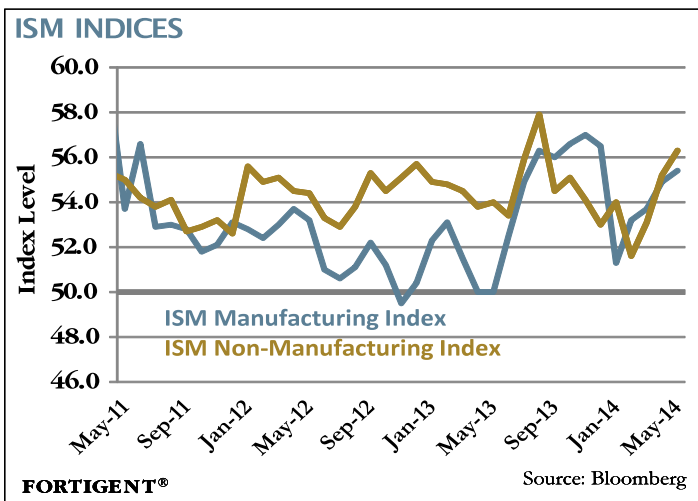


## May Flash Report – June 5, 2014 (Month Ending May 31, 2014)

### ECON: SUPER MARIO GOES SUPER KEYNESIAN

**Economic Data:** The second estimate of first quarter GDP showed the US economy contracted by 1.0% quarter-over-quarter. This is a substantial shortfall relative to consensus forecasts of a 0.5% decline. Investors did not seem overly concerned with the disappointing GDP revision as markets remained in positive territory. The primary reason for the pronounced negative revision was a larger than previously estimated decline in private inventories and wider than originally reported trade deficit. Stripping out trade numbers and inventories, GDP was revised up to 1.6% from 1.5%.

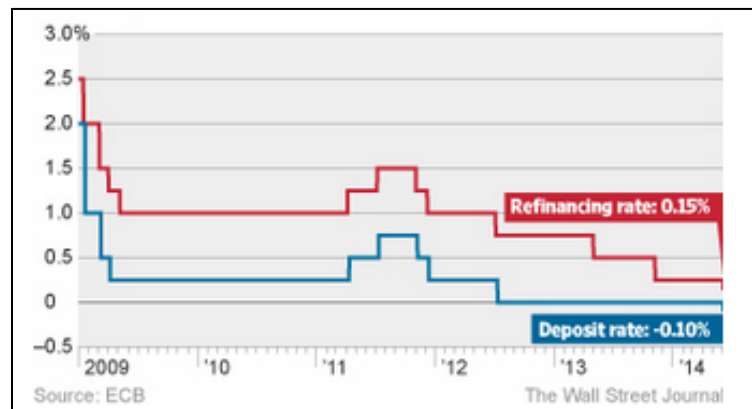


Despite several errors in the initial report, the ISM indices came in positive for the month of May with the service sector jumping to 56.3 from 55.2 in April and the manufacturing sector expanding from 54.9 in April to 55.4. The ISM Non-Manufacturing index has trended in expansionary territory (i.e. above 50) for 53 straight months as activity rebounded from the impact of severe winter weather in January and February. The ISM Manufacturing index improved in May but fell just shy of economists' expectations of 55.5.

On the housing front, home prices continued to climb, albeit, at a slowing rate. The

S&P/Case-Shiller Home Price index increased roughly 1.2% month-over-month in March, exceeding expectations of a 0.7% increase. However, year-over-year growth slowed to 12.4% in March from 12.9% in February, reflecting weaker homebuyer demand. This was confirmed by slower pending home sales growth. Pending home sales growth rose 0.4% month-over-month, coming in well below expectations of a 1.0% increase. With decelerating data coming out of the housing market, debate surrounding Fannie Mae and Freddie Mac's roles moving forward has grown more heated as the Fed continues to taper its asset-purchasing program and home loans grow more expensive.

