the last six months of 2013, margin debt rose an alarming $70 billion to a record $444 Billion.

But 2014 could still end on a higher note for the year. Goldman Sachs forecasts a rise in the S&P 500 to 1900 or roughly a 2.8% gain. Morgan Stanley Research economists expect global GDP growth to accelerate from 3.0% in 2013 to3.4% in 2014. That should provide plenty of support for global equity markets, barring any further geopolitical disturbances.

**Market Indexes**
**First Quarter, 2014**

| INDEX | Q1'14 | YTD | 12 Months | 10 years |
|---|---|---|---|---|
| S&P 500 | 1.81% | 1.81% | 21.86% | 7.42% |
| Russell 2000 | 1.12% | 1.12% | 24.9% | 8.53% |
| Europe, Aust., Far East | 0.66% | 0.66% | 17.56% | 6.53% |
| Barclays Agg. Bond | 1.84% | 1.84% | -0.10% | 4.46% |
| Dow Jones REIT Index | 10.35% | 10.35% | 4.35% | 8.05% |
| Treasury Bills | 0.01% | 0.01% | 0.07% | 1.65% |

- The S&P 500 is an index of 500 large, well-established companies
- The Russell 2000 is an index of 2000 small companies
- The Europe, Australasia, Far East Index (EAFE) is an index of developed countries around the world
- Barclays Aggregate Bond Index is an index composed of investment grade bonds
- The Dow Jones REIT Index is an index of commercial real estate properties