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Financial Market Commentary: 2nd Quarter 2013

A Policy-Driven to a Fundamental-Driven Financial Market is Bumpy

As the U.S. equity rally continually gained admirers early in the quarter volatility returned to the markets late in the quarter. For those who finally dipped their toes back into the sea of risk assets, the recent market swings may have felt as if they'd got in at the wrong time. However, according to most experts, business fundamentals in the U.S. have not changed except that the Federal Reserve has indicated that a strengthening economy may allow them to potentially scale back quantitative easing earlier than previously expected. If the Fed's goal in announcing a swifter tapering of asset purchases was to avoid the current U.S. equity rally from becoming another asset bubble, they may have succeeded. The pendulum has swung from concerns that the Fed will stay loose for too long to fear that the Fed will be too quick to tighten. Concerns that the financial market rally has been an entirely Fed-induced party sent shock waves across most asset classes during the months of May and June. While it may be true the Fed is backstopping the economy, the Fed is not driving the stock market.

Fundamentals Are Cautiously Sound as the U.S. Remains Positioned for Growth

Within the recent months U.S. stocks have come under some pressure and it appears that the U.S. economy may be entering another slow patch. This cycle is a common occurrence during an expansion. According to most economists and analysts, U.S. businesses are in good shape, driven by pent-up demand, affordability and a pickup in the housing sector, which has the potential to continue its gains in the second half of the year. Houses are being built, and the housing sector is a labor-intensive part of the economy. In the last recession, most of the private sector job losses came from this sector, which is starting to recover from depressed levels.

Historically U.S. assets have offered a higher return on equity compared against Japan, and it is also becoming true against major European indices. This higher return, combined with lower U.S. energy prices, is attracting capital to the United States. The capital flow to the United States is driving the U.S. dollar higher. Keep in mind there is an inverse relationship between the dollar and commodities. In other words, as the dollar rises, commodity prices tend to fall. The U.S. economy which is consumer-driven benefits from lower commodity prices. Although U.S. consumers have been constrained by moderate wage increases, lower commodity prices offer more buying power. This virtuous circle is one reason why the U.S. consumer and the U.S. stock market are thriving compared to counterpart asset classes.

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Effects of the Feds Monetary Policy Change

Many argue that since the U.S. Dollar (USD) is the world's reserve currency, the U.S. can run fiscal deficits, increase debt and have the Fed print money to buy the debt and most countries will continue to hold the USD as well as U.S. Treasuries. This status creates a large and ready demand for U.S. Treasuries.

Comments from the Fed regarding the conditional ending of its bond-purchasing program were inevitable, as it is not a realistic expectation that the Fed could print money indefinitely. In addition, many believe the longer the program continues, the longer distortions in the market would last. Furthermore, it is important to remember that the end of printing new money does not mean the end of loose monetary policy. The Fed has yet to provide any detail on the process of unwinding its balance sheet, and it may not likely happen in the near term. Despite the Fed eventually discontinuing new purchases, and even gradually raising interest rates, it would still equate to fairly loose monetary policy given the size of the Fed's outstanding balance sheet. In terms of total policy, the Fed still provides a lot of liquidity to the rest of the world.

Additionally, any policy change would be a function of economic fundamentals, primarily regarding the strength of the U.S. labor market. Given that inflation does not appear to be a near-term constraint, it is unlikely that the Fed would tighten monetary policy without further economic improvement. Even if interest rates do rise, an environment of improving U.S. economic fundamentals would be beneficial for the rest of the world.

What about Bonds in a Rising Rate Environment

It is important for investors to disentangle recent negative fixed income returns and distinguish between permanent and temporary declines. While the value of fixed income assets can decline due to rising interest rates, the indiscriminate sell off of these assets, including foreign, emerging-market, and higher-yield sectors, tends to be an emotional trade and consequently the effect of the "herd mentality" with less consideration given to the fundamentals of these assets.

