OVERVIEW

Economic Analysis and Market Review

Q2—2013

- More to Q2 than just "taper"
- The spread of quantitative easing
- Outlook for the markets

The second quarter is over and according to the news, it was all about the talk of the "taper", the Fed's hint that QE3's days are numbered, but a closer look at the signs would suggest that there's more going on under the surface. Fed Chairman Ben Bernanke has said before that his stimulus program to the tune of $85 Billion per month will be phased out as unemployment declines to 6.5% and inflation rises to around his target of 2-3%. That's not happening and isn't about to happen until probably the second half of 2014 according to many economists. For the Fed to think about tapering off their bond buying would imply that the economy is recovering nicely and inflation is still around the corner. But that doesn't appear to be the case. Take manufacturing, albeit a small part of our economy, but manufacturing in the US unexpectedly shrank at the fastest pace in four years, showing that the slowdown in business and government spending is holding back the world's largest economy. The Institute for Supply Management's (ISM) Factory Index fell to 49 (above 50 signifies growth) in June, the lowest reading since the second quarter of 2009. The reading in May was 50.7. Manufacturing is only about 12% of our economy but it's hard to see this segment performing much better with across-the-board federal budget cuts and critical overseas markets that are struggling at this time. The ISM Services Index, representing a much larger segment of the US economy, came in at a solid reading of 54 (above 50 indicates growth) which would suggest that there is growth afoot and tapering the stimulus will come. Keep in mind, however, that the Fed's benchmark is 6.5% unemployment and we're currently at 7.6%. I think QE3 has a lot more room to run.

The impact that QE1, 2 & 3 have had on our economy and our markets is significant. So much so that now Japan is giving it a try. Their new prime minister, Shinzo Abe, has had enough — no more deflation, no more overvalued yen, no more wage stagnation and no more "lost decades" — so he has set the Bank of Japan on a course of super easy monetary stimulation.

In April he launched a 7 trillion yen ($75 Billion) per month quantitative easing program to get their economy moving on a faster track. With a bond buying program done with full employment in Japan, all the effects of their QE1 will be reflected in their prices. In addition, the value of the yen relative to the dollar will decline making exports cheaper. Of course, then with renewed activity and higher earnings, Japanese stocks will rise. And they have. The Japanese stock market was the best performing market in June (+1.75%) and the best in the second quarter with a gain of 4.4%.

Witnessing the success of the Fed's quantitative easing policy and the nascent results of Japan's similar program, one has to wonder if Europe will have an epiphany and embark on a program of printing money to help raise their economies from stagnation. It may not happen, however, as Europe's history of hyperinflation, a possible consequence of an easy monetary policy, hasn't faded from memory.

In the stock market, the second quarter began as just a mirror image of the first quarter, a continuing pattern of higher highs and higher lows until June 19 when Fed Chairman Bernanke first hinted that his quantitative easing might soon be wrapped up. He didn't say it was imminent but that's what the market heard and down it went. Not just stocks (-1.5%) but everything – bonds jumped 11 basis points (when rates rise, prices drop) and gold lost 2.0%. In the days that followed, it was more of the same. Stocks lost another 4.2%, gold dropped another 5.5% and Treasury bond rates climbed 34 basis points. But given where interest rates are currently, the stock market can't stay down for long. The low global interest rate environment is making equities attractive relative to fixed income and forcing the stock market higher. It is very hard at this point to make a solid case for investing in bonds when interest rates are so low and can only go higher from here. The zero interest rate climate we're in today is causing investors to effectively move up the risk spectrum and buy riskier assets.

Can this rally in stocks continue? I think it can. There will be a lot of volatility when the tapering process begins but scaling back the easy money program would be a sign that the economy is in good shape which is a healthy environment for stocks. It would also be a time of rising interest rates thereby causing losses in the bond market and another reason to shift over to stocks. What could go wrong?

Market Indexes
Second Quarter, 2013

INDEX	Q2'13	YTD	3 YEAR RET.	10 YEAR RET.
S&P 500	2.91%	13.82%	18.45%	7.30%
Russell 2000	3.08%	15.86%	18.67%	9.53%
Europe, Aust., Far East	-0.98%	4.10%	10.04%	7.67%
Barclays Agg. Bond	-2.32%	-2.44%	3.51%	4.52%
Dow Jones Real Estate	-1.29%	5.65%	18.98%	10.68%
Dow Jones Real Estate	0.02%	0.04%	0.11%	0.00%

- The S&P 500 is an index of large, well-established companies
- The Russell 2000 is an index of 2000 small companies
- The Europe, Australasia, Far East Index (EAFE) is an index of developed countries around the world
- Barclays Aggregate Bond Index is an index composed of investment grade bonds
- Wilshire Real Estate Index is an index of commercial real estate properties