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June 2014 Commentary

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The Economy

The U.S.

The slow recovery continues. A common theme since the end of the recession has been positive economic growth, albeit at a slower pace than anyone would like. At the beginning of 2014, most economists believed that we were on the verge of economic "escape velocity." The consensus view was that the U.S. economy was very close to accelerating. But just as we see signs of quickening growth, new data emerge to sink our optimism.

First quarter GDP growth was revised down once again in June, this time to a reading of -2.9%. This economic contraction was the largest since Q1 of 2009. Weakness in domestic consumer spending, apparently in part from a severe winter in much of the U.S., combined with a decline in export activity contributed the majority of the decline. No matter how you analyze it, the GDP revision was an unexpectedly bad reading and a tough way for the economy to start the year. The IMF cut their 2014 growth forecast for the U.S. to 2%.

Still, leading indicators remain positive for the U.S. economy. June's ISM Manufacturing report was largely in-line with expectations, with a reading of 55.3. A reading above 50 indicates expansion in the manufacturing sector. The latest reading from the Conference Board's Leading Economic Indicators Index showed reason for continued optimism. The index rose in May for the fourth straight month, reflecting improved consumer confidence and a better employment market.

The latest round of housing data came in better than expected. New home sales climbed in May by 18.6%, while existing home sales gained by 4.9%. Despite mortgage rates for homebuyers that are significantly higher than a year ago, housing remains a positive economic force.

Consumer spending rose 0.2% in May, as reported by the Commerce Department. The reading was not terrible news, but certainly not good news. Adjusted for inflation, spending actually contracted in May. For the economy to get back to 3% growth in the second half of 2014, consumer spending will have to be much higher.

The World

Global stocks rallied into the end of the second quarter, despite mixed economic reports from Europe and Japan. Valuations of international and emerging market stock indices are lower than their U.S. counterparts and look attractive.

Japan's economy is slowing, following a recent sales tax hike that is intended to help pay for the massive spending strategy of the Japanese government. While the slowing was expected, economists believe that Japan is weathering the tax hikes better than expected.

The European Central Bank announced unusually aggressive stimulus measures in June, seeking to address the deflationary forces at work in Europe. The ECB announced plans for negative deposit rates and up to 400 billion Euros in loans to European banks, all in an attempt to stimulate growth and prevent deflation. These measures may not be enough, so there will likely be more announcements to come from Mario Draghi and the ECB regarding monetary stimulus.

China finally reported some good news in June, as their factory activity index hit a six-month high. Most Wall Street economists believe that China is taking the right steps to address the slow-down in its economy, leading to a steadying of growth expectations. China's most recent data on factory output and retail sales exceeded expectations, a welcome change from the downward revisions seen in the past two years. China's health, or lack of health, will have a significant impact on global markets in the coming years.

The Markets

Stocks continued their upward trend in June, as U.S. and international stock markets rallied to end the quarter. Large cap stocks in the U.S., as represented by the S&P 500 Index, gained 2.07% for the month and ended the second quarter up 7.14%. The S&P 500 has now advanced in six consecutive quarters, the longest winning streak since 1998. Small cap stocks gained in June as well, as the Russell 2000 Index climbed by 5.32%.

The developed international stock market index, the MSCI EAFE, gained 0.96% in June and finished the second quarter up 4.78%. Year-to-date losses in Japan have been offset by gains in continental Europe.

Emerging market stocks have been a bright spot in 2014, with the MSCI EM Index rallying 2.66% in June and 6.14% year-to-date. Emerging markets experienced their best quarter since 2012. Fears of an EM liquidity crisis following the Fed's taper have subsided, and the emerging markets are gaining attention from global investors.

High quality bonds were essentially flat in June, as the Barclays U.S. Aggregate Index rose by 0.05%. The yield on the U.S. 10-year Treasury bond remained just above 2.5%, reflecting slightly slower growth expectations for the U.S. and the global economy in 2014. The Barclays U.S. Aggregate High Yield Index gained 0.84% in June, continuing the strong rally for lower credit quality fixed income.

Commodities remained strong in Q2. The Bloomberg Commodity Index, formerly known as the Dow-Jones UBS Commodity Index, rose by 0.60% in June. Year-to-date, the index is up 7.08%. Precious metals have gained in recent weeks, while crude oil prices remain elevated due to renewed conflict in Iraq.

Table of Returns

June 30, 2014

	Performance(%)				
	1 Month	Year To Date	1 Year	3 Years	5 Years
Equities Index					
S&P 500 Index	2.07	7.14	24.61	16.58	18.83
Russell Midcap Index	3.29	8.67	26.85	16.09	22.07
Russell 2000 Index	5.32	3.19	23.64	14.57	20.21
MSCI EAFE (net) Index	0.96	4.78	23.57	8.10	11.77
MSCI Emerging Markets (Net)	2.66	6.14	14.31	-0.39	9.24
Fixed Income Index					
Barclays Aggregate Index	0.05	3.93	4.37	3.66	4.85
Barclays Global Aggregate	0.73	4.93	7.39	2.57	4.60
Barclays 1-10 Yr. Muni	0.01	3.20	4.27	3.56	4.19
CSFB Leveraged Loan	0.60	2.77	6.11	5.67	8.78
Barclays US Corp: High Yield	0.84	5.46	11.73	9.48	13.98
Other Index					
HFRI Fund of Funds Composite Index	N/A	N/A	N/A	N/A	N/A
Bloomberg Commodity Index Total Return	0.60	7.08	8.21	-5.17	1.98
Wilshire US REIT Index	1.00	18.08	13.54	11.69	24.04
S&P Developed Property	1.60	12.33	15.30	10.95	18.06
LPX 50 TR	3.18	4.73	28.80	13.25	21.83
Citigroup 3 Month T-Bill Index	0.00	0.01	0.02	0.05	0.07

Closing Thoughts

A new confirmation of improving economic growth came on July 3: U.S. employers added 288,000 jobs in June, and job growth in April and May was sharply revised upward. The June gains marked the fifth consecutive month that nonfarm payrolls grew by more than 200,000, a streak unmatched since the late 1990s. Meanwhile, the unemployment rate dropped to 6.1%, the lowest level since September 2008.

The vagaries of month-to-month economic news and market reactions are usually more distracting than helpful to long-term investors. Successful long-term investing is seriously undermined by reacting to recent economic news or trying to anticipate near-term movements in the financial markets. A long-term view, risk management, and diversification are the hallmarks of enduring portfolios.