

Economic & Market Review

~ Second Quarter 2013 Investment Newsletter ~

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Executive Summary

In each of the past three years, economic activity started with a burst of momentum that slowed into the spring. Data released at the start of the second quarter suggested a continuation of that trend. Against previous months, labor markets weakened somewhat in March and April, manufacturing growth eased materially, and both retail sales and durable goods orders contracted in March.

A slowing trend was not unique to the U.S. Notably, China's first quarter growth was disappointing, and the nation's resurgence in economic growth was increasingly doubted as the quarter progressed. The world's second largest economy faced slowing retail sales growth, fading industrial production, and weakness in both export demand and investment spending. As for Europe, diminished growth expectations suggest a seventh consecutive quarter of recession in the second quarter and a contraction for all of 2013.

Despite a weaker economic landscape, investment markets performed well during April and investor sentiment was unabashedly bullish. U.S. credit spreads tightened to levels last seen in 2007, stock markets hit new highs, and margin debt rose to over 2% of GDP for only the fourth time in history.

Commodities were a notable exception to generally favorable investment market returns in April. Copper, widely viewed as a leading indicator, fell into bear market territory (down over 20%). Additionally, gold collapsed during the month due to diminished inflation fears, slower economic growth, and the potential of forced selling by beleaguered European nations.

Capital market momentum from April extended into May as investors pushed both domestic stocks - and margin balances - to new all-time highs. Following suit, high yield debt yields also fell below 5% for the first time in history.

Exuberance diminished, however, in the final third of the month. Contraction in Chinese manufacturing intensified global growth concerns and tripped up the meteoric rise of the Japanese stock market that

began last November. U.S. monetary policy also went under a microscope following suggestions by Bernanke that the Fed may back off of bond buying in coming meetings. On this news, bonds weakened, capital market volatility rose, and the dollar rallied. By month end, every major asset class other than domestic equities had lost ground.

Global growth concerns and Fed watching continued into June. Statements following the Fed's June meeting proved even more disconcerting to investment markets and details of Japan's overhauls came up short. U.S. bond funds of all types suffered record outflows, interest rates backed up to two year highs, and Japanese stocks were volatile. Fixed income markets worldwide, from Europe to emerging markets, were hit by the potential of Fed unwinding. When the dust settled, every asset class was down in June. The carnage was broad and in some cases deep. There was no place to hide.

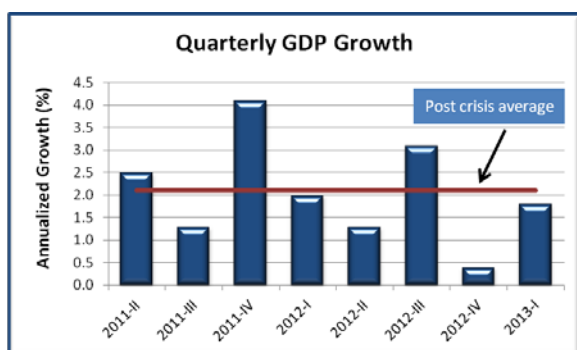
The downdraft in global investment markets suggests a belief, likely incorrect, that the Fed's timing will be rather soon. Furthermore, the notion that interest rates are about to return to normal is misguided. On these points, central bankers worldwide reassured markets that the end of easy-money policies remains a long way off. Even Fed officials explained that worries are overdone, and the economy is simply not healthy enough to support the monetary deceleration envisioned by investors. Manufacturing is showing marked weakness – nearly worldwide. Strength in the dollar will slow domestic growth and put downward pressure on an already tepid rate of inflation. Furthermore, rampant beggar-thy-neighbor currency devaluations across the globe will magnify all of the above. These are notable Fed concerns. Likewise, the Fed considers the labor market to be far from healthy and has expressed concern about the impact of fiscal constraint (tax increases and sequestration cuts) on domestic growth. Following their disruptive second quarter communications, they can now add self-induced asset price weakness and the negative impact of higher mortgage rates to their list of worries.



