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2013 SUMMER INVESTMENT OUTLOOK

June 2013 marks the fourth year of recovery from the severe 18 month recession of 2008-2009. This has been an excellent four years for the stock market which has more than doubled in value from March 2009 lows as measured by the popular indices. The economy, on the other hand, has recovered at a subpar pace of approximately 2% in real dollar terms, a figure roughly half the normal recession recovery rate. Factors responsible for the lackluster showing include: a weak improvement in housing until recently (home prices remain 15-20% below the pre-recession peak), subdued capital spending and business confidence, a stubbornly high unemployment rate of 7.5% (closer to 13% when those who have temporarily stopped looking for work are included), limited growth in state and local government spending, and lower federal government spending in the last six months under the sequester program.

The federal government led by the Obama White House has deployed the full measure of traditional fiscal and monetary policy in efforts to restore growth to a higher track. On the fiscal front, deficit spending averaging over $1.2 trillion per year in the 2009-2012 period moved the needle very little and policy makers turned to the monetary tools of the Federal Reserve Bank. Chairman Bernanke has obliged with an unprecedented expansion of the central bank's balance sheet and a series of easy money strategies (so called quantitative easing). The Fed has kept short term interest rates at nearly zero, or the lowest level in the history of the republic, for four plus years and is currently buying $85 billion of government bonds and other fixed income instruments every month in continuation of this policy.

Fed policy was successful three and four years ago in stabilizing the country's banking system but more recently has driven up the price of risk assets including stocks, real estate, and selected commodities. The bond market today is generally selling at record price levels with low income returns. Both government and corporate bond markets in the 10 year or less maturity sector have yield returns less than the likely inflation rate and can be viewed as confiscatory of investor capital. The so called junk bond market has regained favor with investors and offers returns above the inflation rate though with considerable risk.

Higher asset prices and the accompanying wealth effect are responsible in some measure for the recent good showing in several consumer sentiment surveys, moderate yet uneven growth in consumer spending, and consumer willingness to spend at a faster rate than the 3% growth in disposable consumer income. The easy money policy of the Fed has also produced a number of unwanted and unintended consequences which will be discussed below.

Under normal circumstances the Fed's job is to serve up the "punch bowl" to get the party of economic growth going once again after a recession, and then judiciously to remove the "punch bowl" and send the party goers home before the party becomes too raucous. In the present situation, instead of doing the latter, the Fed seems to have brought out ever larger "punch bowls" and then spiked the punch. Up to this point the punch and party have generally been well received by the investment community with the Dow 30 and S&P 500 reaching record levels in late May and recording above average gains year to date despite a modest June pull back.

Year-to-Date Market Returns (excluding income)

	06/17/13 Price	Change From Year-End
Dow 30 Industrials	15,180	+15.8%
S&P 500	1,639	+14.9
NASDAQ Composite	3,452	+14.3
MSCI ACWI-exUS*	255	+1.9

**MSCI All Country world Index excluding U.S.*

It is noteworthy that capital continues to flow to the US stock market and away from foreign markets reflecting the relative strength of the US dollar and perceived strength of its economy and institutions. Many previously robust foreign economies (China, India, Brazil, and Russia) have slowed, Europe is in recession, and policy makers overseas are facing their own set of serious economic challenges.

Near and Intermediate Term Outlook

In our view the US economy is currently in uncharted waters and current predictions have more than the normal uncertainty. A number of positives are driving continued growth, even if at a subpar rate. Consumers continue to spend, albeit in a subdued and sporadic manner, and growth in housing and common stock prices is having the expected positive wealth effect on consumer attitudes and spending. A close look at current GDP figures also shows that the private sector economy is growing at a 3% plus rate while the total growth is closer to 2% reflecting the recent decline in public sector spending. This is a good thing on a long term basis as it is growth in the private sector that produces sustainable long term employment, new industry, and tax revenues to fund the government sector.

Another positive development is the unexpected growth in domestic oil production through hydraulic fracturing of shale oil deposits found in many regions of the continental United States. This oil is generally recoverable at prices above $70 per barrel and total domestic production has grown by over two million barrels per day since 2008 and by over one million barrels per day in the last year. Domestic production currently exceeds nine million barrels per day and exceeds imports for the first time in over 20 years. Shale oil production is a boon to the industry, its infrastructure partners, and the states, which receive royalties and fees. Crude oil output from federal leases in the Gulf of Mexico, new opportunities in the North Slope of Alaska, and an ever improving domestic pipeline system are all positive contributors to the resurgence of a domestic energy industry. While lower oil imports are a positive for the United States, the country's current account trade deficit remains at a stubbornly high $40 billion per month due to the taste for foreign goods and the strong dollar which makes them cheaper.

