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June 2013 Commentary

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The Economy

The U.S.

The most recent economic data point to a continuation of the "plow horse" economy of the last few years: slow but steady growth for the U.S. GDP growth here at home remains anything but impressive. The Commerce Department amended its Q1 estimate for the growth of the U.S. economy, now calculating an annual growth rate of 1.8%, down from a previous estimate of 2.4%. For the year, most Wall Street economists still project the economy to grow in the 2% range. While the U.S. appears to be in better shape than many countries in Europe and the developing world, conditions are by no means ideal.

June's ISM manufacturing and non-manufacturing surveys confirm the tepid domestic growth picture. The ISM manufacturing index improved for the month, registering a reading of 50.9. A reading above 50 indicates economic expansion. The ISM non-manufacturing survey, a gauge of service sector growth, was 52.2 in June. Both numbers reveal that that business activity is growing, but barely.

Employment conditions in the U.S. have improved in 2013, a bright spot with real consequences for the average American. The jobs report for June was better than expected. The Labor Department reported an increase of 195,000 workers in June, well ahead of expectations. Wages have risen by 2.2% in the trailing twelve months, while core inflation has risen by about 1.5% in the same time period. With wage growth above inflation, real incomes have risen. With an increase in real income comes an increase in consumer spending.

The most notable economic events in June surrounded Fed Chairman Ben Bernanke's commentary on the economy. Following a two day policy meeting on June 19, Bernanke explained the Federal Reserve's latest outlook. Bernanke's comments had a dramatic impact on financial markets. The Fed chairman indicated that by 2014 the Fed would consider slowing its bond buying program (currently at a pace of $85 billion per month), given expected continuing improvement in the U.S. economy. Bond yields spiked and stock prices dropped on the news.

The Fed's quantitative easing policy has kept interest rates artificially low and provided a backstop for stock prices. The speculation of this so called "tapering" of the Fed's stimulus roiled markets and injected volatility into the bond market not seen for several years. The 10 Year U.S. Treasury Bond rose to 2.48% at the end of June and has climbed even higher since. While rising interest rates due to improving economic conditions are

most welcome, many economists worry that the Fed's current optimism is unwarranted. Still, the Fed is injecting an enormous amount of money into the markets each month.

The World

A global slowdown has taken shape across much of the world. The IMF hinted in June that they would further revise down their estimates for global growth in 2013, now projected to be 3.3%. Europe's recession continues without an end in sight. Japan's economy, despite massive monetary stimulus in the first quarter, is still growing in fits and starts. China's most recent economic data suggest a renewed slowdown. The economies of Latin America have weakened in 2013.

All eyes turned to Egypt at the end of June, where its citizens took to the streets to protest the Muslim Brotherhood and its democratically elected President, Mohamed Morsi. Following mass protests, the Egyptian military removed Morsi as President and called for new elections. The situation remains tenuous and violent. At a high level, the problems in Egypt represent deeper issues throughout the Middle East. The Arab Spring, which had brought so much hope to the region just a few years ago, has begun to crumble. Crude oil prices spiked over concern of the Suez Canal, which Egypt controls.

China faces several difficulties in the first year of its new political leadership. Much of China's growth in the last decade has been predicated upon an increase in debt. After fifteen consecutive years of annual GDP growth above 7.5%, the Chinese economy is now slipping below this benchmark. Accumulating bad loans and an increasingly risky "shadow" banking system have proven worrisome to Chinese central planners, who are looking to shore up their country's government-owned commercial banks through stricter lending practices. The result is a slowing of economic activity.

Commodity prices have suffered as a result of the global slowdown. The so-called commodity "super cycle" of the past decade was driven by a voracious appetite for energy, metals and agricultural raw materials. As emerging countries like China and India grew, their demand for commodities drove global prices to record highs. With slower global growth comes less demand for commodities. Gold and silver have plunged in 2013, along with industrial metals like copper. While oil prices are elevated due to political concerns in the Middle East, the supply and demand fundamentals suggest that energy prices could be headed lower.

The Markets: A Month of Correction

Stock markets worldwide fell in June, as speculation of Fed tapering caused a downturn. For the month, the S&P 500 lost 1.34%. The U.S. index is still up substantially for the year, finishing June with a 13.62% year-to-date gain. Small stocks slumped as well, down 0.51% in June. Risk assets have risen on the back of quantitative easing and fell in June as investors began to fear the end of the extraordinary Fed stimulus.

