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Market Commentary *Mid-Summer 2013*

Suspicious of Stocks and Anxious Over Bonds

As is obvious to most of us, the US stock market has become the world's top performer through what is now history: the first half of 2013. The Dow, the S&P 500 and the NASDAQ have all reached new highs. The mid and small cap indexes have done even better. The lesson to be learned here is that, despite what investment instinct or common sense might otherwise dictate, ***"You can't fight the Fed".***

We, however, have chosen to remain rooted in caution coupled with a reluctance to chase the next market top which could always be its last peak. It's about plying risk management, and avoiding "the greater fool theory": who will be the last to buy in and hence the first to sell off!

Our conviction is driven by our belief that these new highs are much less the product of stock market fundamentals and almost exclusively the planned outcome of the Fed's massive liquidity program, now four years old. From the outset, its mission was to directly reflate the economy and indirectly improve our personal sense of wealth. Those objectives are being reinforced at each market up-turn but at what future risk? Four years of yield curve manipulation have finally driven most income-starved investors to the stock market for its promise of greater returns: returns which can no longer be found in bonds. At the same time we believe most investors are becoming complacent to the risk they are accepting in exchange for those returns. So, lest time has dulled our memory or we simply choose to remain complacent as to how these striking highs have been achieved, the drama and volatility that unfolded before us in early May through mid-July are a painful reminder of just how addicted the financial markets have become to stimulus. Accordingly, this brief but volatile period should serve to reinforce the notion that, in the end, there are no free lunches!

While the stock market seems to have returned to its pre–May trading levels stretching for new highs almost daily, the bond market, long on memory, has become excessively bearish on the notion of imminently raising rates. And while bonds yields have receded from earlier peaks, angst over owning bonds has driven huge outflows from bond funds leaving others to navigate a depressed market.

So what do we read in all of this? First, the good news - as temporal as it may be.

The mid-year market turmoil was in our mind an untimely over-reaction. Why? We believe the Fed has been overly optimistic in its growth estimates. To us, reducing unemployment to 6.5% anytime soon still remains a bridge too far. Constraining inflation to 2% seems almost irrelevant given that inflation is running closer to 1% right now. The imposition of new taxes

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early in the year combined with the fiscal drag of a second round of sequestration in October and the huge yet undetermined cost of “Obamacare” will all serve as near-term headwinds to measurable growth. This should prevent the Federal Reserve from being any less accommodative than they have been in the last four years.

So - the bad news? As they say, in the end everything will be alright. If so, eventually the economy will find its way back to robust growth. When that prospect nears, we must be prepared to “pay the piper” for the many years of easy money. The pain will likely be similar to that seen at mid-year. We can only hope it will be as abbreviated.

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