TERRA NOVA
ASSET MANAGEMENT

U.S. Financial Markets
June 2014

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All market corrections this year were mainly a reaction to geopolitical tensions with Russia, and were mostly in the range of 5% with main profit taking taking place in high-beta sectors such as biotechnology and some social media and technology stocks. The wait-and-see mode of investors has been characterized by extremely low volatility in all markets. Over the course of four months, the leading U.S. stock indices have moved in a trading range within plus or minus 2% until they stabilized in May. The S&P 500 TRA was up 5% as per 05/31. The 10 y treasury fell from 3% to 2.5%.

Fixed Income Market -Outlook

The Federal Reserve Bank is likely to keep long term interest rates low even after termination of QE end of Q3 as they will hold their portfolio and reinvest treasuries that matured and thus not change from being a net buyer to a net seller. The main reason for continuing the expansionary money policy are the conflicting signals from the labor market. Although the unemployment rate dropped to a new low, and private sector job creation reached a pre-crisis peak unit labor costs remain largely depressed with the exception of skilled workers.

Although, a major impact on interest rates would be in our opinion if investors lose confidence in any of the major currencies relative to others due to geopolitical risks and start to reallocate their assets into dollar-denominated assets, we think this risk is benign. On the contrary, we expect the economy to turnaround swiftly in the next quarters from a lackluster weather related Q1 to end 2014 in the range of 2.5% to 3% p.a. In line with this development we expect the 10y treasury yield to rise in a controlled manner to 3.255 in 2014 and 4% in 2015/16.

Long duration bonds were in demand despite high valuations because yields seemed still attractive relative to other asset classes. The 10y treasuries have returned 10 % this year the most since 1995 (Bank of America data) and reached a level of 2.53% at the end of May. Corporate bond spreads have therefore tightened and the average corporate bond spread is now at 110 basis points , 10 basis points tighter since year end. We do not expect much further upside but rather expect the market to trade within a tight trading range for the remainder of the year. We have moderately shortened duration this year, and continue to closely monitor our exposure to credit risk.

Economy

GDP contracted by 1% in Q1 and was revised from 0,1%. Exports declined at a 6 percent rate in the first quarter, while imports rose as trade subtracted 0.95 percentage point from GDP. Also, very weak investment in residential real estate could not be offset by solid energy related consumer spending. This is likely to have been a weather related aberration in a moderate upward trend in the economy. Recent data, for example double digit sales in the auto industry in May, however, suggest that a sharp rebound is unfolding likely to spur a broad recovery in the following quarters. Short term slowing growth rates in autos, housing, and aerospace industries, the prospect of higher interest rates at some point, and new geopolitical uncertainties could potentially hold the economy back in 2014. Longer term, however, we are confident that the housing market has ample room for improvement, oil and gas production continues to accelerate and government austerity measures are likely to taper off. Furthermore, as the global economy is slowly recovering U.S. exports should follow suit

Corporate Earnings

Composite earnings in Q1 increased by 1.4% in the S&P 500 on 1.1% higher revenues and largely flat margins. Ex finance total earnings for the S&P 500 would have been up by 3.6% on 3.3% increase in revenues. Only 33% of companies beat sales expectations and earnings growth of 5.5% yoy was the lowest in four quarters. Guidance has been overwhelmingly negative again this quarter. We expect a strong turnaround in the next quarters reflecting the overall positive economic trend.

Outlook

After last year's incredible rally the S&P 500 has now returned over 21% per year, on average, over the last five years. After this strong development, the market is still fairly valued with the trailing PE of the S&P 500 at 17 versus the median of 16.6 since 1983.

The impulse for higher stock prices has to come from corporate earnings and consumer spending in our opinion. Stock prices were supported in recent years because companies consolidated, refinanced, bought back their shares and raised dividends. Going forward the focus will be on increasing revenues and profits. This will largely be possible when global economies recover and China can stage a soft landing.

We recommend to stay invested with ample exposure in dividend paying stocks. We continue to find tax advantaged Master Limited Partnerships and municipal bonds, REITs, and the following growth areas in the U.S.A. especially interesting:

A sector which looks attractive on a price/fair value basis is energy, especially equipment-, services-and midstream companies as the evolution of U.S. and global gas markets continues. In the consumer cyclical sector, the auto industry and retailers have reached critical inflection points as the auto industry is moving towards better gas efficiency and the retailers towards a structural shift to e-commerce. Especially retailors with exposure to emerging markets with a growing base of middle-class consumers, are able to maximize sales online, control costs and to defend better against labor, material, and energy costs. In basic materials chemical conglomerates are attractive as they continue to reallocate their asset portfolios to specialty chemicals and away from cyclical commodity chemicals to achieve a more consistent profitability and stable earnings. Another industry in this sector are building materials. The U.S. has the lowest fuel taxes outside of OPEC members. The quickest and most economically sound solution for funding highway spending would be to raise gas and diesel taxes. Another area of growth is commercial real estate as steady macroeconomic improvement leads to a slow and steady increase in demand for commercial real estate space without spurring too much construction of incremental supply, a favorable condition for REITs. Lastly, utility companies which corrected strongly in the Q1 due to higher interest rate expectations, provide good value as their average dividend yield of 4% is 1% higher than the 10y treasury yield and second only to the median telecom dividend yield of 5.5%. Most utilities refinanced, strengthened their balance sheets and profited from the weather related higher electricity prices. A return of 7%-8% for income oriented investors seems, therefore, a fair assumption in our opinion.

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