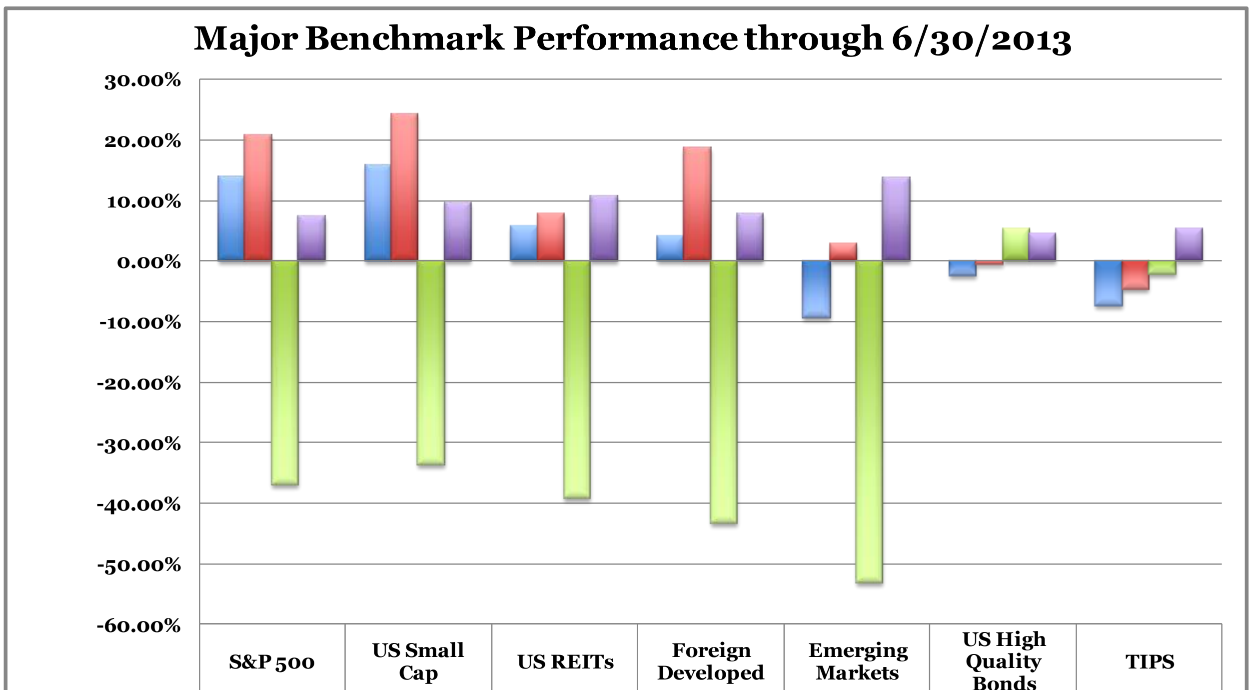
Market Summary and Outlook 2nd Quarter 2013

The equity markets ended the first six month of the year ahead. However, all of the gains came in the first five months of the year, and while equity markets were up for the quarter, the bond markets were all down. June was a very unusual month in that everything was down: all equities, commodities, and fixed income.

In the chart below, we compare the major markets and asset classes year-to-date and for the last 12 months. As you will note, despite the June declines, the equity markets are especially strong on a year-to-year basis, and although fixed income is down, performance in 2008 (as depicted by the green bars) is a reminder why we do not recommend just equities in client portfolios. Please note the high quality bond benchmark was up over 5% that year. Our conclusion remains that over the longer term diversification works as the best protection against market volatility.



	S&P 500	US Small Cap	US REITs	Foreign Developed	Emerging Markets	US High Quality Bonds	TIPS
YTD	13.82%	15.86%	5.65%	4.10%	-9.57%	-2.44%	-7.39%
12 Months	20.60%	24.21%	7.69%	18.62%	2.87%	-0.68%	-4.78%
2008	-37.00%	-33.79%	-39.20%	-43.38%	-53.33%	5.24%	-2.35%
10 Year (ann.)	7.30%	9.53%	10.68%	7.67%	13.66%	4.52%	5.20%

June Gloom

The biggest news story of the 2nd quarter was speculation over when the Federal Reserve would start to taper their $85B monthly bond purchases of Treasury and mortgage-backed securities. The Fed's policy of quantitative easing has sent stocks soaring this year and while Chairman Ben Bernanke has cautioned that as the unemployment rate drops the Fed will gradually taper the policy, starting in May, Bernanke started to be more specific with his comments which spooked both the stock and bond markets. Following Bernanke's comments on June 18, the US equity market started a slide that lasted several days. It has since recovered and is still up double digits for the year. However, the really shocking movement has occurred in the bond markets: the 10 year Treasury bond yield was at a low of 1.62% in early May. By June 30, the yield had climbed to 2.5%.