Nevertheless, investors should keep the recent sell-off in bonds in perspective. As events in June demonstrated, it is possible to lose money in bonds, but the volatility of high-quality bonds is still significantly lower than that of stocks. Over the longer term, it is important to include bonds in most portfolios as an anchor to counterbalance the risks taken in equities.

The Current Picture is Not as Great for the Rest of the World

Even as the U.S. real economy continued its moderate recovery, other parts of the world showed weakness. Europe is still dealing with slow growth and recession in select countries. Unemployment is at very high level throughout much of the Southern Eurozone and political uncertainty continues to affect Greece.

China showed the greatest level of uncertainty, as an apparent liquidity squeeze in the banking system, driven by a shortage of cash, drove interbank interest levels to record highs. The Chinese central bank initially refused to intervene but later had to inject cash to support the system. This, combined with slowing growth of 7% to 8% in the Chinese economy, drove down Chinese equity prices, which was a large contributor to emerging market weakness. It's hard to imagine that 7% to 8% annualized growth is considered slow when compared to U.S. economic growth.

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Allocate Capital Consistent with Long-Term Goals and not Short-Term Market Gyrations

The downward adjustment and subsequent partial recovery may reflect a growing understanding that the real economy is normalizing and that interest rate policies must do so as well. At the same time, the gradual withdrawal of the Fed from fixed income markets may require further adjustments as overall demand drops.

For the U.S. and global financial markets, more volatility may come. Although recent events have created weakness, there does not appear to be any obvious reason for significant further declines. As always, external shocks are possible, but at this point it appears that markets may have stabilized. With this in mind, it is important to focus less on short-term market gyrations and instead allocate capital in a manner consistent with one's long-term goals.

Disclosure: Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Free Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. It excludes closed markets and those shares in otherwise free markets that are not purchasable by foreigners. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moodys, Fitch, and S&P is Ba1/BB+/BB+ or below.

Equity Performance

Equity Index	Style	YTD Return As of 6/30/2013	1 Year Return As of 6/30/2013	3 Year Return As of 6/30/2013	5 Year Return As of 6/30/2013	10 Year Return As of 6/30/2013
Russell 1000 TR	U.S. Large Cap Stocks	13.91%	21.24%	18.63%	7.12%	7.67%
Russell MidCap TR	U.S. Mid Cap Stocks	15.45%	25.41%	19.53%	8.28%	10.65%
Russell 2000 TR	U.S. Small Cap Stocks	15.86%	24.21%	18.67%	8.77%	9.53%
MSCI EAFE NR	Foreign Developed Stocks	4.10%	18.62%	10.04%	-0.63%	7.67%
MSCI EM NR	Foreign Emerging Stocks	-9.57%	2.87%	3.38%	-0.43%	13.66%
DJ US Real Estate TR	Real Estate	4.83%	8.39%	17.02%	6.88%	9.75%
DJ UBS Commodity TR	Commodities	-10.47%	-8.01%	-0.26%	-11.61%	2.39%

Fixed Income Performance

Fixed Income Index	Style	YTD Return As of 6/30/2013	1 Year Return As of 6/30/2013	3 Year Return As of 6/30/2013	5 Year Return As of 6/30/2013	10 Year Return As of 6/30/2013
BarClays US Aggregate Bond TR	U.S. Core Bonds	-2.44%	-0.69%	3.51%	5.19%	4.52%
BarClays US Corporate High Yield Bond TR	U.S. High Yield Bonds	1.42%	9.49%	10.74%	8.91%	6.88%
BarClays Global Aggregate Bond TR	Foreign Developed Bonds	-4.83%	-2.18%	3.55%	3.68%	4.79%
Morningstar Emerging Market Bond	Foreign Emerging Bonds	-5.20%	2.47%	6.10%	8.28%	8.42%
CitiGroup 3-Month T-Bill	Cash	0.03%	0.08%	0.09%	0.23%	1.63%

Source: Morningstar®.

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