**Central Banks:** As markets had anticipated, the European Central Bank (ECB) decided to cut rates to historical lows while announcing a series of measures to increase lending. The ECB dropped its main refinancing rate from 0.25% to a record low 0.15% while also lowering the interest rate on overnight bank deposits to -0.10% from 0.00%. ECB President, Mario Draghi, also announced



the implementation of a targeted long-term refinancing operation that provides banks with access to low interest rate loans. Furthermore, Draghi expressed that the ECB could implement a large-scale asset purchasing program similar to those currently employed by the US Federal Reserve and Bank of England. Central bank and government officials in Germany have been strong opponents of this type of program as they believe it is in violation of the ECB's mandate. Germany Chancellor, Angela Merkel, declined to comment following the ECB's decision.

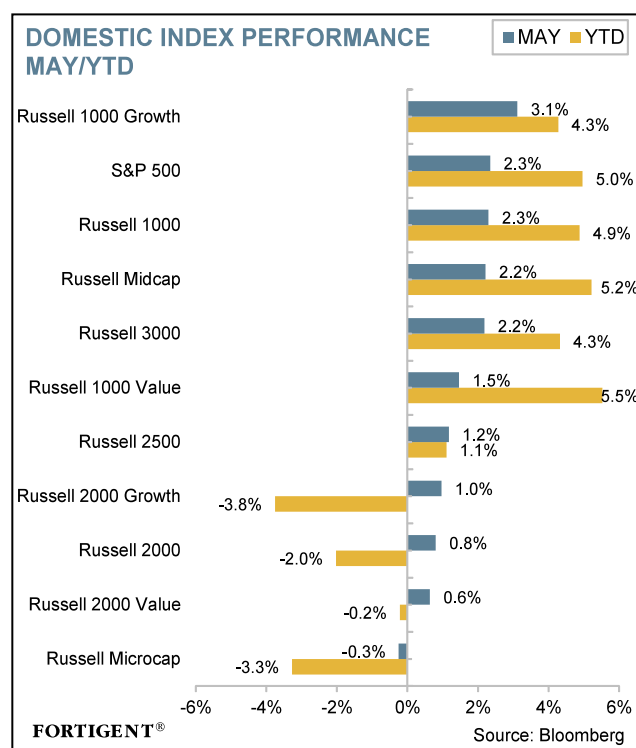
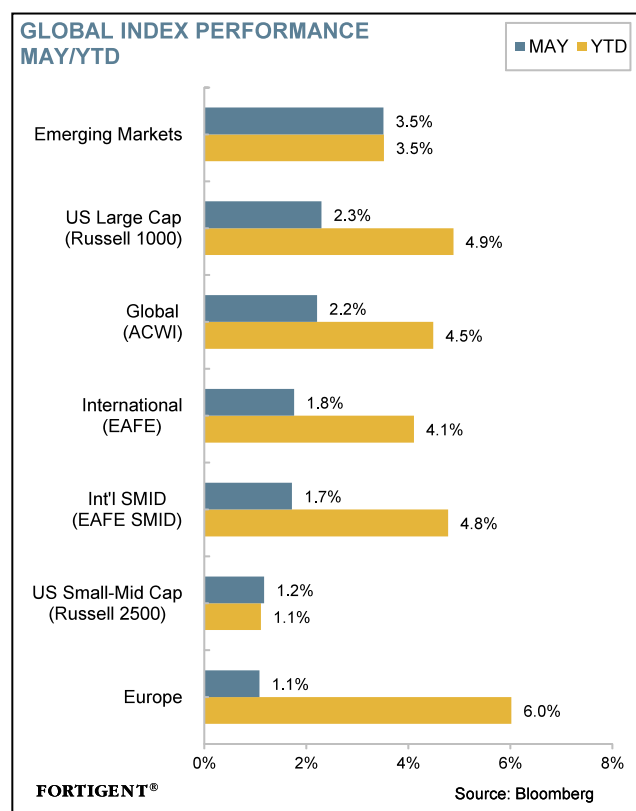
**Source: CentralBankNews.info, ADP Employment, Bloomberg, Reuters, WSJ**

