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May Investor Letter

Central bank policies spur markets globally

by Chris Brown, Chief Investment Officer

Dear Pax World investors:

Strong performance in the U.S. and several major foreign stock markets during the first three weeks of May could not be undone by declines on a few days during the last week of the month. We were reminded of just how reliant this bull market continues to be on the policies of the U.S. Federal Reserve (the Fed) and other central banks. Several observations during May reaffirm our investment thesis that a moderately paced, low level U.S. economic recovery continues to favorably influence the domestic stock markets.

U.S. markets: rotation from defensive to more cyclical stocks

While hitting consecutive new record highs during the first three weeks of the month, the Dow Jones Industrial Average (DJIA)[1] and Standard & Poor's 500 Composite Stock Index (S&P 500)[2] added 2.24% and 2.34%, respectively, for the four week period ended May 31, 2013, and the NASDAQ[3] index was up 4.02%.

A major contributor to NASDAQ's relatively stronger result was the information technology sector, which was part of a rotation from April's market movers when defensive sectors such as utilities, health care and consumer staples led the way higher. May's positive stock performance was driven to a greater degree by stocks from cyclical sectors. The strongest increases were in financial (6.09%), industrial (4.93%), and information technology (4.55%) sectors. Favorable performance of these sectors suggests investors may be gaining confidence in the sustainability of the economic recovery and placing their investment dollars in stocks of companies they believe will continue to benefit during the remainder of the cycle.

There were other positive signs for the economy and equity investments in May. Recoveries in the housing and automotive industries continued. April home sales, prices and building

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KEY TAKEAWAYS

- Strong performance in the U.S. and several major foreign stock markets during the first three weeks of May could not be undone by late-month declines.
- We were reminded of just how reliant this bull market continues to be on policies of the U.S. Federal Reserve and other central banks.
- Europe's major stock indexes delivered positive performance amid record low interest rates.
- Emerging markets that have been able to sustain stable economic performance may be overlooked.
- Japan's "Abenomics" economic program remained the most noteworthy story in the Asian markets.
- Several observations during May reaffirm our investment thesis that a moderately paced, low level U.S. economic recovery continues to favorably influence the domestic stock markets.

permits issued were higher. Car sales appeared to accelerate in May after a tepid April with analysts predicting a 7% increase over the prior year's May results.

Continued commodity price declines may be evidence that investors, anticipating potential deflation globally, could be shifting dollars to the equity markets on expectations of continued price/earnings multiple expansion[4]. Lower costs for materials could further benefit corporate profits which would support higher stock prices. Late in the month, Bloomberg News reported record flows of money into U.S. balanced mutual funds that buy stocks and bonds, potentially signaling more confidence among the segment of investors who have been tentative about returning to stock investments following the 2008 crisis.

What, then, caused the reversals in U.S. stock market performance at the end of the month? In a word: uncertainty. Investors appeared to grow concerned that the Fed was preparing to change its current policies regarding bond purchases and low interest rates. However, the Fed's stance is that it will continue its policies until unemployment has improved to 6.5% and inflation reaches a target of 2%. Both targets are still a fair distance away. Even with the consecutive days of declines at the end of the month, the Chicago Board of Exchange Volatility Index (VIX), a measure of investor sentiment, remained subdued, reading 16.30 on May 31, up from its 52-week low of 11.05 in March 2013 but well below the 52-week high of 27.73 about one year ago.

European markets shake off bad news

Positive economic signals were harder to discern in Europe during May. The European Union's first quarter gross domestic product (GDP) fell 0.2%[5] from the fourth quarter ended December 31, 2012, the sixth consecutive quarterly decline. While Germany's GDP grew 0.3% on an annualized basis for the quarter, France, Italy, Spain, Greece and Portugal saw contractions. Nevertheless, the region's major stock indexes delivered positive performance. During May, France's Cotation Assistée en Continu (CAC 40)[6] index was up 3.74%, Germany's Deutscher Aktien Index (DAX)[7] was up 5.50%, and the Financial Times/London Stock Exchange (FTSE 100)[8] index was up 2.84%, when measured in local currencies. Once again, record low interest rates – the European Central Bank cut interest rates again in May – and efforts to boost liquidity are benefitting the equity markets in the region. Some smaller emerging markets in the region that have been able to sustain stable economic performance are, perhaps, being overlooked in this environment.