International stock indices also declined in June. For the month, the MSCI EAFE Index fell by 3.55%. Japanese markets fell significantly, reflecting renewed pessimism in their most recent experiment with the Bank of Japan's monetary stimulus. Europe remains mired in a difficult recession, also contributing to the EAFE Index's decline. The MSCI Emerging Markets Index fell 6.37% in June. The emerging markets decline reflects new concern for a slowdown in several emerging economies. The slowdown in China has been significant.

Bonds prices fell in June, as yields climbed. The Barclays U.S. Aggregate Index fell by 1.55%, as an expectation of Fed tapering caused bond yields to rise. High yield bonds declined by 2.62% in June. This decline in junk bonds was a very significant downward move; risky bonds are being re-priced as yields rise. The Barclays Global Aggregate Index declined by 1.18% in June as global bonds suffered as well.

Commodities have sold off markedly on the speculation that the U.S. Fed will begin to taper. For June, the Dow Jones-UBS Commodity Index declined by 4.71%. Gold and silver prices have plunged in 2013, and inflation expectations continue to soften. West Texas Intermediate crude oil has stayed near $100 recently, balancing political concerns with slower growth.

Table of Returns

June 30, 2013

	Performance(%)				
Equities Index	1 Month	Year To Date	1 Year	3 Years	5 Years
S&P 500 Index	-1.34	13.82	20.60	18.45	7.01
Russell Midcap Index	-1.21	15.45	25.41	19.53	8.28
Russell 2000 Index	-0.51	15.86	24.21	18.67	8.77
MSCI EAFE (net) Index	-3.55	4.10	18.62	10.04	-0.63
MSCI Emerging Markets (Net)	-6.37	-9.57	2.87	3.38	-0.43
Fixed Income Index					
Barclays Aggregate Index	-1.55	-2.44	-0.69	3.51	5.19
Barclays Global Aggregate	-1.18	-4.83	-2.18	3.55	3.68
Barclays 1-10 Yr. Muni	-1.61	-1.34	0.34	3.36	4.60
CSFB Leveraged Loan	-0.55	2.81	7.63	6.84	5.76
Barclays US Corp: High Yield	-2.62	1.42	9.49	10.74	10.94
Other Index					
HFRI Fund of Funds Composite Index	N/A	N/A	N/A	N/A	N/A
Wilshire US REIT Index	-1.66	5.94	8.41	18.50	7.20
S&P Developed Property	-2.49	3.14	15.60	16.67	5.12
LPX 50 TR	-1.05	14.66	35.71	18.89	-0.30
Citigroup 3 Month T-Bill Index	0.00	0.04	0.10	0.08	0.23

Closing Thoughts

Following World War I, Presidential candidate Warren G. Harding proposed a "return to normalcy" for the American people. The idea resonated with the American public, as Harding was elected in 1920 with over 60% of the popular vote. In many respects, our financial markets are now trying to figure out a "return to normalcy."

After five years of extremely unusual monetary stimulus, Ben Bernanke and the Federal Reserve are trying to put the country on a glide path to normal economic policy. The volatility that we witnessed toward the end of June in both the bond and stock markets was very much related to this. Markets are struggling to understand the direction of economic growth, interest rates and government stimulus. The mere suggestion of tapering by chairman Bernanke caused a massive upward tick in bond yields. While a return to normalcy is welcomed by both Wall Street and Main Street, getting there could be painful.

Our monetary policy has created record low interest rates. Short-term interest rates are still targeted to be 0% to 0.25%. Until very recently, the 10 Year U.S. Treasury Bond yielded below 2%. Investors, desperate to earn returns above the rate of inflation, have increasingly allocated capital to riskier asset classes. We

witnessed, for example, record high prices in junk bonds earlier this year. As interest rates rise and normal conditions ensue, investment losses could be substantial in the fixed income space.

The focus, as always, is on the long term. Losses in longer duration bonds over the past month have been noteworthy. While losses in the fixed income market are never welcome, a higher interest rate environment is a long-term benefit for savers and investors. Investors can expect better risk-adjusted returns when their bond portfolios have higher yields. As bonds mature and are reinvested, they are reinvested at higher interest rates.

The first half of 2013 was a very good one for investors with a diversified portfolio. Stocks have rallied tremendously. The second half of the year appears a bit more uncertain. Slower economic growth and rising interest rates could both provide short-term head winds to the markets. And yet, a return to normalcy is very much in sight. Over the long term, well positioned investors should benefit from a normally functioning economy and less government stimulus.