## GLOBAL EQUITIES: GLOBAL GROWTH SET TO ACCELERATE?

Global equity markets scoffed at the old adage to "sell in May" as the MSCI ACWI index rallied 2.2% in what has historically been the beginning of a seasonally weak period of the year for equities. Japanese equities led to the upside, rallying 4.1% in anticipation of additional monetary easing from the BOJ. Emerging market equities broadly outperformed, led by India (+9.6%) and China (+4.7%) on confidence that recent progress on political reforms would lead to accelerating economic growth. Developed market equities most exposed to emerging markets enjoyed the strongest participation in the global rally, while areas most exposed to developed market economies lagged considerably. Most notably, small and mid-cap US stocks continued to lag as investors awaited clarity that the US economy was improving after an unusually harsh winter, while European stocks underperformed as investors await clarity on monetary policy support from the ECB in early June.

### US:

Positive earnings results, expectations for improving global economic growth, and dovish comments from several Fed officials drove a rebound in US equities in May. The S&P 500 rose 2.3%, but strength was concentrated primarily in the second half of the month. Strength in the US dollar appears to be the catalyst for the steep climb off the lows on May 15, driven by expectations that the ECB would engage in quantitative easing to battle deflationary pressures in the Eurozone. US dollar strength pushed commodity prices lower, which in turn led to strong gains in many of the



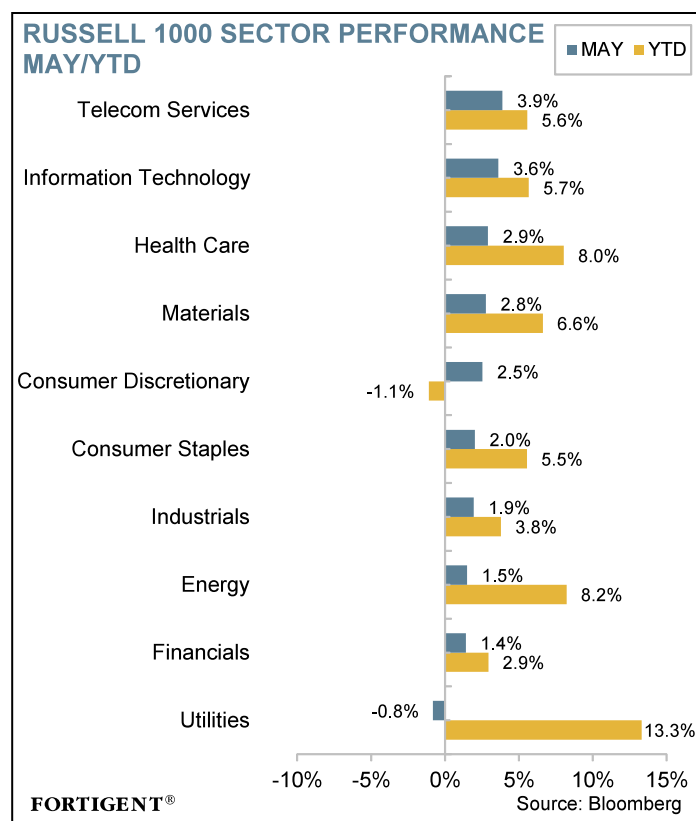
growth-sensitive areas that underperformed most in the recent correction. Most of the outperformance in May was concentrated in large cap stocks, especially those most leveraged to improved global economic growth. Small cap stocks on the other hand, which are typically more sensitive to moves in the domestic economy, continued to lag as investors await clarity on economic momentum coming out of the harsh winter in Q1. Implied volatility declined sharply to the lowest levels in more than a year, with the VIX falling 14.8% to 11.4.

Sector trends were almost a complete reversal of what occurred in the prior month, with many of April's worst performers taking leadership positions in May. This was particularly evident in health care and technology, where many of the momentum-oriented names hurt last month regained some lost ground. Rebounds were less pronounced in the domestically-sensitive consumer discretionary and financial sectors, prior leaders whose recent underperformance remains a headwind for the broader markets. Utilities was the only sector down for the month, driven largely by profit taking after the extreme winter weather in the US drove earnings upside via higher heating costs. While market cap leadership continued to favor large cap over small cap, style leadership was less consistent. Growth outperformed value in both large and small cap indices, but the degree of outperformance was much more significant in large cap. This most likely reflects improved optimism surrounding international economic growth, where large cap stocks have a much larger share of non-US revenue.