Economic Review and Outlook

Economic Growth

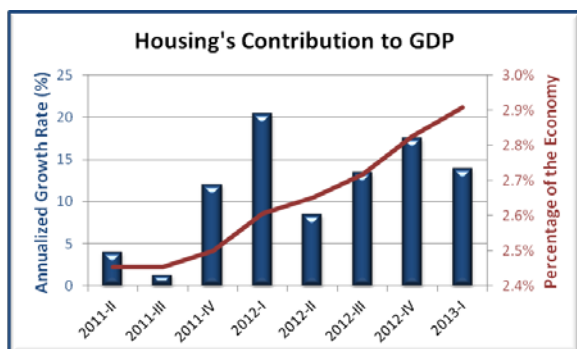
U.S. GDP grew at an annualized rate of 1.8% in the first quarter of 2013, only half of the pace forecasted in late March. This was the fourth quarter out of the past five where growth was below the 2.1% post-crisis average.



Data Source: U.S. Department of Commerce

The key detractor to growth in the period was government spending. For the second quarter in a row, a rapid contraction in defense spending pushed government outlays lower. Federal spending fell at an annualized rate of 8.7% while state and local spending dropped by 2.1%. Aggregate government spending fell by 4.8%, the tenth decline in the past 11 quarters. Absent the government drag, U.S. economic growth would have been nearly 1% higher.

U.S. housing helped to compensate for weakness in government spending. Residential housing grew 14% on an annualized basis in the first quarter, the eighth consecutive quarter of growth.



Data Source: U.S. Department of Commerce

Moreover, by outpacing the rest of the economy, housing is gradually becoming a larger component of total economic output. Once contributing 6.2% to aggregate U.S. domestic production, residential housing fell to 2.4% of the economy following the financial crisis. As shown in the previous graph, housing has regained some of its lost ground.

Looking forward, \$85 billion in sequestration cuts will be observed in second quarter data and increasingly felt as the third quarter progresses. Slower than expected emerging market growth and a continuing recession in Europe are also weighing on U.S. growth. In response, economists have lowered their expectations for both second quarter and full-year domestic growth to 1.7% each.

Once envisioned to be the year of global growth reacceleration, 2013 is not playing out as hoped.

For investors, however, the most important development in terms of economic growth came not from the U.S., but from across the globe. China's factory output has been weak, and investment spending is slowing. Growth for the year ended in March fell to 7.7% versus 7.9% in 2012. This was particularly disturbing considering expectations of a reacceleration of growth to 8.0%. The ability of the government to meet its official 7.5% growth target for 2013 is now being questioned by some economists.

Once envisioned to be the year of global growth reacceleration, 2013 is not playing out as hoped. Indeed, citing government spending cuts in the U.S., stagnation, at best, in Europe, and disappointing growth in China, the International Monetary Fund (IMF) recently trimmed its forecast for global growth down to



3.3% for 2013. If anything, IMF revisions are actually behind the curve. As shown in the following table, private sector economists have slashed expectations even further.

Global Growth Rates

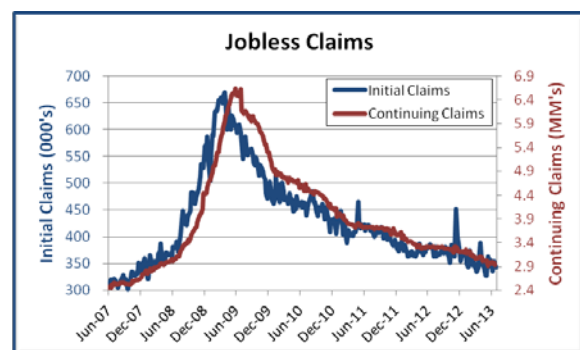
	2011	2012	2013 Q2 Start	2013 Q2 End
Euro zone	1.5	-0.5	-0.5	-0.7
U.S.	1.8	2.2	2.2	1.7
China	9.3	7.8	8.2	7.4
Japan	-0.6	2.0	1.2	2.0
Brazil	2.7	0.9	3.3	2.3
India	7.3	5.1	5.8	5.4
Advanced	1.7	1.2	1.3	1.1
Emerging	6.9	5.4	6.4	5.4
World	3.8	3.0	3.3	2.9

Data Source: Goldman Sachs

Excluding Japan, growth forecasts for all major economies have been trimmed over the past three months. Moreover, world growth in 2013, for both advanced and emerging economies, is now expected to be at or below that of 2012.

