PREPARING TO COME ABOUT

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Anticipation of the end of quantitative easing has led to a period of heightened awareness, an increase in interest rates, and stock market volatility. However, with lower levels of inflation and stronger economic growth potential, investors will eventually benefit from positive inflation-adjusted returns on bonds and solid earnings growth. Stock prices are fairly valued, and long-term investors should stay the course – potentially taking advantage of attractive rebalancing points in response to market volatility but not necessarily in anticipation thereof.

The Tapering of Quantitative Easing

Despite what was supposed to be welcoming news, both stock and bond investors were spooked by Federal Reserve Chairman Ben Bernanke's remarks on June 19. He made it quite clear that the Federal Reserve will continue an unprecedented amount of quantitative easing. Additionally, he spelled out a conservative, data-dependent, and rational end to the easing program.

In sailing, this would be analogous to "coming about" or turning the boat into the wind which helps provide a smooth change in direction. In essence, Mr. Bernanke gave the order to "prepare to come about."

The market however heard Mr. Bernanke give the order to "prepare to jibe" which is a more dangerous maneuver since a sailboat changes directions by turning *away* from the wind thereby causing a more rapid transition. In a monetary sense, the thought of jibing means the Federal Reserve's withdrawal of quantitative easing and asset price support might be swift. The market, or shall we say crew, prepared by trimming the price of stocks and raising the interest rate sails.

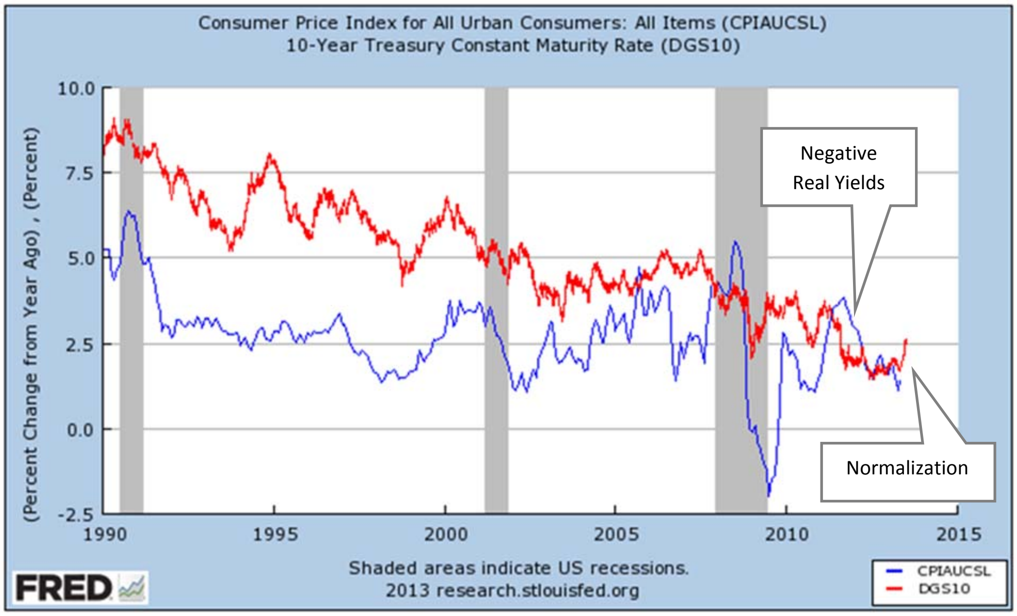
Until Fed policy actually changes, it is indeed quite supportive of strong asset prices. After all, 0% interest rates and $85 billion/month of new investment dollars into the markets should do a lot to push up prices. However, market participants will continue to anticipate a seemingly shorter timeline of eventual monetary tightening.

Interest Rates are Normalizing

The sheer brute force of quantitative easing has led to falling and ultimately record low interest rates that have caused distortions along the interest rate curve. The surplus of interest rates over inflation is called "real" rates. Whether one considers money market rates or long-term Treasury bond yields, real rates are normally positive. Since 2011, quantitative easing has caused several real rates to become negative (inflation higher than interest rates).

As more and more bonds dipped into the negative real rate territory, investors largely benefitted as rates fell. However, real rates can only reside in negative territory for so long since most investor's like to earn money on an inflation-adjusted basis. Two-months ago, many investors indeed balked at negative real rates, and yields began to rise.

10-Year Treasury Bond Yields (red line) are Normally Higher than Inflation (blue line)



Markets are attempting to bring rates to a more normalized level despite the Fed's ongoing efforts to the contrary. When rates go up, bond prices fall. As we've seen over the past two months, rates have indeed risen without a slow-down in quantitative easing (10-year Treasury bond yields, for example, rose approximately 100 basis points or 1%). This has led to falling prices for bonds and bond funds. Generally speaking, the "duration" of a bond is an estimate of its price reaction to a change in interest rates. A bond with a duration of 5 years, for example, is estimated to fall 5% in price when rates rise by 1%, a duration of 10 years leads to a 10% price drop with a 1% rise, etc.

Given this move in addition to low inflation (approximately 1.4%), "real" rates for longer-maturity instruments are now positive – and much of the heavy lifting has been done in favor of rate normalization. We do not feel we are at the start of a large and continued upward movement in interest rates - absent a major uptick in inflation or demand for borrowing.

Consumer and Commodity Prices Remain Muted

The main argument in favor of excess price inflation in the near-term is that the money supply is much larger as a result of quantitative easing. That isn't exactly true. Most of the Federal Reserve's assets reside in "excess reserves" which represent potential, not actual, money supply. Money in circulation, as most economists count supply, has indeed grown, but not abnormally. As more money is borrowed from "excess reserves" (i.e. new bank loans), money supply will pick up.