Regionally, Asian markets uneven

Japan's "Abenomics"[9] economic program remained the most noteworthy story in the Asian markets during May. The Nikkei 225[10] market index had -0.62% decrease for the month based on the yen. That result reflects substantial declines at the end of the month when, once again, uncertainty about central bank policy put investors on edge. As measured in local currencies, two other major regional exchanges recorded increases for the month: the Shanghai exchange (SSE)[11] index and India's (S&P BSE SENSEX) exchange index[12] were up 5.63% and 1.31%, respectively. Australia's (S&P/ASX All Ordinaries) index[13] declined -4.93%. The Australian central bank lowered its benchmark interest rate in an effort to spur the economy in the face of declining activity in the mining industry there. The Hang Seng Index[14] fell -0.81%. Increasingly, indicators in China point to a continued slowing as industrial production recedes and the government's efforts to dampen price increases in the housing market through increased interest rates has not yet had an appreciable effect.

Stock selection remains critical

Certainly 2013 has brought a welcome relief from the risk-on/risk-off investor behavior of the past two years. During those years shifts in investor sentiment were followed by spikes in volatility and higher correlations[15]. Dispersion in stock performance across sectors and industries has increased in 2013. For example, the utilities sector had the strongest performance (tied with health care) with an 18.4% return in April. In May, it had the worst (-9.06%). These conditions increase the opportunities to select stronger performers across the equity sectors. Our jobs as active portfolio managers remain focused on picking the best performing stocks from among the best performing sectors. We continue to focus on leadership within the sectors as we position portfolios to benefit from changing business and economic conditions.

Sincerely,
Chris Brown
Chief Investment Officer
Pax World Investments

[1] *The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq. One cannot invest directly in an index.*

[2] *The S&P 500 is the Standard & Poor's composite index of 500 stocks, a widely recognized, unmanaged index of common stock prices. One cannot invest directly in an index.*

[3] *The NASDAQ is a computerized system that facilitates trading and provides price quotations on more than 5,000 of the more actively traded over the counter stocks. One cannot invest directly in an index.*

[4] *Price/earnings multiple is a valuation ratio of a company's current share price compared to its per-share earnings calculated as: market value per share divided by earnings per share (EPS). Also sometimes known as "price multiple" or "earnings multiple."*

[5] *"Week in Review for the week 5/13/2013 – 5/14/2013" StocksandNews.com, http://www.stocksandnews.com/week-in-review.php?aid=NDA0N19XUg==, May 18, 2013.*

[6] *The CAC 40 is the French stock market index that tracks the 40 largest French stocks based on market capitalization on the Paris stock exchange. One cannot invest directly in an index.*

[7] *The DAX stock index represents the largest and most liquid German companies that trade on the Frankfurt Exchange. One cannot invest directly in an index.*

[8] *The FTSE 100 is an index of blue-chip stocks traded on the London Stock Exchange. One cannot invest directly in an index.*

[9] *"Abenomics" describes the economic and monetary policies of Japanese Prime Minister Shinzo Abe and the Bank of Japan, respectively. These include low interest rates and government bond purchases intended to spark economic activity and higher rates of inflation.*

[10] *The Nikkei 225 Stock Average, the leading and most-respected index of Japanese stocks, is a price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. One cannot invest directly in an index.*

[11] *The Shanghai Index or SSE is a market composite made up of all the A-shares and B-shares that trade on the Shanghai Stock Exchange. One cannot invest directly in an index.*

[12] *The S&P BSE SENSEX (S&P Bombay Stock Exchange Sensitive Index) is a free-float market capitalization-weighted stock market index of 30 well-established and financially sound companies listed on BSE Ltd. representing some of the largest and most actively traded stocks representative of various industrial sectors of the Indian economy. One cannot invest directly in an index.*

[13] *The S&P/ASX All Ordinaries Index represents the 500 largest companies in the Australian equities market drawn from eligible companies listed on the Australian Stock Exchange. One cannot invest directly in an index.*

[14] *The Hang Seng index is a market capitalization-weighted index of 40 of the largest companies that trade on the Hong Kong Exchange. One cannot invest directly in an index.*

[15] *Correlation is a statistical measure of how two securities move in relation to each other. The correlation coefficient ranges between -1 and +1. Perfect positive correlation is a correlation co-efficient of +1 which implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random.*

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