Employment

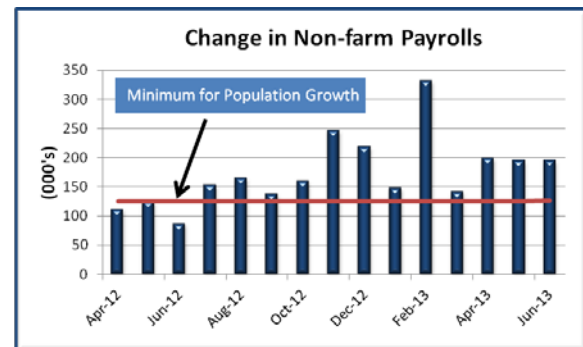
The labor market is gradually improving. The ratio of job openings to unemployed workers continues to trend higher, and jobless claims, both initial and continuing, have fallen to pre-crisis levels.



Data Source: U.S. Department of Labor

The unemployment rate has fallen to 7.6% from 8.2% at this time last year and payroll growth

has exceeded that required for population growth in every month over the past year.



Data Source: U.S. Department of Labor

While the labor market has undeniably improved, the pace has been dismal and total progress is lacking. Based on the Department of Labor's so-called U-6 number, 22.6 million individuals are either unemployed or underutilized by the U.S. economy. This number is 8.3 million higher than what would be expected in more normal times. At the current pace of job creation, it would take nearly 10 years to return the economy to what economists would consider "full employment." Clearly, after nearly four years of post-recession recovery, the level of labor market slack remains excessive, and the trajectory to closing the gap is insufficient. As discussed later, these facts must be considered when anticipating how rapidly the Federal Reserve will withdraw the use of unconventional monetary tools and how anxious they will be to actually tighten monetary policy.

The Consumer

Despite weakness in the labor market, the consumer is reasonably healthy and fairly confident in economic prospects. The Conference Board's Consumer Confidence index hit a new post-recession high in June and is approaching the long-term average after years of dismal readings. The personal savings rate is low, but has ticked higher each month since bottoming in January. Retail sales continue to grow on a monthly basis and auto sales, already at a strong level, are accelerating higher.



Household balance sheets are in great shape as well. Net worth is at a new all-time high, total consumer debt relative to GDP is at the lowest level since 2003, and delinquencies are a multi-decade lows. Lastly, fixed financial obligations relative to disposable personal income are at a level last seen in the early 1980's and just above the lowest level in recorded history.

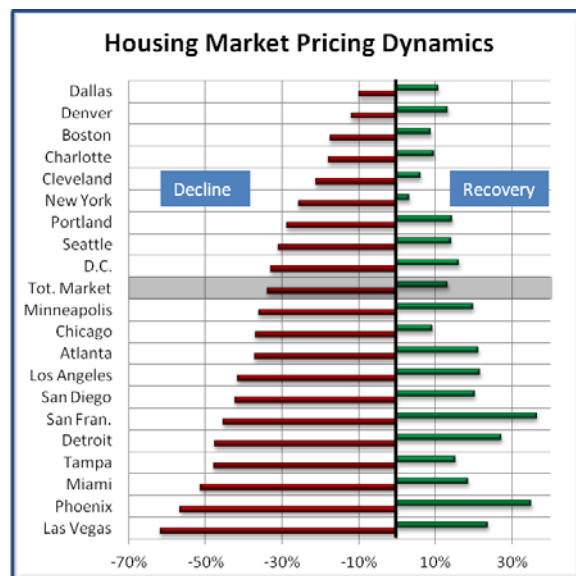


Real Estate

The housing recovery that began around the start of last year continued through the second quarter. Sales volumes of both new and existing homes are up by strong double digits and inventories are tight. Furthermore, each of the 20 major real estate markets have experienced sequential monthly price gains since December of last year. Through April, home prices were up 12.1% from the previous year and 13.5% from the market trough in January of last year.



As a general rule, the markets that were hit the hardest are those that have had the strongest recoveries.



Despite the snapback, however, any given percentage decline requires a greater percentage gain to fully recover. In the case of the overall housing market, for example, the peak to trough decline of 34% requires a 52% gain just to get back to even.

Housing prices have a long way to go, yet market fundamentals became more attractive over the past five or six quarters. Good progress has been made. Unfortunately, mortgage rates, key pillars of housing support, were damaged during the second quarter. A material rise in interest rates over the past two months took 30-year mortgage rates from 3.35% at the start of May to an early July level of 4.29% (both rates are based on market averages reported by Freddie Mac including 0.7% in fees and points). As a result, the average buyer can now afford 8% less home.

