MARKET PERSPECTIVE

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> **"NEARLY ALL MEN CAN STAND ADVERSITY,**
> **BUT IF YOU WANT TO TEST A MAN'S CHARACTER, GIVE HIM POWER."**
>
> **ABRAHAM LINCOLN**

THE FED'S CHALLENGE: When to pull the punch bowl- and by how much

In reviewing the events of this past quarter, we would be remiss not to mention the recent remarks on June 19th by Ben Bernanke, Chairman of the Federal Reserve, which temporarily spooked global financial markets; including bonds, commodities, and equities. The possible contemplation by the Fed of "pulling away the punch bowl" alone rattled the investment marketplace.

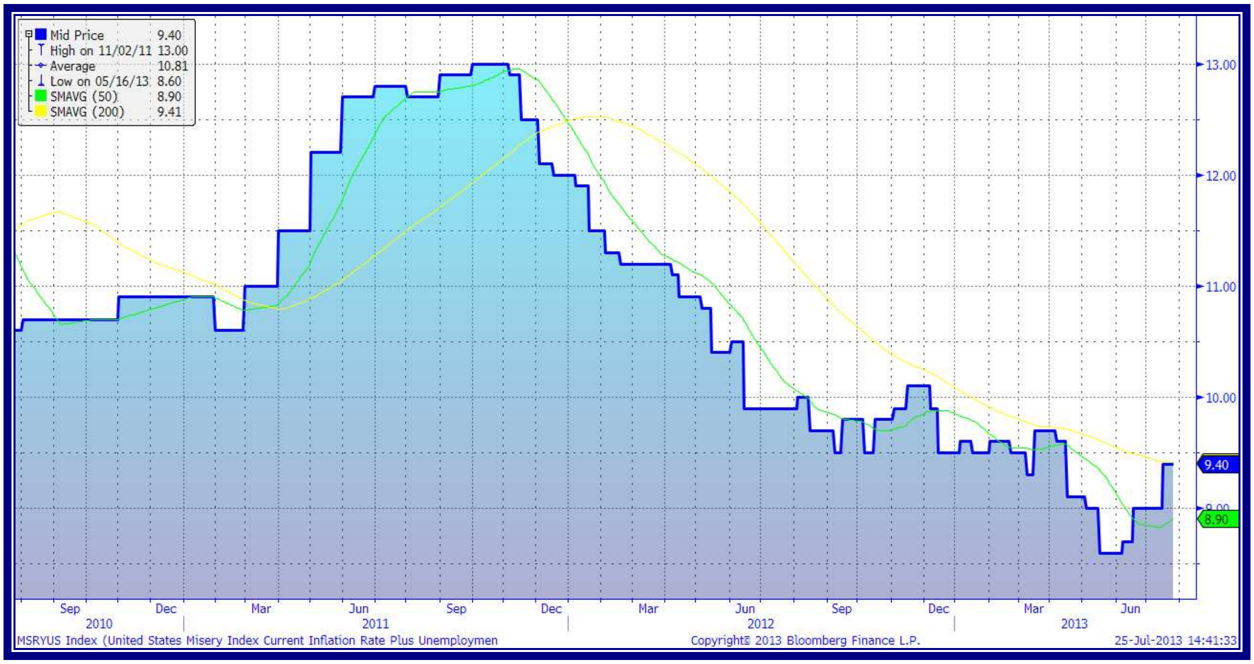
However, markets have recovered nicely, hitting new highs, once the chairman concluded his congressional testimony on monetary policy last Wednesday. Bernanke acknowledged his belief that "the market is beginning to understand our message, and the volatility has obviously moderated."

Investors have come to the realization that monetary quantitative easing has to end at some point; otherwise hyperinflation would be the end result. Many analysts, including ourselves, believed that monetary quantitative easing would end when inflation started trending higher, and not in a period when it was trending lower. Nevertheless, Ben Bernanke outlined a plan in June for halting it by mid-2014, on the assumption that economic growth would be 3% or higher. He also emphasized that if economic growth were to remain lackluster, the Federal Reserve would continue along the current monetary path. Initially, financial investors seemed to take the position that the possibility of ending the program by mid-2014 was an actual reality and markets responded accordingly.

Apparently, the message is that Bernanke & Co. wants stock prices to rise and bond yields to fall. This seems to be the Fed's "shadow" mandate, which lurks behind the Fed's official dual mandate - to lower the unemployment rate to 6.5% and to boost inflation back to 2%. Federal Reserve Governor Sarah Bloom Raskin stated in a recent speech that the quest to address asset bubbles is "challenging." She cited the complexity of identifying real time sharp deviations in asset prices from fundamentals. Bernanke echoed this sentiment during a recent Q&A saying, "I don't think we can guarantee that we can prevent any bubble." Currently, the Fed's priority, between the two shadow mandates, seems to be to boost stock and bond prices rather than to avert asset bubbles.

