Investment Management of Virginia

Investment Viewpoint

July, 2014

Overview

As of the end of the first quarter of 2014, we observed consolidation in the equity markets with performance resting in a tight range across most indices. Second quarter stock performance proved to be significantly more discriminating and distributive across different capitalization ranges and sectors. The S&P 500, S&P 1500, S&P 600, and Russell 2000 closed the quarter with total returns of +5.23%, +5.05%, +2.07%, and +2.05%, respectively. Sector rotation continued with Energy (+11.4%) and Utilities (+6.8%) leading; and Consumer Discretionary (+3.1%), Financials (+1.8%), and Industrials (+3.3%) each lagging – effectively the reverse of 2013 performance trends. (These sector figures exclude dividends). Year-to-date through June 30th, Energy and Utilities led the 10 sectors with double-digit total returns of +12.98% and +18.65%, respectively.

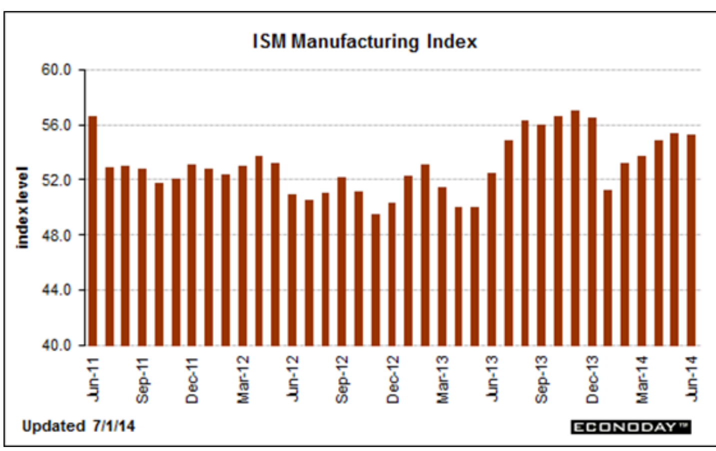
Adverse winter weather, accompanied by shifting healthcare expenditures, low inventory builds, and subdued consumer spending, delivered negative GDP growth for the first quarter (-2.9%). During the second quarter, the weather warmed, logjams were removed, and pent-up demand and animal spirits were turned loose. Most economic and sentiment indicators gathered steam into spring and early summer, with recent data reflecting an impressive rebound both at home and abroad.

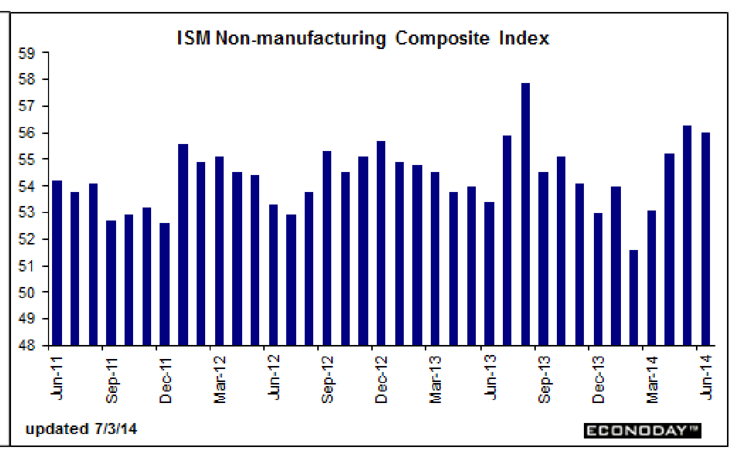
Despite concerns over elevated earnings multiples, potential inflation, and rising tensions in the Middle East, we believe that further advances in the markets are possible near-term; but they depend heavily on continued improvements in earnings, as multiple expansion likely has run its course for this cycle. As was stated in the June *2014 S&P Dow Jones Indices Lookout Report*, "The central question gnawing at investors is will future GDP growth be strong enough to deliver higher earnings?" Continued and sustained economic expansion will be essential. Presently, the economic data and backdrop appear to be improving.

