Quarterly Newsletter

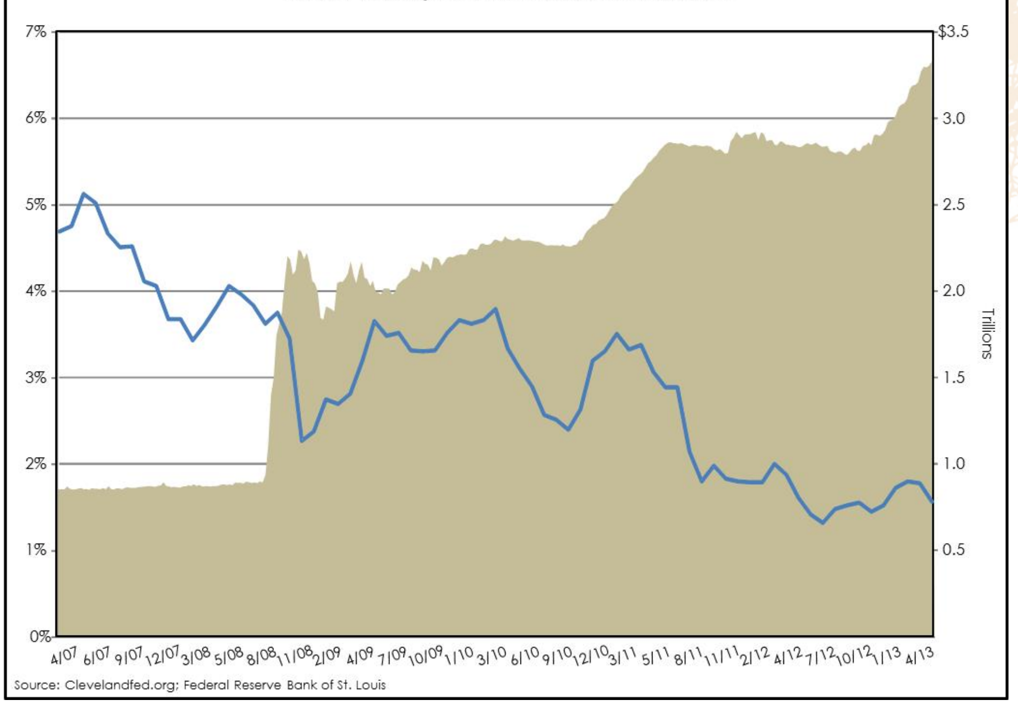
JULY 2013

CAPITAL MARKETS UPDATE | Domestic equity continued to lead the way in the 2nd quarter as small cap stocks added 3.0% and large cap stocks rose 2.9% to finish the quarter up 15.9% and 13.8% on a year-to-date basis, respectively. The rally remains relatively thin, however, with virtually every other major asset class suffering losses over the last three months. The benchmark ten year Treasury yield rose 81 basis points or 49% in response to the Fed Chairman Ben Bernanke's suggestion that the Federal Reserve may taper its aggressive bond purchase program sooner than originally expected. These developments pushed bond prices lower, while international investments were hit by a combination of the Federal Reserve's new course and the rise of the US dollar relative to foreign currencies. Commodities lost the most ground as gold continued its decline.

MONETARY POLICY 101 | We've made reference to the activity of major central banks to stimulate the global economy in recent newsletters and wanted to expand on this important capital market participant in this issue. As background, monetary policy is the process used by a government's central bank to control the monetary asset base or "money supply" in the economy. The aim of monetary policy is generally to promote price stability and low unemployment. Central banks seek to achieve these two goals by engaging in open market operations, or the buying and selling of various financial instruments, usually to maintain a target interest rate or currency exchange rate. For example, during periods of slow growth or recession, central banks will increase money supply and lower target interest rates through open market operations to stimulate borrowing and capital investment with the ultimate goal of creating jobs and modest inflation. Similarly, if the stimulus is effective, central banks will tighten money supply and increase target rates to ensure economic growth and inflation remains steady and the economy doesn't get overheated.

