Market Commentary

Second Quarter 2013

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While the second quarter of 2013 was another positive one for the broad equity markets, the modest positive return masked significant volatility within the equity and fixed income markets. The benchmark S&P 500 index rose by 2.9% during the quarter on a total return basis. This brings the total return on the S&P 500 to 13.8% for the first half of 2013. The Dow Jones Industrial Average rose by an identical amount, marking its best first half year since 1999. Fixed income markets saw extreme volatility over concerns about the end of Quantitative Easing (QE). The benchmark 10-year US Treasury note yielded 2.49% at the end of the second quarter, significantly higher than the 1.85% three months earlier.

Economic Outlook

Rather than focusing on the very strong equity results for the past six months, investors have been laser-focused on the modest declines experienced in the past six weeks. Since mid-May, when investors began to worry that the Federal Reserve might begin winding down its latest Quantitative Easing (QE), bond markets have been in disarray and equity markets have moved lower. We are a bit puzzled by both, but for different reasons. Parsing Fed Chairman Bernanke's statements, we point out that tapering does not mean stopping bond buying. Bernanke said the Fed was looking to begin tapering its bond purchases in coming months if the expected economic growth continues to improve. In more normal times, this would make sense to investors – an improving economy would allow the Fed to foster less economic stimulus. Bonds sold off dramatically, with the yield on the 10-year Treasury note spiking from 2.10% to 2.62% in just over one week. Again, we point out that Bernanke says he is looking to taper QE before hopefully ending it at some point in 2014, tied to an improving economy. If the economy shows new signs of weakness, we do not think the Fed will end its QE. Additionally, ending QE does not also mean increasing short-term rates. Most economists believe it will be at least 2015 before the Fed begins to raise short-term interest rates. So, with that as a backdrop, we have rising long-term rates that steepen the yield curve. A steeper yield curve incentivizes banks to make loans since they borrow short-term and lend long-term. This should help the private sector of the economy as loan availability should increase. Ignoring most of Bernanke's comments, bond investors ran for the exits, pushing yields dramatically higher.

Turning to equity markets, while a portion of the stock market gains in the past four years was likely due to the Fed's QE, we again point out that Bernanke said any reduced easing would be determined by future economic growth. Equity investors sold stocks because they believed the Federal Reserve was going to stop flooding the system with money, which they interpreted as leading to lower stock prices. What they fail to realize is that earnings for the S&P 500 have doubled over the past four years, which is the single most important reason for higher equity prices. So while some of the equity market gains may have been due to quantitative easing, the overall health of the US economy is better than it has been in the past five years and thus the primary catalyst for higher stock prices can continue. The last two weeks of June were a classic example of investors being driven by policy rumors rather than focusing on economics and underlying fundamentals. This "risk on / risk off" mentality, fostered by the Federal Reserve, led to a very crowded trade that can be quite unpleasant when it gets rapidly unwound.

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Consumer spending should continue to grow at an accelerating rate based on the recovery in housing. Home prices are one of the most important variables for consumer confidence and it is clear that there is a national recovery in home prices well under way. When backing out the negative growth from government spending, real GDP has been growing faster than the reported figures. Governments on all levels from federal down to municipal have been cutting spending for most of the past 24 months which has dampened overall GDP growth.

Portfolio Positioning

While most investors are curious about the near-term outlook, predicting the next three to six months is always the most difficult. As your investment advisors, the near term is much less relevant to us than the longer term. During the strong run from the November 2012 lows, we saw some signs of equity valuations beginning to disconnect somewhat from earnings growth and US economic activity. This does not mean we believe the bull market that began in March 2009 is over, merely that we think it is time for a breather. The six month rally ending in May was led by industries and investment styles that are defensive in nature - healthcare, consumer staples, and dividend-paying stocks. Bull markets are usually led higher by growth areas like technology and cyclical companies so we believe some consolidation may be warranted before equity markets resume their upward movement. Revenue growth remains very challenging for most firms and margin growth can only push earnings so far before top-line growth becomes necessary.

Client equity portfolios continue to see modest changes, in line with our low turnover strategy. We continuously monitor positions and sell when we find something better to replace a current holding. We believe economic growth will accelerate modestly in the second half of 2013 and into 2014 as budget deficits continue to decline, interest rates remain historically low, the effects of both the budget sequester and the early year tax hikes abate, and debt service levels moderate. In our last commentary we questioned the wisdom of buying high dividend yielding stocks in an effort to capture yield. We have long believed that it is not absolute yield that matters but rather the ability and desire for management teams to steadily grow dividends over time. This strategy benefitted client portfolios recently as the highest yielding stocks and ETFs sold off the hardest during the latter half of the quarter. Those that have the ability to grow their payouts fared much better.

Conclusion

We always remind clients to look at the longer term. When volatility strikes suddenly, investors tend to focus myopically on the returns for the most recent week or month. We advise considering the 16.8% annual return for the S&P 500 over the past three years, rather than the modest 1.3% decline for June 2013. Client portfolios are structured to withstand short-term volatility while remaining poised to grow methodically over the long-term. With one half of 2013 completed, and the major indices already up significantly for the year, the summer months may see some continued volatility as both equity and fixed income markets try to ascertain the Federal Reserve's next moves. We do not expect a meaningful decline in either the equity or fixed income markets but rather heightened volatility which we will monitor for opportunities to purchase securities that are temporarily mispriced due to investor concern.

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