The Fed's official goal is, in effect, to lower the Misery Index. In the past, bull markets in stocks tended to occur when the "Misery Index" (the sum of the official unemployment rate and the inflation rate) is falling, or at least not rising. The index is down from a cyclical peak of 13% during November 2011. We forecast that it will remain around 9% through the end of next year, suggesting that the current bull market may last at least until then, if not longer.

<u>Misery Index (Unemployment + Inflation)</u>



CLOSE-UP: The Economic Landscape

The final revision of real GDP for the first quarter was growth of 1.8%, with twelve-month growth through the first quarter of 1.6%. The consensus among economists for the current quarter is growth of 1.5%. There has been a slowdown of some recent statistics from the faster growth reported in the first quarter. The good news: inflation rates have also slowed against the backdrop of the recession in Europe; and there has also been slower economic growth in China, a large buyer of commodities. The producer prices continue to rise over the past year, with the consumer price index (CPI) up only modestly at 1.4%. Industrial production was unchanged in May, rising 1.6% over the past year and demonstrating a slowing trend. Capacity utilization dipped slightly, while motor vehicle production continued to be one of the bright spots in the economy with output up 6.7% year-over-year.

Manufacturing, which led the economy in its earlier recovery stage, has weakened in recent months and warrants monitoring. The weak growth in global trade is restraining progress in exports, which accounts for some of the weakness in manufacturing. Manufacturing, however, only accounts for 12% of the U.S. economy. In contrast, the Non-Manufacturing Index (services) showed continued strength in the current business upturn. The new orders and the employment index, coupled with advancing retail sales, represent a sustained growth pattern.

Although the savings rate has fallen to 2.5% in recent months, this suggests that consumers have expanded debt levels to maintain purchases. The good news is that employment levels are up 2.1 million over the past twelve months.

We believe that the outlook for the economy at best is continued growth at an annual rate of 2.5%, in contrast to the Federal Reserve's forecast of 3% in the second half of the year into 2014. As a result, their recent suggestion - that quantitative easing would be removed if the economy continued to strengthen - might be premature. While the financial markets initially reacted negatively to Ben Bernanke's comments on June 19th, it is also possible that he wished to remove some of the recent speculation in financial markets based on the idea that "cheap money" is everlasting. Fortunately, his recent testimony did not materially alter the wealth effect of rising asset prices, including real estate, which has helped fuel some of the gains in the economy. Certainly, the outlook for housing has improved in terms of sales of existing and new homes as well as housing starts. The leading indicators are still rising 2.3% through April and according to the Conference Board, consumer sentiment for May is 6.5 points higher than the previous month.

A Balmy Season for Second Quarter Earnings

- With 18% of the S&P 500 companies having finished their reporting, results for the Q2-2013 earnings season are mixed compared to the same point in Q1. Of the 91 Q2 reporters to date, 65% have exceeded industry analysts' estimates. That falls short of the 69% during the same time period in Q1-2013. On the revenue side, 50% are beating estimates so far, up from 44% for Q1. The Q2 surprise has weakened as more firms have reported. The 3.4% earnings surprise is behind Q1's 5.3% surprise at the same point, and the revenue surprise of -0.1% is on par with Q1's -0.2%. Earnings for these 91 companies are up 13.6% y/y on a sales gain of 5.0% - slightly better than the 11.8% earnings and 3.4% sales in Q1.

The Outlook for the Financial Markets

- We continue to forecast 2.3% real GDP growth in Q3, with 2% CPI inflation and corporate profits increasing by 7.0% for the year. The risk is a return to recession as has happened in Europe because of poor policy choices. As we have mentioned in the past, however, we too need to make better political policy choices with regard to regulation and taxes to right our under-utilized economy.