### International/Emerging Markets:

International equities saw a reversal in May as emerging markets outperformed developed. Russia (+12.2%) was the major winner, as the country appears to be experiencing a relief rally after a significant drawdown due to the Ukraine conflict. India (+9.6%) continues to enjoy support from positive political sentiment, as the pro-business BJP led by Narendra Modi won a clear majority in the recently concluded election. China (+4.7%) surprised to the upside considering the country's ongoing slowdown and geopolitical tensions, but improved April trade data and PMI (49.4 – still indicating contraction) helped to support equities. It appears that the pace of the country's deceleration may be slowing, but more data points will be necessary to further confirm.

Japanese equities broke out of their year to date slump, turning in a positive 4.1% for the month. The Nikkei strengthened late in May after Bank of Japan Gov. Kuroda stated that monetary easing was having its desired effect and that he was confident that the bank would meet its 2% annual inflation target. This was later confirmed with the April CPI print of 3.4% YoY, a 23-year high, which was helped by the 3% sales tax increase on April 1. Somewhat similarly, European equities rose in anticipation of the upcoming ECB meeting, in which many investors expect Mario Draghi to announce further easing measures to combat deflation.



US telecom stocks led all sectors in May, despite weakness in AT&T after the company announced its bid for DirecTV. The sector enjoyed strong performance in bellwethers Verizon and T-Mobile. Technology stocks were also strong, both in the US and internationally.

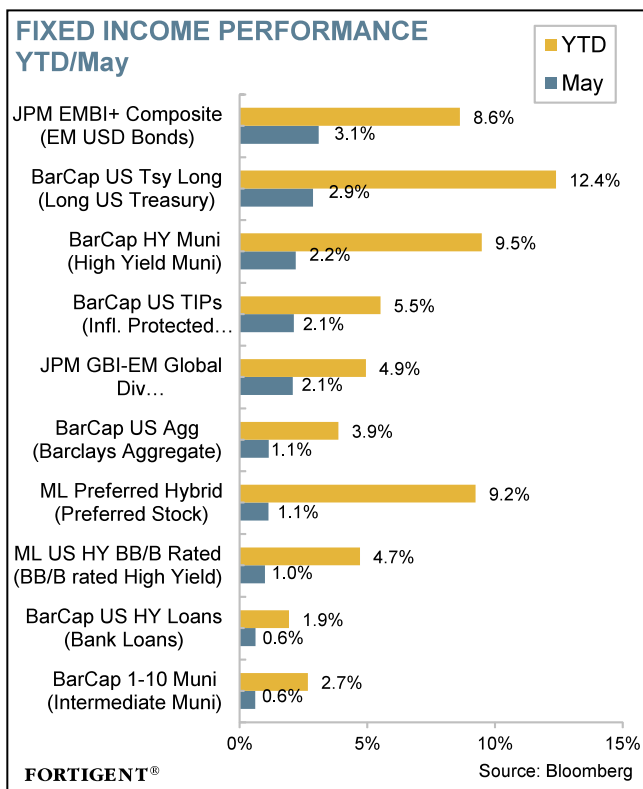
Source: MSCI, Bloomberg, WSJ, The Economist, Morgan Stanley, Bespoke, FactSet, Russell, Reuters, J.P. Morgan, Barclays Capital, Financial Times, Goldman Sachs

## FIXED INCOME: A RALLY, REALLY!

Fixed income markets continued 2014's string of solid performance as yields fell across all fixed income sectors along with US Treasuries. The fixed income market reaction presents a bit of a conundrum; with the Dow and S&P 500 reaching new highs at the end of May this suggest some belief the US economic slowdown in the first quarter was an aberration. Under normal circumstances Treasury yields should rise. This month's move appeared more of a reaction to global activity as developed fixed income markets yields compressed in anticipation that the European Central Bank's and Bank of Japan's easing efforts likely offsets the US Federal Reserve Bank's tightening. There was also investor reallocation; with long term investors around the globe preferring the additional yield available in US Treasuries relative to nations such as Germany and Japan. In looking at the numbers, the Treasury yield curve continued to flatten while the 10 year US Treasury reached its nadir near month end at 2.48%.

