INVESTMENT OUTLOOK

DIXON, HUBARD, FEINOUR & BROWN, INC. investment counsel

- Global markets up in second quarter.
- Bond yields still down for the year.
- Low market volatility may be a positive.
- Potential correction in second half of the year.

Second Quarter 2014 Review & Outlook

by Whitney Brown

Also in This Issue

All major asset classes from stocks to bonds to commodities gained in the second quarter. The broader U.S. market, as represented by the S&P 500 and the NASDAQ Composite indexes, added 5%. Developed markets in Europe and Asia also rose but trailed the U.S. Emerging markets sprang to life after a lengthy hiatus and matched the gains in U.S. markets. Small capitalization U.S. stocks endured a stiff correction in the quarter but still managed a small gain for the period.

Financial markets have not followed the game plan laid out at the beginning of the year by a multitude of prognosticators. Stocks were supposed to "melt up" on growing confidence in the economy and the return of individual investors to the market. The next move, depending on the bullish or the bearish script, was to be either a correction, aka buying opportunity, or a complete collapse like a house of cards. Bond prices were slated for a pummeling as the economy picked up steam and the Fed was forced to move up the timetable for rate hikes. None of that happened. Bond prices rose as yields moved decisively lower on downward revisions for growth in the U.S. and globally. The stock market took a short breather then resumed grinding its way higher.

The most remarkable thing about this market has been a very distinct lack of volatility. That means the typical day-to-day fluctuation in average market prices has been very low with small, steady gains and little downside movement. A number of market observers believe the low volatility is a dangerous sign of investor complacency. However, a more complete analysis indicates that periods of low market volatility can last several years or more and are associated with substantial market gains. High volatility is prevalent during bear markets and reaches extremes at market bottoms.

Generally, the market underpinnings remain on firm footing. The correction in small cap stocks over the quarter has led to some loss of momentum and a narrowing of breadth (number of stocks trending with the market). Despite the waning momentum, investors have demonstrated very little desire to sell, adopting a wait and see approach instead. And, though market sentiment may be too optimistic on a short-term basis, we are a long, long way from "irrational exuberance". The vast majority of global stock markets are in long-term uptrends as well, confirming the action in the U.S.

Market Measures	2nd Qtr.	YTD
S & P 500 (price)	4.7%	6.1%
Dow Jones Industrial Average	2.2%	1.5%
NASDAQ Composite	5.0%	5.5%
Russell 2000	1.7%	2.5%
MSCI EAFE	2.9%	2.9%
Barclays Capital Inter Gov't/Credit Bond Index	1.2%	2.3%
	6/30/14	6/30/13
10-Year Treasury Bond Yield	2.53%	2.49%
Three-month Treasury Bill Yield	0.04%	0.04%

Of course, there are risks. In an aging bull market, corrections can become surprisingly intense. An unexpected, though unlikely, surge in wage inflation due to a tightening labor market could rattle the market for fear the Federal Reserve would be forced to raise rates sooner than anticipated. An eagerly awaited reacceleration of economic growth in the second half of the year could fail to materialize. There is always the chance of an unforeseen external shock that could roil markets and deal a setback to the economy.

The benefit of the doubt still goes to the bulls. The market is in a well-established uptrend. In the absence of extreme readings for market valuation and investor sentiment, a spike in inflation expectations, or an oil price shock, a market correction in the second half of the year should be manageable. It could offer a prime opportunity to put idle cash to work.

Demographics and the Stock Market by Jim Hall

The investment world is famous for having a myriad of statistics and formulas all created in an effort to provide some level of predictability or directional edge for the stock market. One simple key factor that is sometimes overlooked relates to demographics and the resulting impact on supply and demand for stocks. We are all familiar with the phrase "Baby Boom Generation" or "Boomers."