Further, when money in circulation speeds up, as in the same dollar being spent frequently, a pick-up in inflation can occur. This is called monetary velocity. Today velocity is very low. In order for velocity to pick-up, we would need to see considerable economic growth.

Aside from the banking dynamics of inflation, consider the disinflationary aspects of commodities, a significant part of inflation indexes.

- The demand for industrial commodities has been reduced significantly as countries like China have cut back funding for capital intensive projects.
- After a long period of emerging market growth and demand for industrial commodities, the production capacity of commodity intensive products has grown massively.
- With new technologies, the supply of energy products has and will continue to grow.
- As "real" rates are now positive (interest rates greater than inflation), the incentives to own precious metals and other real assets has been reduced in favor of financial assets.

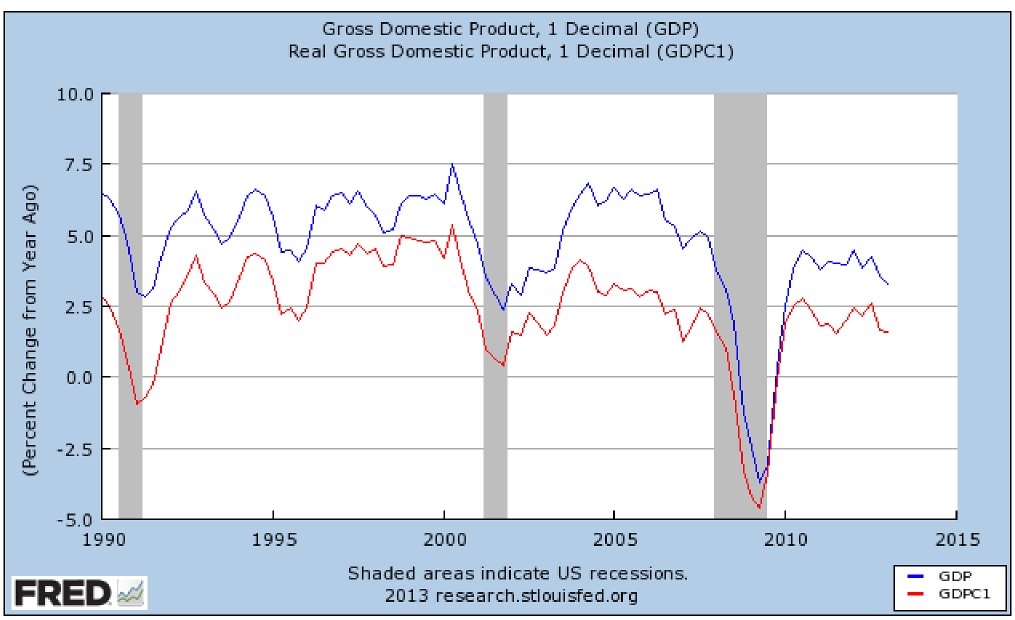
While inflation has been rather tepid over the past few years, a pick-up in economic growth might lead to higher inflation.

Heading towards Stronger (than Expected) Economic Growth

The past year has not provided robust economic growth:

GDP 1st Quarter 2012 (12m):	\$15.478 trillion
GDP 1st Quarter 2013 (12m):	\$15.984 trillion
Nominal GDP Growth:	3.3%
CPI Inflation:	1.4%
Real GDP Growth:	1.9%

Typically, "Nominal" (i.e. total) and "Real" (i.e. inflation-adjusted) economic growth would be in area of 6% and 3%, respectively.



Fortunately, several factors seem to support solid economic growth:

1. Consider that consumer confidence is now higher than it has been since 2007 (as measured by The Conference Board). As higher, albeit normal, levels of confidence returns, consumer spending (the biggest component of economic growth) increases.
2. Energy production has and will continue to expand as a result of technological advancements related to oil and natural gas. From a Gross Domestic Product standpoint, this creates jobs, stimulates domestic investment, and reduces imports. However, the full impact of this economic shifting will probably occur over the course of the next several years.
3. Housing, which has been an economic drag for a few years, is now an economic driver. We are starting to see the benefits of pent up housing demand. As the housing market halted, at least two segments of the population were frozen out of the market: first-time homebuyers and homeowners with upside-down mortgages. Now, with prices low (but picking up), lending moderately easier than two years ago, and rates still quite reasonable, both of these segments are returning to the market.

The Stock Market is Fairly Valued, and Opportunistic Investing will Dominate

Businesses tend to grow about as fast as the economy. That means long-run earnings and stock prices of businesses grow in the 5-6% range. Investors benefit further by receiving dividends, currently in the 2% range. Finally, investors benefit if the companies in which they invest or the stock market as a whole are mispriced or undervalued.

This third component of investor return is why many consider metrics like the price-to-earnings multiple; though market operators tend to have different opinions about the market's valuation. Our view is that the market, as a whole, is fairly valued.

Fair valuation means investors will benefit from long-term business growth and dividends which we believe will fall in the 7.5% range. It also means that instances of market volatility will offer attractive rebalancing points in the subsequent periods. Finally, relative to other asset classes, equities remain the best place to allocate funds with long-term objectives.

Summary

In this environment of heightened awareness of monetary policy, we expect the balance of 2013 to bring further stock market volatility. However, low inflation, higher bond yields, and stronger economic growth potential will bring solid future returns for fixed-income investors as well as continued corporate earnings growth. Stock prices are fairly valued, and long-term investors should stay the course – potentially taking advantage of attractive rebalancing points in response to market volatility but not necessarily in anticipation thereof.