There is also positive news on the federal deficit front in that the deficit ending this September 30th (government's fiscal year) is projected to fall to $650 billion from nearly $1.1 trillion last year. The lower deficit reflects the impact of tax increases imposed January 1st, tax planning by many individuals and corporations to pull taxable income into fourth quarter calendar 2012 when rates were lower, the sequester program taking roughly $80 billion out of annual federal spending, and above average dividend payments to the Treasury from several government entities. The deficit could increase in fiscal 2014 if higher taxes impede growth and entitlement program spending accelerates. The statutory debt ceiling will be reached sometime this fall and prospects for a comprehensive solution to the problem seem dim given the entrenched partisan positions of those in power. The mismatch between what the government takes in and what it spends continues and the cost to carry the debt (nearly $17 trillion) will rise dramatically as interest rates return to normal levels and put an additional heavy burden on the already pressured government budget. Reasonable long term solutions to the deficit issue can be found such as extending the eligibility age for social security (done successfully during the Reagan years), but every solution is thus far opposed by powerful lobbying groups with no one willing to compromise.

Corporate earnings growth, a key driver of stock prices, has slowed from low double digit rates in recent years to middle single digit rates this year while current revenue growth is even more modest. Cost cutting, productivity enhancements, and a reluctance to make investments for future growth have kept profit margins high but are likely to recede going forward. Second half earnings progress may show only modest advancement and fall beneath Wall Street projections which call for strong double digit growth. Earnings will also be impacted by the strong dollar as foreign profits translate into fewer US dollars for reporting purposes.

Economic conditions outside the United States are currently challenged. The broadly defined Euro zone (a total GDP larger than the US) is experiencing recession conditions. Southern European countries including Greece, Italy, Spain, and Portugal are faring the worst with real GDP contraction greater than the 1% reported in the first quarter for the Eurozone and unemployment higher than the 12% Eurozone average rate. France and its coastal neighbors are now in a no growth mode, German growth has slowed, and Great Britain and Switzerland (not members of the Euro currency countries) have little if any growth. Europe as a whole has entered its second recession in five years and its GDP is 2.8% lower than at the beginning of 2008 as compared with a 3.6% cumulative advance in the United States over the same time period.

Key economies outside of Europe are also posting slower than normal growth. Brazil, Russia, India, and China, (the BRIC Countries) are growing at notably below anticipated trend line rates and this has accounted for a softening in demand for many raw material and industrial products. China, the world's second largest economy, now approaching six trillion dollars, is a major question mark going forward given excessive financial leverage, central government planning, and the complexities and competing needs of the many economic institutions that operate within the country. A reasonable guess is that the Chinese economy will expand in the 6-7% area for the full year, or roughly half the rate of growth in the 1995-2010 period. Japan continues its 20 year period of little or no growth despite massive support from that country's central bank. In short, the international sector will not be the positive force of growth it has been over the last 25 years making the US and its subpar but steady 2% growth rate look relatively attractive.

The timing of when and how Chairman Bernanke and the Federal Reserve Bank unwind their unprecedented easy money policy will have an important impact on economic activity and the capital markets going forward. We concur with those observers who believe easy money has been too much for too long and has produced unintended and often unwelcome consequences. First off, easy money and low interest rates have created a bubble in the bond market. The benchmark 10-year Treasury, for example had an average yield of 4.5% in the 1995-2007 period while averaging only 2.0% thus far in 2013. There has also been a lowering of quality in the bond market as junk bond issuance has run at an annual rate of $285 billion year to date and many of these carry weak or "covenant lite" features for the bond investor. The 10-year Treasury would decline some 20% if yields were to return to normal while junk bonds will decline more severely and have a significant default rate as well. In another distortion, corporate financial officers have taken advantage of low borrowing rates to fund massive stock buyback programs (Apple, Intel, and others) and retire stock paying a higher dividend yield than the after tax cost of the borrowing. This has helped push stock prices higher and is inconsistent with traditional capital market theory that calls for money to be borrowed for company expansion.

The lengthy period of easy money has also abetted the federal government debt problem by allowing the government to borrow more at essentially negative real interest rates. The federal budget will be severely strained by higher borrowing costs when interest rates return to normal levels which economists project could add up to $500 billion of outlays in five years. It can also be said that current policies are favoring borrowers and punishing savers rather than being fair and evenhanded. Another concern is the risk of notably higher inflation given the normal monetary lag effect and the Fed's intensive focus on the unemployment rate. Inflation once released is very difficult to reign in and has adverse consequences for both stocks and bonds.

The Fed said at its May meeting that it would exercise some flexibility in its planned monthly bond purchase program, hinting it may gradually taper off or modestly increase the program if deemed appropriate. This message and tone are likely to be repeated in the months ahead. The path of least resistance would be for the Fed to buy fewer bonds than planned if moderate growth in the broad economy and employment picture continues. Chairman Bernanke is unlikely to serve beyond his current five year term ending next January and his legacy may very well be to leave his successor the challenge of returning Fed policy to a neutral position. Policy makers will have few, if any, tools however should the economy unexpectedly deteriorate.

Investment Conclusions

Investors are advised to be cautious at this juncture given slowing corporate profit growth, stock markets near all-time highs and bond markets in a bubble condition. Focus should be on the protection of capital by taking profits in companies where prices have gotten well ahead of underlying fundamentals. Simultaneously, new purchases should be highly selective and in companies where positive change and growth is unappreciated by the investment community at large. As for bonds, maturities should be kept short and quality standards high with the conviction that yields will return to normal and appropriate levels in due course. Higher than normal cash equivalent positions can be viewed as a buying reserve and a stabilizer to overall portfolio value as stock and bond markets experience their normal price corrections.

6/18/13