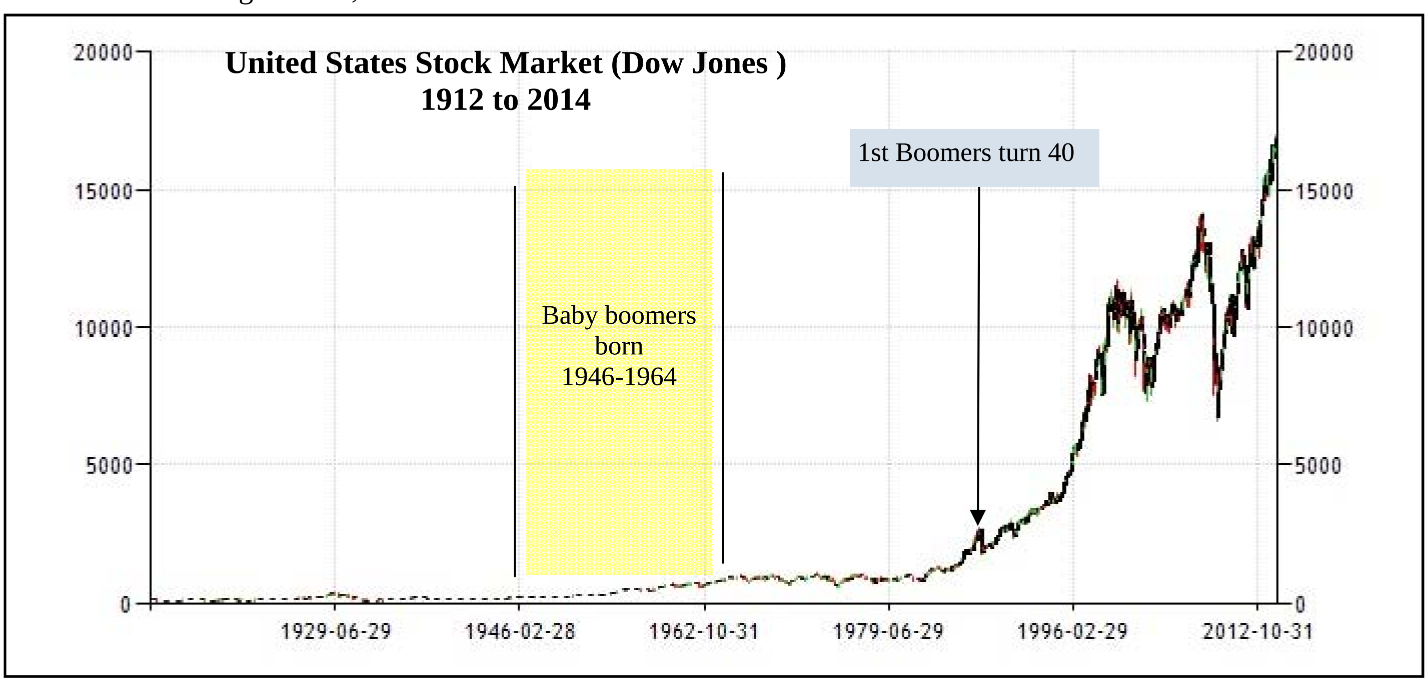
The easiest way to understand the Baby Boom phenomenon is to think back to the years prior to World War II; we were in the midst of a long-enduring Depression. After the war ended, our industry was growing, the economy was expanding, and people were optimistic. So optimistic in fact, couples married, had children, and set about "creating better lives" for their families. There were roughly 76 million people born between 1946 and 1964. As a group, these 76 million people were generally better educated and garnered more high-paying jobs than prior generations. Those high-paying jobs translated into greater wealth and more investments, especially when 401K plans and retirement accounts began replacing traditional pension plans.

Obviously stock prices are a reflection of demand (or lack thereof) for stocks. As more people desire to hold stocks either as outright investments or in their retirement accounts, that increased demand for stocks will cause their prices to rise. Think back to the '50s and '60s; it was rare to talk with anyone who owned stock, let alone owned an investment portfolio. As you can see in the chart of the Dow Jones Industrial Average below, from 1900 until 1980 the stock market took almost 80 years to reach 1,000. Since 1980, it has marched steadily higher to its current level of roughly 17,000.