Economic Trends

"Year-to-date acceleration increases the odds that the expansion has indeed entered a new chapter." (ISI Group)

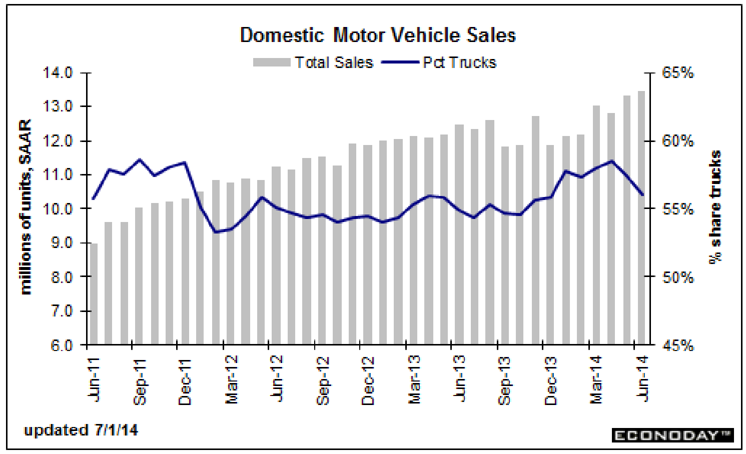
- According to Deutsche Bank, investors should "expect the global economy to gain traction over the coming quarters. U.S. growth should trend above 3% for the remainder of the year, the Eurozone economy is expected to strengthen on the back of a recovering periphery, while China growth looks to have bottomed-out in Q1, moving forward with an export-led recovery. Despite the improving growth outlook, central banks continue to maintain their dovish bias given the fragile nature of the recovery to date, the ongoing need for deleveraging and the threat of persistently low inflation."
- As seen in the charts below, recent manufacturing and service purchasing manager surveys demonstrate sharp rebounds from the adverse weather-related declines reflected in the January data. Furthermore, both measures indicate healthy expansion in manufacturing (55.3) and service related (56.0) industries. In the history of this data series, at no point has an economic

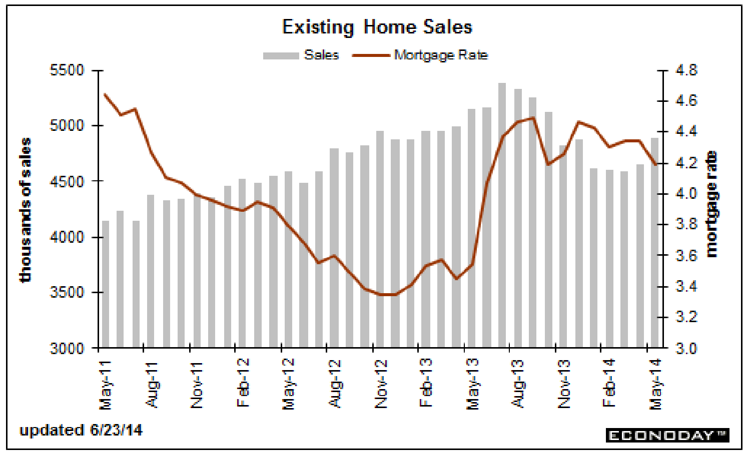




recession occurred concurrently with readings greater than 50.

- In June, vehicle sales increased to a 17.0 million annual rate, the strongest since July 2006. Sales of both North American-made and foreign-made vehicles rose in the month. Domestic vehicle sales rose to a 13.5 million annual rate, as can be seen in the chart.
- Existing home sales jumped 4.9% in May on top of April's 1.5%, the first back-to-back monthly gain for this series since April-May of last year. Notably, the single-family component of the June data – heretofore the laggard – rose 5.7%.
- Inventory-to-sales, which had risen during the first quarter, moved back toward lean levels, perhaps boding well for forward inventory rebuilding.
- Construction spending remained soft but turned up somewhat. An uptick in public spending appears long overdue.
- Utilization and industrial production advanced; margins and productivity decelerated as wages, hours worked, and unit costs rose. Inflation emerged on several fronts.
- "In unison a number of indicators have hooked up YTD, including bank loans, revolving credit, railcar loadings, and first call earnings revisions. The fact that these four indicators all show the same YTD acceleration increases the odds that the expansion has indeed entered a new chapter." (ISI Group, June 10, 2014)