CURRENT DOMESTIC MONETARY POLICY | Since the financial crisis in 2008, the US central bank, known as the Federal Reserve (the Fed), has maintained a highly accommodating monetary policy stance. As the global economy dove into recession, the capital markets froze and the Fed responded by instituting a near-zero target policy for its short-term interest rate. The panic did not subside, which led the Fed to launch a series of quantitative easing (QE) strategies aimed at restoring confidence by providing liquidity to critical capital markets. QE1 was an $800 billion purchase of mortgage-backed securities in an unprecedented attempt to rescue the crashing housing market. QE2 was a purchase of $600 billion in Treasury bonds beginning in November 2010, which lowered the borrowing costs of the federal government's bail out packages and deficit spending. A little less than a year later, QE3 sent a longer-term support signal by purchasing $40 billion in mortgage-backed securities per month through at least 2015. Most recently, what some observers are calling QE-Infinity adds $45 billion per month in purchases of Treasury securities without a specific end date. QE3 and QE-Infinity will add $1 trillion in assets to the Fed's balance sheet in 2013, which is expected to grow to $5 trillion by the end of 2014. The adjoining chart illustrates the growth in the Fed's balance sheet and the decline in the 10 year Treasury yield over the last 6 years.

10 Year Treasury Yields & Federal Reserve Assets



Source: Clevelandfed.org; Federal Reserve Bank of St. Louis

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At a press conference on June 19, Chairman Ben Bernanke explained the Fed's future plans this way, "Although the Committee left the pace of purchases unchanged at today's meeting, it has stated that it may vary the pace of purchases as economic conditions evolve….Going forward, the economic outcomes that the Committee sees as most likely involve continuing gains in labor markets, supported by moderate growth that picks up over the next several quarters as the near-term restraint from fiscal policy and other headwinds diminishes. We also see inflation moving back toward our 2 percent objective over time. If the incoming data are broadly consistent with this forecast, the Committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases later this year. And if the subsequent data remain broadly aligned with our current expectations for the economy, we would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear (2014). In this scenario, when asset purchases ultimately come to an end, the unemployment rate would likely be in the vicinity of 7 percent, with solid economic growth supporting further job gains, a substantial improvement from the 8.1 percent unemployment rate that prevailed when the Committee announced this program."

EVERYONE ELSE IS DOING IT! | The US central bank has not been alone in its attempts to stimulate growth and rebuild confidence over the last 5 years. In fact, virtually every other developed country's central bank has taken similarly extraordinary measures, most notably The Bank of Japan (BOJ) and the European Central Bank (ECB).