The correlation can easily be drawn between the front edge of the 76 million Baby Boomers hitting their peak earning years as they turned 40 and the relatively quick 16,000 point rise over the past 34 years. Probably many of the Boomers were planning to migrate into a more fixed-income flavored portfolio in their retirement; however, with life expectancies increasing from about 60 years for a person born in 1930, to about 70 for a person born in 1960, combined with the unusually low fixed interest rates we've seen over the past few years, it's obvious many Boomers have chosen to stay in the market and garner their supplemental retirement income via dividends.

This begs the question "What happens to the market when rates start to rise?" For sure some of the Baby Boomers will rotate out of stocks and into fixed income which will provide downward pressure on stock prices. But, don't forget about the Boomers' kids ("Echo Boom," 80 million people born between 1982 and 1995) coming along. They are just now nearing their peak earning years and will most likely be the catalyst to continue driving stock prices even higher.

Keep in mind investments in the market aren't guaranteed to increase simply because of demographic pressures. Success in the market also involves research, analysis, and monitoring as there are numerous factors that can cause broad market pullbacks or individual stocks to decline.



Using Moving Averages to Keep in Sync with the Major Stock Market Trend by Watt Dixon

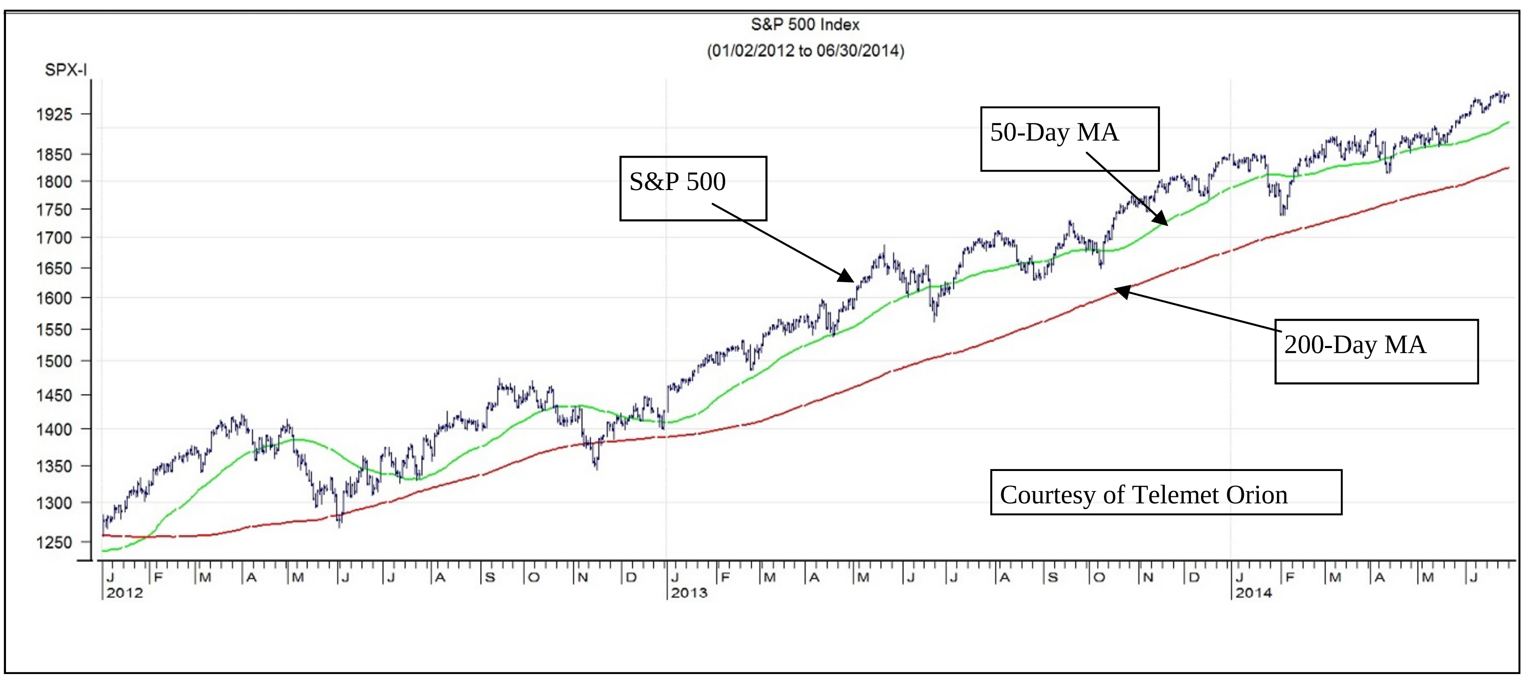
There is no question that the current bull market is getting on in age. While some market valuation methods see this market overvalued, other indicators are pointing to a fairly valued or even slightly undervalued market. The 1990's was a period when the stock market was believed to be overvalued for many years. Despite this fact, stocks continued their upward move for many years. By staying with the major trend of the market rather than worrying about valuation, an investor would have participated in most of the gains of this tremendous run up in stock prices. Staying in sync with the major trend of the stock market is very important.