Developing fixed income markets rallied as well as the search for yield remained a global pastime. EM dedicated bond funds captured assets and extended a nine week streak of inflows through the end of May; hard currency bonds (\$ and EUR denominated EM) captured the bulk of flow. Local currency bond mandates did capture some flow as well but outflow from Japanese retail and pension investors weighed a

bit on this area of the markets. Nevertheless yields for local currency benchmarks reached their year to date nadir as well, touching 6.59% at month end. Currency exposure for a US investor was a bit of a detractor as depreciation from the Russian Rubble and South African ZAR weighed on benchmarks. The broad dollar index remained essentially unchanged.



## US Treasury Yields

Security	12/31/2013	5/31/2014	Δ Yield
90 Day	0.05	0.03	-0.02
2 Year	0.38	0.37	-0.01
5 Year	1.74	1.54	-0.20
10 Year	3.03	2.48	-0.55
30 Year	3.97	3.33	-0.64

SOURCE: BLOOMBERG

## AAA Municipal Yields

Security	12/31/2013	5/31/2014	Δ Yield
2 Year	0.52	0.49	-0.03
5 Year	1.49	1.32	-0.17
10 Year	2.97	2.60	-0.37
20 Year	4.58	4.02	-0.56
30 Year	5.18	4.69	-0.49

SOURCE: BLOOMBERG

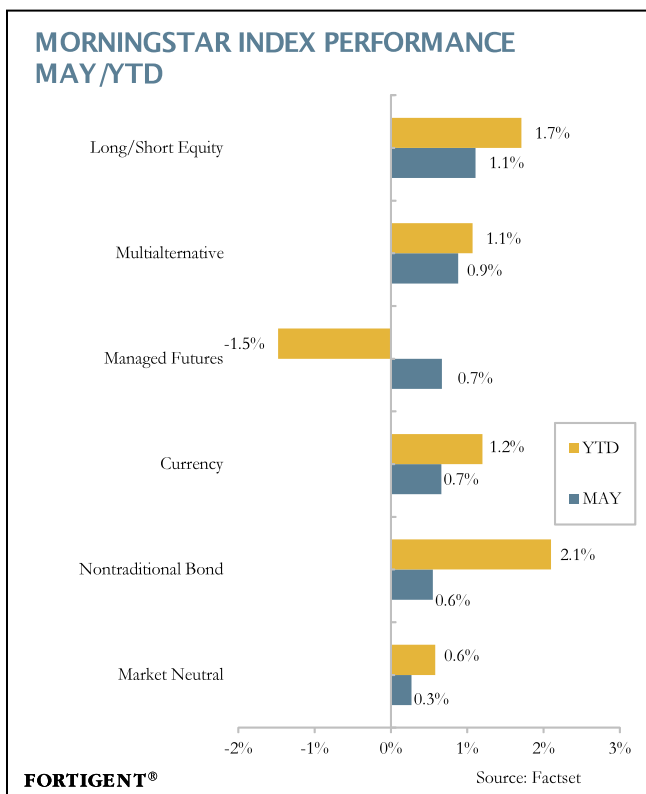
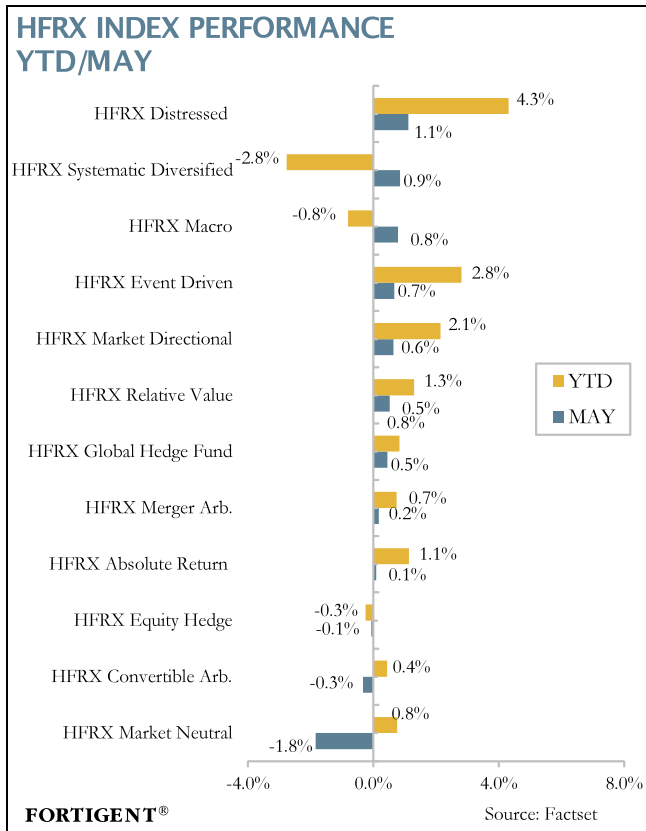
Municipal bonds followed the US Treasury move in yield resulting in another strong month for the muni market. In fact, this was the strongest monthly gain since January and the third strongest monthly May performance since 1998. Retail fund inflows remained strong with taxable investors recognizing strong relative value compared to high quality taxable instruments. Institutional investors were a bit less enthused about the market selling a bit into strength; however the continued rally in the US Treasury market seemed to temper their appetite to capture gains. Supply did not fully meet the retail demand causing muni yields to collapse even further. The additional yield offered for lower quality muni credit collapsed as well highlighting the thirst for safe yield and income.