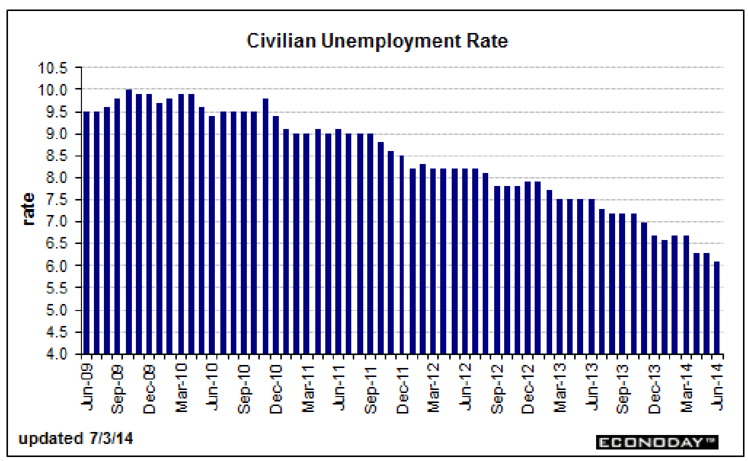


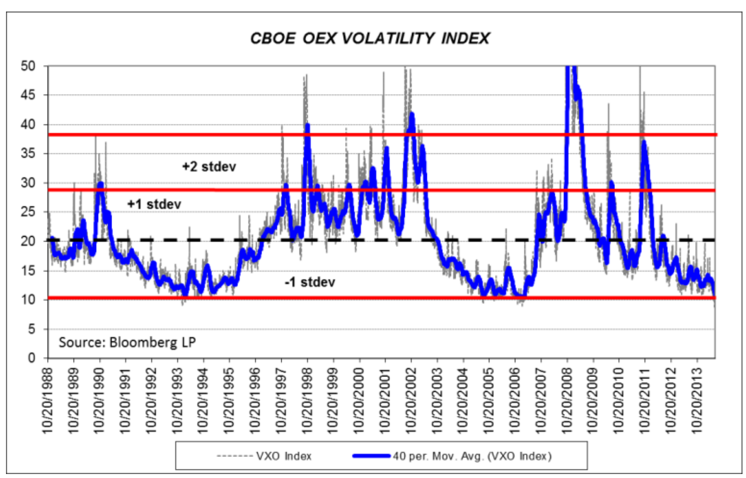


Financial Conditions/Monetary Trends

"Big Surprise" - Lower interest rates; more easy money.

- The second quarter's "Big Surprise" was the flattening of the U.S. yield curve (long rates falling) even as equities advanced and inflation emerged. We attribute this phenomenon to absolute fears about weak GDP and relative faith in U.S. markets versus other alternatives.
- In fact, U.S. Treasuries (along with British Gilts) attracted money flows on a massive scale, driving the 10-year U.S. Treasury yield down to 2.6%. Oddly, this figure remains within a point of the yield for like-maturity paper from lesser quality Mexico, Italy, Spain, and Portugal! Given a menu of choices that includes only low and lower yields (all manipulated by central banks), investors flocked to quality and creditworthiness.
- The E.U. central bank recently set a negative interest rate (-0.1%) for deposits and suggested ECB rates will remain low for another 2 ½ years.
- In the U.S., the FOMC further reduced its asset purchase program. In July, the Committee will "add" to its holdings of agency mortgage-backed securities at a pace of $15 billion per month rather than $20 billion per month, and will add to its holdings of longer-term Treasury securities at a pace of $20 billion per month rather than $25 billion per month, still adding $35 billion of stimulus.
- Civilian Unemployment, "while elevated", continued to make progress toward the Fed's statutory mandate.