By following "Moving Averages," investors can often filter out the day-to-day choppiness of the market and focus on the big picture, or the major trend. A moving average is an average of a certain body of data. The average "moves" because as each new day's price is calculated, the oldest price is dropped off. So, in a 200-day moving average, only 200 days of price action are used. Therefore, the body of data to be averaged (the last 200 days of closing prices) moves forward with each new trading day. In the chart below, you can see the 200-day moving average (bottom red trend line) is a much smoother pattern than that of the market (S&P 500) itself.

A moving average is a trend-following device. Its purpose is to confirm that a new trend has begun or that an old trend has ended or begun to reverse. It tracks the progress of the trend. It does not predict market action like some price charting patterns might do. The moving average is a follower, not a leader. It is a smoothing device, making it easier recognize the underlying trend.

One of the most basic uses of moving averages in technical analysis involves following the movement of a market index's price relative to its moving average. Specifically, when the price line crosses the moving average line, often referred to as "moving average cross-over," a buy or sell signal is a given (depending on the current trend of the market). So, if during a bull market with both the price line and moving average line trending upwards, the price line broke below the moving average line, one would view this as the beginning of a possible correction.

A moving average "cross-over" is a strong indicator of the possibility of a market correction or breakout. However, the direction of the moving average, used as a confirmation of the major price trend direction, is the most reliable use of this technical principle. At DHFB, we prefer the longer-term 200-day moving average to confirm the direction of the major market trend. The shorter term 50-day moving average is useful in spotting early weakness in a trend and pinpointing buy or sell points. The chart below shows both the price of the S&P 500 and moving averages in confirmed uptrends, a bullish sign.



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Supreme Court Ruling Affects Inherited IRAs by Ted Feinour

Earlier this month the United States Supreme Court unanimously ruled that inherited IRAs are not protected in bankruptcy. The Court's ruling turned on three key legal distinctions between inherited IRAs and those that are established and funded either through annual contribution or by rolling over assets from a company-sponsored retirement plan.

First, an IRA beneficiary who has inherited the account cannot make additional contributions to that account. Individuals are allowed to deposit money into retirement accounts such as traditional IRAs and Roth IRAs. The tax advantages encourage such deposits, but inherited IRAs are only for withdrawals.

Second, all beneficiaries of inherited IRAs must take withdrawals and pay the resulting tax on those proceeds regardless of age, and third, the early withdrawal penalty does not apply to inherited IRAs. Withdrawals from traditional IRAs and Roth IRAs before age 59½ are subject to penalties unless certain exceptions are met.

Generally, non-spousal IRA heirs must either withdraw the total account balance within five years of the original owner's death or begin to take required minimum withdrawals each year starting by December 31 of the year after the original IRA owner died. The purpose of an inherited IRA is not to have protected retirement funds available for one's lifetime, and the court found that "nothing about the inherited IRA's legal characteristics would prevent (or even discourage) the individual from using the entire balance after bankruptcy proceedings are complete."

Therefore, The Supreme Court made the distinction between inherited IRAs and traditional or Roth IRAs and decided inherited IRA funds should not qualify for the same bankruptcy exemption protections as retirement funds.