**Sources: Barclay's Capital, Bloomberg LP, J.P. Morgan, Municipal Market Advisors**

## ALTERNATIVES: EQUITIES UP, RATES DOWN, TREND FOLLOWERS GAIN

**Hedge Funds:** Hedge fund performance on the month was mostly positive with the exception of market neutral strategies. Despite a stellar April, market neutral strategies declined 1.8% in May. Declines were experienced across factor-based models and fundamental and trading oriented strategies. Given their inherent nature to long value versus growth, underperformance on the month comes at no real shock as growth stocks outperformed value.

Notable outperformance on the month came from distressed and macro focused strategies. Distressed strategies gained 1.1% as restructurings across technology, consumer, and communications sectors were advantageous. Macro strategies reversed April's drawdown with 79bps of positive return. Amongst macro focused strategies, managed futures fared best, ending the month up 85bps. Managed futures managers (i.e. trend followers) were able to capitalize on steady trends experienced across equity, fixed income, currency, and commodities markets.





**Liquid Alternatives:** Alternative mutual funds were positive across the board in May, with long/short equity and multialternative as the best performers. Returns were generally in line with to higher in the 40 Act space relative to their hedge fund counterparts.

Long/short equity returned 1.1% for the month, participating in the 2.4% rally that occurred in domestic equities. Performance for long/short equity managers was roughly in line with the overall beta profile of the category, suggesting little positive or negative alpha. Mutual funds were able to outperform comparable hedge fund indices, as the HFRX Equity Hedge Index shed roughly 0.1%. Sector positioning was important, but long/short equity funds struggled as a result of an overweight in financials, which were only up 1.3%. Multialternative was the second best performing category as managers finally caught a tailwind from positions such as long US Dollar.

Overall, liquid alternatives performance improved after a quiet April, but it was generally a story of beta at the index level. Individual managers demonstrated alpha generation capabilities, with some long/short managers capturing almost 100% of the equity market performance despite modest net exposures, as one example.