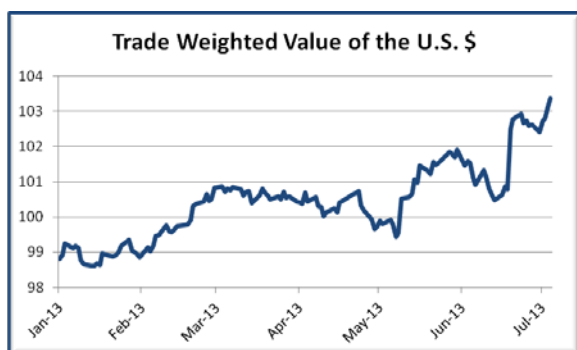
A jump in mortgage rates often creates an initial flurry of activity as worried purchasers accelerate the process to find and close deals. Hence, a spike in summer volumes and prices is entirely likely. Following the rush, however, it is entirely plausible that housing market growth dynamics will diminish. Importantly, the political and economic ramifications of a



weaker housing market are not lost on the Federal Reserve. Their agenda of a gradual reduction in unconventional monetary policies may take a back seat if housing market fundamentals deteriorate.

Commodities and Inflation

Inflationary pressures have diminished and expectations for future inflation are tame. Likewise, a number of factors have come together to create headwinds for commodities. Supply pressures in a number of key markets have eased. Weather conditions have been more favorable than in previous years, long-term expansion projects have come on-stream, and dramatic growth in U.S. energy production has helped to keep energy markets well supplied. Concurrently, slower economic growth, particularly in China, has relieved pressure on the demand side of the equation. Financial markets, namely currency movements, have been material and impactful as well. Japan's rapidly declining currency has acted to export deflation to countries with less aggressive monetary policies. Similarly, the rise in the U.S. dollar serves to restrain domestic prices as well as to dampen commodity prices quoted globally in U.S. dollars.

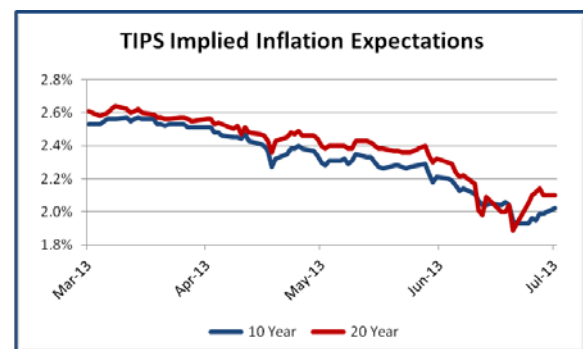


Data Source: U.S. Federal Reserve

Finally, Federal Reserve statements suggest a less aggressive monetary stance is on the horizon. For investors, that means a reduced threat of inflation down the road and less need for portfolio tools traditionally used to combat that risk.

In accordance with the aforementioned points, commodities were hammered during the quarter. The Commodity Research Board (CRB) index dropped 7% with several commodities fairing far worse. Among other declines, copper hit bear market territory by mid April and gold's drop of 23% was the most in a single quarter dating back to 1920!

Treasury Inflation Protected Securities (TIPS) were shunned by investors, and inflation expectations plummeted.



Data Source: U.S. Treasury/Summit Calculations

The Federal Reserve is as concerned about disinflation and deflation as it is about inflation, perhaps more so. Rapidly falling commodity prices, easing inflationary pressures, and diminished inflation expectations will be weighed by policymakers before easing off from bond purchases.

Fiscal Policy

For a pleasant change, fiscal issues in the U.S. were fairly quiet during the quarter. The government's fiscal position was surprisingly healthy as well. Favorable receipts and controlled outlays have delayed debt ceiling issues until September or even October. Likewise, the country's projected fiscal year 2013 deficit was revised lower by \$200 billion to a new estimate of \$642 billion. The deficit this year will be the first below \$1 trillion since 2008 and represents 4% of GDP. Of course, as the annual deficit shrinks so does pressure on Congress to implement long-term budget reform.



Monetary Policy

If the first half of the quarter could be characterized by concern over China and global growth, the second half was all about Fed policy. Ben Bernanke's May 22 Congressional testimony kicked off a financial tsunami of sorts in the capital markets. His public comments at the conclusion of the Fed's meeting on June 19 only intensified investors' concerns and spurred a fairly dramatic repricing of assets. In the carnage that ensued, the 10-year Treasury yield moved from an early May low of 1.66% to an early July high of 2.73%.