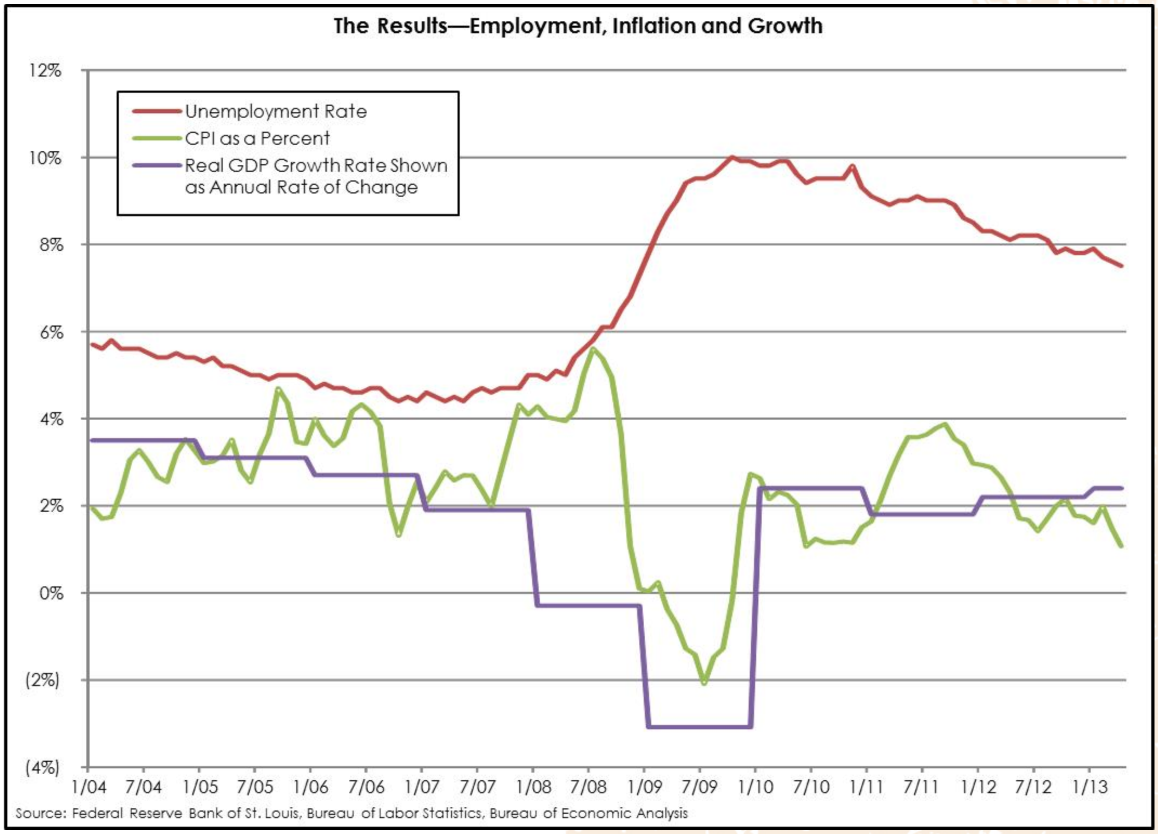
Japan has been fighting deflation and stagnant growth for well over a decade. In October 2010, the BOJ launched an asset purchase program and bought ¥9.9 trillion of government securities under the program the following year. In 2012, the BOJ bought roughly ¥29 trillion or over 50% of all new Japanese government bonds issued to finance the country's deficits. That same year the asset purchase program target size was increased twice by ¥10 trillion each time to a total of ¥90 trillion. In the current year, the BOJ is expected to increase its purchases of government securities to an annual pace of ¥50 trillion and will also purchase corporate bonds, stocks and Japanese real estate investment trusts. These measures (self-funding deficits and growing net government debt that already exceeds 150% of GDP) are clearly risky, but they may be bold enough to change the private sector's expectations. If consumers and corporations expect inflation (higher future prices) rather than deflation (lower future prices), they will likely spend, hire and invest today rather than waiting for lower prices in the future.

The Eurozone, on the other hand, is taking steps to avoid a Japanese-like period of deflation. The ECB has been slow to join the party until recently due to the complex nature of the monetary union and concerns that the stimulus measures wouldn't significantly impact the regions that needed it the most. Nevertheless, the ECB dropped its benchmark lending rate 0.25% to 0.50% in May and left the door open for further action. Unemployment in the region is around 12% and inflation is 1.2%, well below the ECB's target of 2%.

THE RESULTS, PLEASE | The results and reviews of the effectiveness of Fed policy actions over the last several years are mixed. Some argue that an extended period of low interest rate policy fueled the housing bubble and sub-prime borrowing binge in the first place, while others believe the Fed was simply fulfilling its mandate to promote price stability and low unemployment. As the chart below illustrates, prices have indeed been steady prior to the crisis and during the period of recovery when measured by the Consumer Price Index or CPI. In fact, the recent decline in commodity prices may be an indication that deflation is a greater near-term issue than inflation.

Also included in the chart is the Civilian Unemployment Rate, which has shown some improvement in recent months, but it is unclear how much of the rate change is due to under-employment and those dropping out of the search altogether.

Lastly, many critics point to domestic economic growth as measured by Gross Domestic Product (GDP), which, at roughly 2% so far this century, is low relative to historical standards. Annualized growth improved in the first quarter of this year (+1.8%) after a disappointing 4th quarter of 2012 (+0.4%), but still indicates relatively weak demand in the economy.



INVESTMENT IMPLICATIONS | So how should investors proceed within this environment of swelling government intervention and uncertainty? At all times it's important to keep three guiding principles in mind: 1) Over the long haul and through market cycles, rational rather than emotional decisions underpin a sound and successful investment strategy 2) Asset allocation should be aligned with our risk tolerance and our financial objectives 3) Broad, global diversification, disciplined rebalancing and tax-wise, cost-conscious investing will best enable success in reaching our financial goals.

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