DANDA TROUVÉ
INVESTMENT MANAGEMENT

Money Managers You Can Trust

July 2014 Thoughts and Insights

The first half of 2014 was very good for our investments despite the many surprises including severe winter weather that disrupted the US economy and geopolitical tensions in Ukraine and the Middle East. While we don't believe we are entering a stock market crisis period like in 2008, there are certainly factors that have our attention looking to the second half of 2014. This note may be more technical in nature than previous quarterly letters, but we would like to share some of the data highlights we use in our analysis. One of the many financial sources we subscribe to is "Breakfast with Dave Rosenberg", a highly respected economist and strategist, and we are citing some of his research notes.

The Q2 earnings season gets underway this week. Companies have become increasingly wary as reflected by the "negative-to-positive pre-announcement ratio" which for Q2 is 4-to-1 negative versus the long run norm of 2.6-to-1, which signals that company's outlooks are weaker than expected. Outside of Tech (+12.3) and Energy (+11.2%), both of which are overweight in your portfolios, there is not a lot of hope for the rest of the S&P 500.

Despite this, the market is currently priced for perfection with the forward price-to-earnings multiple (P/E) at 15.7x, which is the highest it has been in nine years. In addition, the S&P 500 has gone 32 months now without a 10% correction, compared to the average 18 month run for bull markets. It is our belief that this market is technically over-extended.

The issue is really where to put your money in an environment where the Fed maintains a zero interest rate policy which is artificially supporting all asset prices. The current landscape where all assets are overvalued relative to historical norms is now being labeled the *Everything Boom*. There are no bargains in absolute terms so investment selections have become a "relative game" meaning investors are asking "what can I earn relative to the 10 year Treasury which is currently at 2.6%".

Amazingly, this has now been going on for six years, even with the US unemployment rate going from 10% to 6%. This was previously the most important metric used by the Fed, but now it has turned its focus to an eclectic group of labor force indicators including the participation rate, involuntary part-time work rates, wage trends, and long-term unemployment rates.

Furthermore inflation has doubled from 1% to 2% and the three month trend in core CPI (consumer price index) is already running at a 2.8% annual rate yet the Fed has shrugged this off as noise. The point I am making is that the Fed previously said that both of the metrics would be used to decide when to increase rates. We are worried that they do not plan to raise rates anytime soon, which is not good for our economy but is supporting the current investing environment. For this reason, we plan to stay the course but are keeping a very close eye on the equity market in particular.

8201 Mission Road, Suite 200 | Prairie Village, KS 66208 | Tel 913-262-1108 | Fax 913-262-2015
www.dandatrouve.com

One of the major problems with this cycle is the lack of productivity growth. Again, due to the artificially low interest rate environment, businesses have chosen to borrow more money at ultra-cheap rates to buy back stock in lieu of making capital expenditures and investing in growth. The Fed may believe that this policy of negative real policy rates is doing good, but in fact, we believe it is doing more harm to the economy at this point and should end.

So what do we do? Since the Fed has indicated that they will not raise rates until 2015 we believe the best approach is to remain invested in all asset classes yet be very attuned to market movements. We may take some equity profits in Q3, and we will continue to focus on dividend and income strategies and protect from inevitable inflation.

As always, we remain dedicated to you, your money and your investments. We welcome phone calls and visits to talk further about any of our thoughts, ideas, and strategies, as well as any questions or comments you might have.

Michelle

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