**Sources:** Bloomberg LP, Hedge Fund Research, Morningstar Direct, Credit Suisse

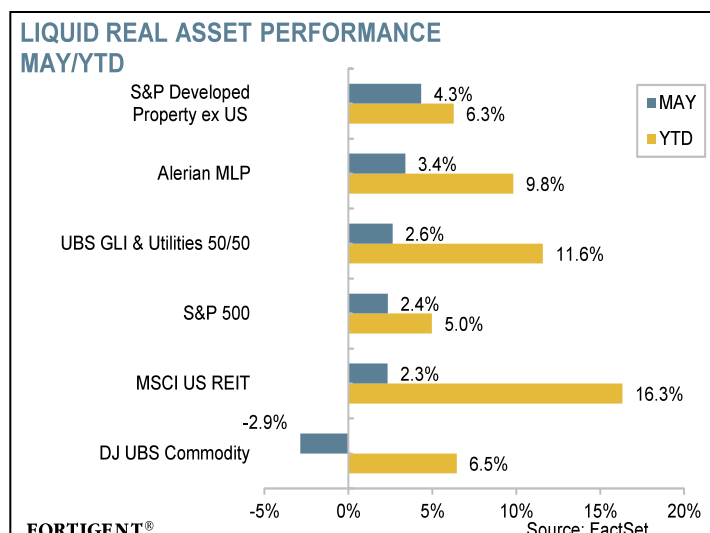
## INTERNATIONAL REITS LEAD

Global rate compression continued to support high-yield real assets during the month, while commodities paused after a strong start to the year. Several encouraging regulatory headlines helped amplify optimism for MLPs.

**Commodities:** The agriculture complex experienced a sharp sell-off in May due, in part, to normalizing weather patterns. Coffee tumbled 14% post a 75% start to the year, as rains in Brazil eased drought conditions. Wheat (-13%) and corn (-10%) fell on robust US and Canada planting data. Natural gas (-6%) rounded out the detractors (the four accounted for 75% of May's weakness) after reports showed greater than estimated storage injections.

WTI Crude and industrial metals provided some reprieve. Crude rose 4%, aided by geopolitical uncertainty in Russia and Libya that placed strain on already tight excess reserves. Industrial metals, particularly copper (+3%) and nickel (+5%), rose on growing hopes for fresh economic stimuli in China.

**MLPs & Global Listed Infrastructure:** MLPs enjoyed their first positive May in five years with the help of Washington DC-sourced headlines. First, the Department of Energy (DOE) released two reports that effectively supported the case for LNG exports (it offered no definitive view of the environmental impact), which was a boon to drillers and pipeline operators. On the same day, the DOE also announced



a change in the application process for LNG export facilities, eliminating one of the steps. Lastly, the EPA announced a new proposal that will require utilities to reduce emissions by 30% by 2030. To comply, US coal consumption will have to fall by 25% over the next 16 years (coal MLPs were down 3.6% in May). Part of the offset will have to come from natural gas - additional support for pipeline operators. Elsewhere in infrastructure, global transportation (+5%) enjoyed a strong month thanks to a rebound in Japanese railway stocks. Weakness came from US utilities, where the aforementioned EPA proposal met with analyst downgrades stemming from a long-term increase in residential solar use.

**REITs:** Although investor flows continued to support US REITs during the month (YTD inflows into REIT funds outpacing underlying equity issuance), most of the story domestically and abroad can be summed up by falling interest rates. REITs tend to display characteristics of positive duration, so when the US 10-year Treasury yield declined below 2.5%, REITs surged. In Europe, where only Portugal and Greece “suffer” local Treasury rates above 3%, yields compressed even further. The same theme persisted into Asia ex-Japan where the regional property index topped 4%. The strongest performance for the month, however, came from Japan, where it was not interest rates, but good old fashioned cap rate compression driving returns. Rental rates along with land prices are on the rise in Japan thanks to scarce new supply. The positive fundamentals helped offset questions surrounding recent tax hikes and the long-term efficacy of Abenomic monetary policy, ultimately helping the Japanese Property index rebound 7% in May after a dreadful start to the year.

**Sources:** MLPHINDSight, MLPDATA.com, S&P, FactSet, Alerian, Barclays, Bloomberg, AP, SNL Financial, WSJ, futuresmag.com, Platts.com, agweb.com, agrimoney.com; Reuters; thehill.com

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