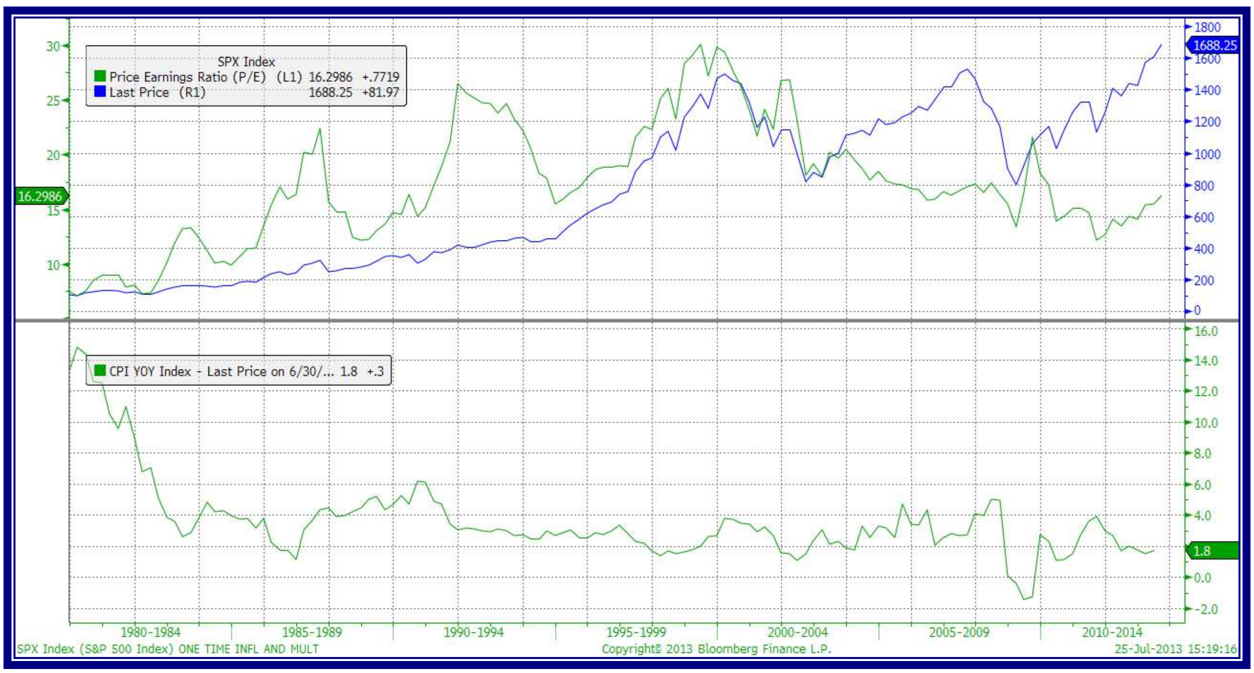
- The relationship between the S&P 500 and inflation is a bit more ambiguous than between the stock market and unemployment. This is because rising inflation tends to boost corporate earnings. However, rising inflation also tends to be associated with rising interest rates, which can depress valuation multiples.

- With regard to bonds, interest rates have increased across the board. Yields on 10-year Treasury bonds have risen to 2.5% from 2.0% in May. Long-term high quality corporate bond rates have moved from 4.83% to 5.47%, long-term municipal bond yields have risen to 4.3% from 3.9%, and 30-year mortgage bonds are now at 4.3% from 3.6% just a month ago. Furthermore, mortgage applications have fallen modestly over this period.

A Historical Perspective …

- The significant decline in inflation during the 1980s and 1990s lowered bond yields, lifting both stock valuations and stock prices. During the subsequent decade, inflation stabilized and fluctuated between 1.0% and 2.5%, but valuation multiples (price to earnings ratios) fell from the excessive highs reached at the beginning of that period. Despite what one might think, this period was followed by a bull market from 2003 to 2007. The growth was led by strong earnings, especially within the Energy, Materials, and Industrials sectors - all boosted by rising commodity prices.

S&P Index Price and Multiple (upper frame) - as compared to the Inflation Rate (lower frame)



- Since 2007, the traditional inverse relationship between the S&P 500's forward P/E and the inflation rate has been turned upside down. The expected inflation rate, as embedded in the spread between the 10-year Treasury and comparable TIPS yields (the difference between Treasuries and inflation expectation), has been highly and positively correlated with the P/E. That's because inflation has been so low and close to zero, since then, that falling inflation has raised the risks of deflation. This could be problematic for earnings.

- Expected inflation recently rose from 1.93% in the end of June to 2.2%, as Fed Chairman Ben Bernanke emphasized that the Fed's goal is not only to lower unemployment, but also to boost inflation closer to 2%. This sentiment has been bullish for stocks, currently selling at 14.6x our $110 per share estimate of earnings for 2013.

IN SUMMARY:

As we take a closer look at several key indicators, the economy seems to be on reasonable footing. The S&P 500 Stock Index (1606) is up over 13.83% year to date with the Morgan Stanley EAFE Index (1638), a measure of foreign stocks, up 4.53%. Commodities have also fallen, with gold ($1280 per ounce) down 7%, copper ($3.09 per lb.) down 7%, and oil ($93 per barrel) off 3%. The U.S. dollar index has been stable over recent months. Falling commodities in conjunction with a stable dollar index suggest inflation may be contained at current levels. A potential lead indicator for global growth (although quite volatile), the Baltic Dry Index rose from 847 to 1098. This measurement of shipping costs made a gain of 29% over the last two weeks of the second quarter. This either suggests that international trade might be stabilizing, or that fewer ships are finally entering the market after five years of over-supply.

We remain constructive on stocks, as we enter the third quarter. As long as investor perception is that the Fed accommodation approach is balanced, then resilient U.S. economic expansion in the near future seems imminent.