TERRA NOVA
ASSET MANAGEMENT

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777 Third Avenue | New York, NY 10017 | USA | tel. +1.212.355.1234 | fax +1.212.355.8873

With heightened geopolitical risks, from Ukraine, Iraq, Gaza, spiraling international sanctions against Russia, a slowing Chinese economy to the Ebola outbreak in West Africa have affected world economies and in particular Europe. The absence of a strong and consistent market reaction in the U.S. to geopolitical crises stands in contrast to short-term market reactions that suggest that these crises have the potential to spin out of control and become contagious. Market reactions were so far short lived and trends, that were in place prior to the various crises seems to always have reasserted themselves. The S&P 500 TRA Index gained 8.3% through 09/30 after a low of -5.7% in February. Essentially, the economic doldrums have not only delayed the process of normalizing monetary policy but led to aggressive monetary expansion especially of late in Europe. There was no growth across the 18-country bloc in the last quarters and inflation is hovering around a deflation-threatening 0.3 percent (below the 2% EZB target) which makes it almost impossible for the weakest economies in Europe to pay down their debts and restore fiscal stability. This development along with a chronically deficient demand is affecting economic growth in Europe. Lower interest rates, soft economies, and the potential for further monetary easing by the ECB have led to a weaker euro. The mechanism of an expansionary monetary policy is different in Europe than in the U.S., where low interest rates are meant to stimulate assets and encourage the housing market. In the Euro Zone the main benefit in the absence of structural changes is a lower Euro making European goods more competitive. The euro declined from a high of 1.39 on 05/06/14 by 10% to 1.2516 to the U.S. dollar. There is a possibility for the euro to trade drastically lower but we do not expect this to happen in a free fall considering the current overall trade surplus of the Eurozone.

The U.S. Economy is gaining Traction

The U.S. economy rebound of 4.2% in Q 2 was stronger than expected and corporate profits surged to a record of 10.6% of nominal GDP. The economic data remained bullish through August. The purchasing manager data for both the service and manufacturing industries continued its robust uptrend. This index has lately been a great predictor of manufacturing which staged a broad based improvement in all but the textile industries. Consumer spending grew at a 2.5% seasonally adjusted annual rate and contributed 1.69 % to GDP growth, nonresidential fixed investment rose at an 8.4%, and business spending on structures, equipment and intellectual property products all provided larger contributions to growth last quarter than first reported. In our opinion the U.S. shows sufficient and steady growth without inflation which gives corporations plenty of time to adjust their business models to slower global growth. Furthermore, the trade deficit has declined in recent months due to lower oil imports and is likely to contribute significantly to a strong Q 3 GDP.

Employment improvement

Although August employment data were below average, year-over-year, three months averaged employment data showed that private-sector employment growth of 2.1% is matching 12-month averages since 2011, and is consistent with consumption (2.23% on average) and GDP growth (2% to 2.5% in 2014). The unemployment rate last month was a seasonally adjusted 6.2%, down from 7.3% a year earlier Although total wages are accelerating in line with the economy incomes still remain 8% below the level of 2007 (Census Bureau) when the recession officially started. Inflation, which has increased from 1 % to 2% since November 2013, will determine the buying power of the consumer and thus the effects on the economy.

Fixed Income Market and the Fed

After a solid rally, especially in the corporate bond market (4% for the Barclays US Agg TRA Index) the yield on 10-year Treasuries had dropped from 3% to 2.3%. Corporations and governments continue to issue new bonds at bottom interest rates to eliminate near-term refinancing risk when yields start to rise. Overall demand by market domineering institutional investors and foreign investors is likely to outstrip supply and continue to bolster prices and keep yields low. Also, oil continues to slide and the strength in the dollar (independent of interest rates) should also help to keep yields down. For the fourth quarter, we think corporate bonds in general will struggle to generate much more than break-even returns. With the Fed exiting its asset purchase program, we think interest rates will rise toward more normalized levels compared with inflation expectations, and the shape of the yield curve. With interest rates poised to rise and credit spreads near their tightest levels since the end of the 2008–09 credit crisis, we expect rising rates to largely offset the yield that investment-grade corporate bonds currently offer. We expect high-yield will provide a better return than investment-grade as the high-yield segment has a much lower correlation to underlying interest rates. Returns for investment-grade bonds are more closely correlated to underlying interest rates and have substantially less excess credit spread to offset rising yields. As this and the improving economy will hold down default rates we expect that high-yield bonds should hold their value better than investment-grade bonds. Industries such as energy and materials are attractive as they corrected due to a supply driven multi-year low in commodity prices.

Outlook

Much of the short term stock market performance (-1.6% in September) will depend on the future strength of the economy. A growth rate of 3% plus would be positive especially when the rest of the world is at zero or less. The domestic economy functions rather independently, but the divergence between the U.S. and foreign economy growth (major EPS driver) is acute. The best approach in our opinion in these uncertain markets risk diversification among asset classes and focus on income producing investments. We recommend to underweight industries such as consumer staples, regulated utilities, and real estate investment trusts with the exception of healthcare REITS as they are especially sensitive to long-term interest rates because of their above-average dividend yields, slow growth, and lack of economic sensitivity. Also, energy is the most out of favor sector right now because of the recent weakness in oil prices and concerns about the weak global economic outlook. In this sector we continue to recommend Master Limited Partnerships with a focus on energy infrastructure. With the recovery of consumer spending, we recommend to equal weight the consumer discretionary sector selectively. As consumer tastes are becoming increasingly discerning, those companies offering differentiated products, better technical aspects, or garnering brand cachet will continue to outperform peers. Also, turning to innovation in health care, the focus of drug companies is shifting toward specialty-care areas, which should increase drug-development productivity. The pipelines of the major biotech and pharmaceutical companies are focused on smaller patient populations in areas such as immunology, virology, and oncology. We believe these areas offer unmet medical need, which should lead to better approval odds and stronger pricing power. Further, despite treating smaller patient populations, these indications can turn into major blockbusters.

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