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INSIGHTS

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2013 Q2 INSIGHTS:
The Timing of the Taper Tantrum.

R**ECAP:** Most asset classes lost ground this quarter as volatility returned to global capital markets and adversely affected some recent winning streaks. Global Equity lost ground in the quarter ending a three-quarter streak of gains. On the other hand, U.S. stocks (S&P 500) gained ground in the quarter and reached a new all-time closing high of 1669, but then lost ground in June and ended a seven-month winning streak. Good news such as Consumer Confidence rising to a new post-recession high (rising consumer confidence correlates to higher equity valuation multiples and thus higher share prices) was mostly offset with bad news as Q1 GDP growth was revised down to 1.8%. So what caused the rise in volatility and subsequent selloff? Whereas Europe was the source of volatility in recent years, this catalyst came from the U.S. as news from Fed Chairman Ben Bernanke rippled around the world.

Chatter began in May that the Federal Reserve would start to reduce the monthly amount of asset purchases known as Quantitative Easing (QE). Even though the talk was not centered on the Fed "ending" QE but merely reducing the $85 billion of monthly bond buying (tapering), 10-year Treasury yields nonetheless reacted negatively and rose 95 basis points (bps) from May 2 (1.63%) to June 25 (2.58%). Expressed as a percentage gain, the 95 bps move in rates was a rise of 58%, in less than two months. The large and quick move in rates caught many investors off guard and there is good reason why—going back to 1962 (the earliest Fed record of daily closes), such a large percentage gain has never occurred in that short of a time span. Again, it is a reminder that we are living in interesting times.

The back up in interest rates negatively impacted bond prices and the subsequent selling cascaded into other assets. Case in point: while the S&P 500 ended the quarter up 37 points to finish at 1606, it finished the quarter 63 points below its high.

	Notable Sectors	Q2	Trailing Twelve Months
Stocks	**Global Equity**	**-0.42**	**16.57**
Stocks	U.S. Large Cap (S&P 500)	2.91	20.60
Stocks	U.S. Small Cap (Russell 2000)	3.08	24.21
Stocks	International Equity	-3.11	13.63
Stocks	Emerging Markets Equity	-8.08	2.87
Bonds	**Global Bonds**	**-2.79**	**-2.18**
Bonds	U.S. Aggregate (High Quality)	-2.32	-0.69
Bonds	U.S. High Yield (Low Quality)	-1.44	9.49
Bonds	International Aggregate	-3.08	-3.40
Bonds	Emerging Market Debt	-5.14	3.09
Other	Gold	-23.31	-23.72
Other	Oil	-0.69	13.65
Other	Inflation	-0.02	1.42

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EQUITY: Global equity markets lost ground in the quarter with plenty of blame to go around. While Europe and Asia posted moderate declines of 2-3%, the bulk of the losses were in Emerging Markets, which lost 8% in the quarter. Once again, U.S. equity markets outpaced foreign counterparts and posted a 3% gain. Small caps again outpaced Large Caps but by a small 18 bps margin, while Value outpaced Growth by 95 bps. The performance in the Value sector was varied as two stalwarts had very different quarters—Financials led the market with a 7.25% gain while Utilities lagged all sectors and lost 2.73%.

FIXED INCOME: Starting a streak of their own, Global Bonds were down for the third straight quarter and have now posted a negative return for the trailing 12 months. There were few places to hide within bonds as the rise in rates affected almost every sector. In the U.S., lower quality credits held up better and lost “only” 1.44%, while higher quality sectors such as Treasuries and Mortgages lost 2-4%. Mirroring equities, Emerging Market Debt lagged and was off over 5%.

ALTERNATIVES: Master Limited Partnerships (MLP) gained 1.94% for the quarter while Real Estate Investment Trusts (REIT) lost 1.58%. The big movers, however, were in Commodities, as that sector lost 9.45%. Oil was essentially flat, Copper lost 10% and Gold lost a whopping 23% and is now down 35% ($668) from its 2011 high ($1891).

OUTLOOK: While the euphoria of the S&P hitting an all-time high was quickly followed by the fear of the 5.8% pullback, it is important to remember that ***volatility is normal***. Consider that since the bull market began back in March 2009, the S&P has experienced *17 pullbacks of 5%*. According to Bespoke Investment Group, the average decline of these pullbacks has been 8.3% (median 7.7%). To reach the average pullback, the S&P would need to fall another 70 points to 1530; but, looking out longer-term (if two quarters is long-term these days), history favors the Bulls. In the 85 years since the S&P 500 was first created, in the years in which the index was up between 10-20% through Q2, the second half was positive 86% of the time and the average gain was an additional 8.16% (median 10.13%).

Signs of strength in the U.S. include an improving Housing sector, an improving jobs market, a secular resurgence in manufacturing due in part to the Shale Oil/Gas revolution, and still easy monetary policy. Overseas, Europe is showing signs of “green shoots” (not unlike the U.S. in 2010), while valuations in Emerging Markets are extremely attractive and much of the bad news may already be priced in.

We are in the early innings of capital markets adjusting to a long and slow but inevitable return to a more normal monetary policy environment. Markets will be fixated on the *timing* of Bernanke’s “tapering” for at least the next 3-6 months and probably longer as our easy and unconventional monetary policy will be difficult to unwind without adversely shocking the economy. Investors should be rejoicing that the Fed believes the economy is strong enough to be weaned off the stimulus and the emergency triage that was necessary due to the onslaught of the Great Recession. As Liz Ann Sonders of Schwab put it, “The end of financial repression (negative real interest rates) and a return to more market-oriented conditions is a good thing, but the journey will bring bouts of volatility and likely more ‘taper tantrums’.” This reinforces the belief that investors should have a long-term, diversified plan ***and the discipline*** that goes along with it.

Sincerely,
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Director of Investment Strategy

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