Bond yields move inversely to bond prices. During the Great Recession of 2008, bond yields dropped to lows not seen in over 50 years. Investors fled the stock markets and invested in the relatively safety of the US bond markets. When demand increases for bonds, the yield drops because the borrower (the US government) is able to pay a lower rate to borrow that money. With the economy improving, the Fed has stated it will cut back on its easy money policies.

The unemployment thresholds for the Fed to start cutting back the bond purchases are 7% and 6.5% to consider raising interest rates (which are currently 0% - 0.25%) on what banks charge to borrow from each other. As of July 5, the unemployment rate is 7.6%, where it has been for several months.

For a primer on bonds and why we continue to recommend them in a diversified portfolio, please refer to our Q12013 Newsleter

Going Forward

When both the stock and bond markets are volatile, it is tempting to make changes to the portfolio that may make you feel better or more in control in the short term. However, since we do not know where markets will go short term (it's impossible to know exactly which factors are driving the markets at any given time), we recommend focusing more on:

1) What you can control
2) Focusing on your long term goals

Financial professionals, including us, believe the markets overreacted to the Fed's recent comments. There is, however, no consensus on what the 10 year rate should be. The current rate is 2.5% - fund managers think the rate should be anywhere between 2.2% and 3.5%.

As painful as it is for rates to rise, it means the economy is improving and we are weaning ourselves off federal support. While there is no guarantee rates won't continue to rise, we do not think they will rise rapidly for a few reasons:

1) While unemployment is going in the right direction, the recovery is still very slow. Job creation is now averaging 200,000 jobs per month, a huge improvement from a much slower rate last fall when the Fed introduced the bond purchasing program to spur growth. Despite encouraging employment numbers, the rate has not changed in several months due to people trying to re-enter the workforce.
2) The US government is not the only buyer of US Treasurys. There are other central banks that continue to buy our bonds which should prevent rates from spiking further.
3) With our aging population, a large segment will invest in fixed investments (bonds) and will maintain a low level of debt.
4) Inflation is only about 1%, well below the Fed's target of 2%.

5) The current and third estimate of 1Q13 GDP is an annualized 1.8%, well down from the earlier estimate of 2.4%. This drop could be due in part to cuts in federal spending. It is still difficult to see a trend in quarterly GDP growth considering 4Q12's growth was a paltry 0.4% and the quarter before that was 3.1%.

Market Valuations

Despite a significant rise since last fall, we do not believe US equity markets are overvalued. Housing data continues to be positive although it will be interesting to see whether demand declines slightly due to rising mortgage rates. To provide some perspective, during the height of the housing boom 2005 – 2007, mortgage rates were 6-8%. They are currently around 4%. Also, manufacturing productivity continues to be strong. Rising manufacturing costs abroad mean more manufacturing jobs will stay in the US. With that said, don't expect the US stock market to keep rising at the rate it has so far in 2013.

International markets, especially emerging markets, have attractive valuations. Emerging markets are down over 11% year-to-date. This asset class has its own unique set of risks (political, transparency of their markets, currency, inflation). However, the strong demographics and low debt levels are what catch our attention. For long term investors who can stomach the volatility, the current valuations should be compelling.

Volatility Ahead

In summary, please be patient with the markets. As we monitor global economic trends and the market's reactions, we continue to believe markets are efficient (i.e. information is disseminated rapidly as it is released) although not always rational.

The slow, unsteady growth of the domestic economy and the uncertainty of foreign economies encourage maintaining well diversified portfolios, including investments in fixed income and equities, domestic and foreign. For the individual investor with excess cash to invest, the volatility caused by these economic conditions combined with long-term appreciation reinforces the decision to invest cash in phases over longer periods of time (dollar-cost-averaging).

Finally, despite the negative performance of fixed income, we continue to like this asset class, especially high quality relatively short term bonds and see them as a steady source of income that should help portfolios in times of market crisis like 2008.

We appreciate your continued confidence in us.

Janet & Barry

Sources: DFA, JP Morgan, Morningstar, WSJ, PIMCO, BlackRock