Particularly perplexing was the fact that Bernanke said exactly what he was expected to say and laid out a timeline no different than economists' expectations for months. Specifically, he said it would be appropriate to moderate bond purchases later in the year provided inflation moves higher and growth accelerates. The pullback from unconventional monetary tools would proceed, in measured steps, during the first half of 2014 with a targeted conclusion by midyear.

The Chairman also provided fairly dovish comments that seem to have been missed by markets. First, the Fed will probably never sell the mortgage backed securities on its balance sheet. Rather, these securities will be allowed to roll off over time. Second, the zero interest rate policy may be extended beyond an unemployment rate of 6.5%. Finally, when the Fed does start to raise rates, it will do so at a very gradual pace. Also overlooked by investors is the fact that the stated Fed requirements for "tapering" of bond buying have thus far failed miserably. Specifically:

- First quarter GDP was revised significantly lower just one week after the Fed's meeting.
- Domestic and global growth forecasts for 2013 have been downgraded.
- Labor market slack remains unacceptable.
- The Fed-induced jump in mortgage rates may stall Fed-desired housing improvements.

- Weak domestic growth and dollar strength are keeping inflation uncomfortably low and well below Fed requirements.
- Inflation expectations have been trending lower and are not stable.
- Asset prices have retrenched despite a Fed goal of enhanced growth through the wealth effect.

In short, markets appear overly pessimistic relative to probable Fed actions. Investors have excessively discounted some data points while overreacting to others.

Governments, Politicians & World Events

China will remain under a microscope. Growth dynamics, questionable monetary policies, real estate prices, and a substantial buildup in credit are all potential flash points. As for credit, Fitch gave the nation its first downgrade since 1997 based on the level of bank credit extended to the private sector - the highest of any emerging market.

Debt in Europe rose last year from 87.3% to 90.6% of GDP. Despite the deterioration, the absence of crisis has encouraged Europeans to adopt a more casual attitude regarding debt levels, deficit targets, and systemic integration. Germany's central banker warned the region would face as long as a decade to overcome the debt crisis. He also cautioned that a lasting solution will only come once politicians stop relying on the ECB and push through structural reforms. The IMF also warned of chronic global crisis in the absence of reforms.

The Bank of Japan (BOJ) outlined plans to pump \$1.4 trillion into the economy over the next two years through open-ended asset purchases. The commitment, to buy 70% of bond supply along with other assets, is targeted to double the monetary base by the end of 2014. On a relative basis, the plan's scale is more than double that of the U.S. Federal Reserve and makes the BOJ the first central bank to target the monetary base rather than interest rates.



Capital Markets Review and Outlook

Overview

U.S. stocks far outpaced all other asset classes in the first quarter. The second quarter followed a similar pattern with one notable exception. In the just completed quarter, domestic equities were the *only* category with positive results. Every other asset class lost ground. On a year-to-date basis through June, and in percentage terms, domestic stocks were up by low teens while all other asset classes were up marginally to down significantly. The investment market dichotomy between the haves and the have-nots was truly stunning.

Investors faced two distinct challenges during the quarter. The first involved weak economic growth and came roughly in the first half of the period. At that time, China's growth disappointed and forecasts of global economic expansion were dialed back meaningfully. The second, arriving in late May and extending past quarter-end, was fear of the Federal Reserve backing off of the monetary throttle. Bernanke's suggestion of "tapering" the use of unconventional monetary tools sent investment markets into a tailspin. Interest rates shot up globally and bond investments of all kinds were hurt. The dollar rallied, yield focused investments lagged, and commodities and emerging markets both got hammered.

Capital Market Returns

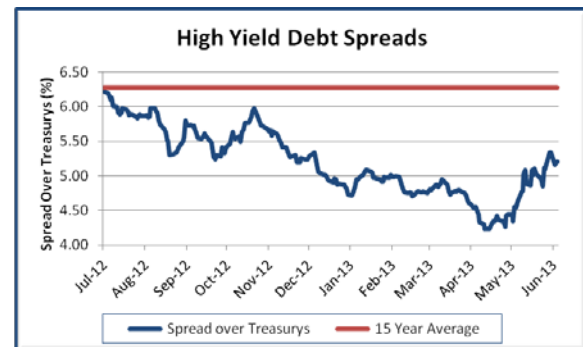
	2 nd Qtr 2013	Year-to Date
S & P 500	2.9 %	13.8 %
Wilshire 5000	2.8 %	14.1 %
U.S. Treasury Bills	0.0 %	0.0 %
MSCI EAFE (Int'l Equities)	-1.0 %	4.1 %
Barclays Aggregate Bond	-2.3 %	-2.4 %
Barclays Municipal Bond	-3.0 %	-2.7 %
MSCI ACWI ex. U.S.	-3.3 %	0.2 %
MSCI EM (Emerg. Mkts)	-8.1 %	-9.6 %
DJ UBS Commodity Index	-9.5 %	-10.5 %