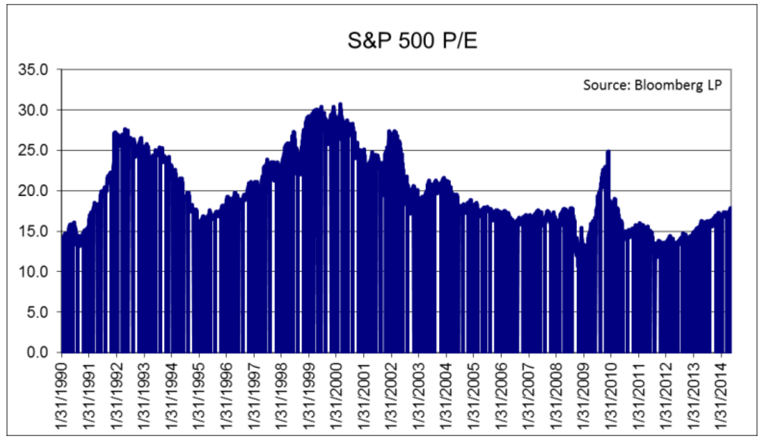


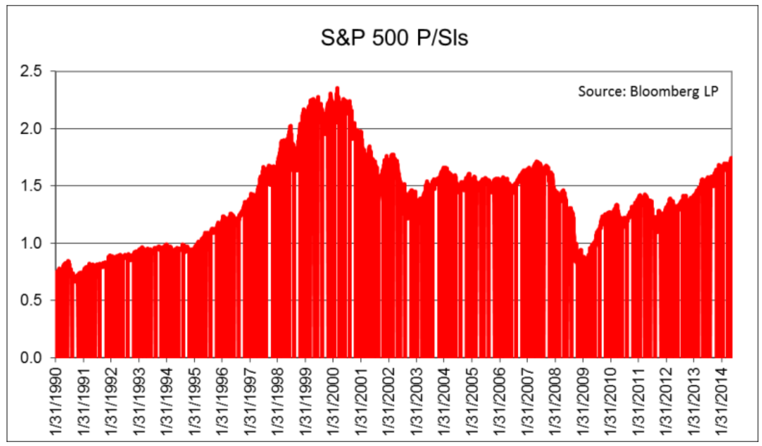


Sentiment Indicators/Market Trends

Sentiment/Market Trends hold a neutral stance.

- The last chart on Page 2 shows that volatility remained at historic lows. As can be seen in the prior two recoveries, low volatility is not necessarily indicative of a declining equity market.
- According to ISI Group, low economic volatility is driving overall capital markets' volatility lower, well below their historic mean. This trend could persist, absent surprises.
- Although market highs often travel with complacency, ISI's hedge fund survey indicated that many investors still give equities little respect. In our view, investor skepticism and frustration appear "healthy".

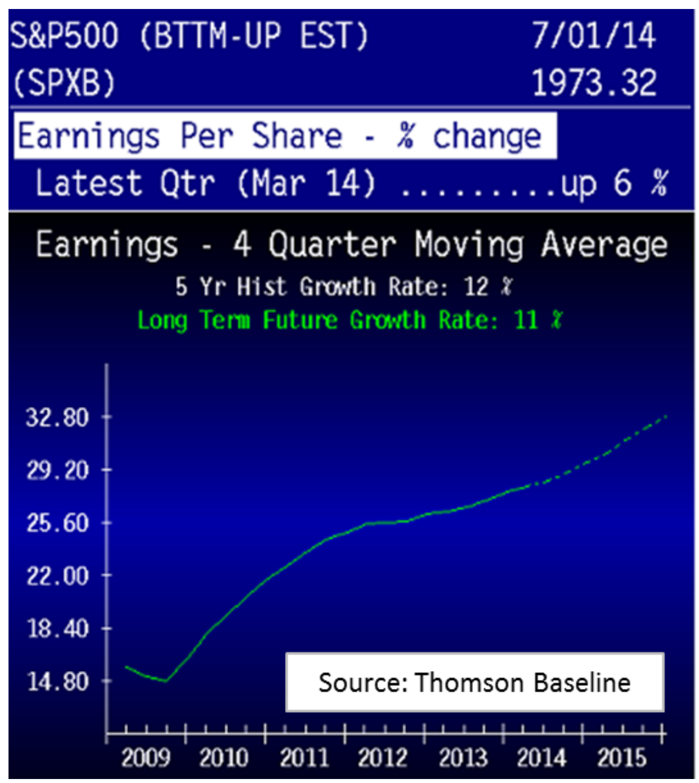




Equity Market Valuations & Earnings

Will future GDP growth deliver higher earnings?

- The adjacent charts suggest that price/earnings and price/sales valuation metrics appear full – but well below the levels associated with the euphoric late 1990s, and also below the spikes generated when the numerator declined less swiftly than the denominator (recessions of the early 1990s and 2009).
- On the other hand, these same metrics appeared "full" throughout the complete recovery period of 2004-2007.
- The final chart illustrates that forward expectations point toward rising and accelerating earnings. S&P 500 earnings are penciled in to expand 6% in 2014 and accelerate to 11% growth in 2015. Of course, these are expectations that require monitoring. As of the end of the second quarter, recent economic data, including global easy monetary policies, abundant liquidity, and a low interest rate environment, provided a positive backdrop, one that we hope will be supportive of rising earnings.



For an in depth review of our Market Pillars and Charts, visit: http://www.imva.net/market-pillars/.

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