Data Source: Morningstar

Fixed Income Markets

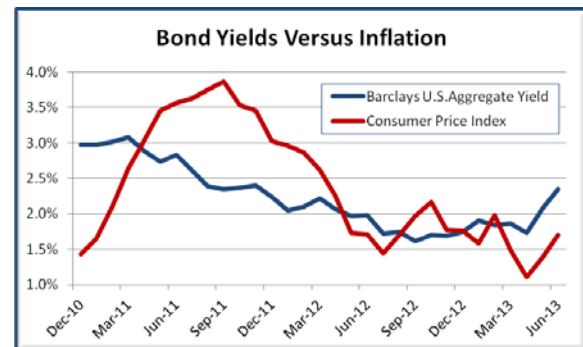
The Barclays Aggregate Bond index lost 2.3% in the second quarter as low yields were insufficient to offset a rise in interest rates. The 10-year Treasury yield rose 65 basis points to end the quarter with a yield of 2.52%. Internationally, the story was similar with the addition that a rising dollar served to magnify losses for U.S. investors. International bonds lost 3.1% for the quarter and were down 6.5% for the year-to-date.

As for credit markets, high yield debt spreads widened significantly following Bernanke's May 22 speech to Congress. As illustrated below, however, spreads still remain fairly tight.



Data Source: BofAML High Yield Master II

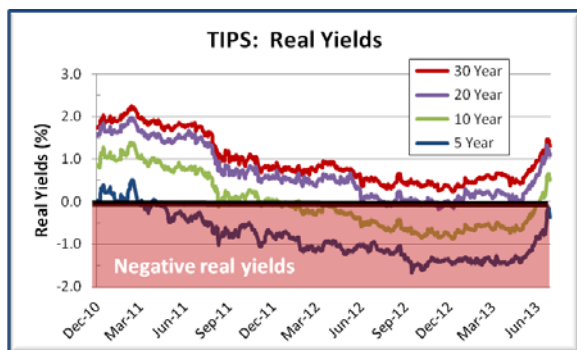
Despite the weakness in fixed income markets, actually because of it, U.S. fixed income investors are now compensated for inflation for the first time in over two years.



Data Source: Bloomberg & U.S. Department of Labor



In a period of massive - and record - outflows from fixed income related mutual funds, the great irony is that prospective returns are actually far more attractive today than they have been in some time. The same goes for inflation protected securities which are now paying more attractive yields than they have in two years.



Data Source: U.S. Treasury & Summit Calculations

Equity Markets

As with the first quarter, the U.S. stock market outperformed all other asset classes in the second quarter. The contrast against other investment categories was only enhanced by the fact that domestic equities rose while everything else fell in value. In some cases, such as emerging markets, losses were steep. In the U.S., no particular capitalization range or investment style outperformed others for the quarter.

Equity Capitalization and Style Returns (Q2)

	Value	Growth
Large	3.2 %	2.1 %
Mid	1.7 %	2.9 %
Small	2.5 %	3.7 %

Data Source: Russell Investments

For the year-to-date, however, small caps and value investing generally outperformed.

Hedge Funds and Alternatives

The HFRI Fund of Funds Composite index was flat for the quarter and up 3.3% for the first half of 2013. Markets driven by unforeseen, yet major policy shifts have been a challenge for hedge fund managers to navigate. Global macro strategies also operate across a wide set of asset classes on a worldwide basis. In a period like 2013, when one asset class performs and most others are down, results will be modest.

Publicly traded REITs fell 3.3% for the quarter, but remain up 4.8% year-to-date. Commodities, the laggards for both the quarter and the first six months, are down 10.5% for 2013 following a loss of 9.5% in the second quarter.

Disclaimers

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