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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

In mid June, it appeared we were in the summer doldrums. The economy muddled along, while the equity markets continued to move higher, reflecting improving fundamentals and attractive valuations. **Bond yields were beginning to rise, putting downward pressure on bond prices. This rise in rates should not have been a surprise given that rates have been at historical lows.** Global news was disconcerting, with civil war raging in Syria, civil unrest in Egypt, Turkey, Brazil, and South Africa, and the consequences of China embarking on a policy to rein in speculative and questionable lending.

Until recently, the domestic U.S. equity market has been able to shrug off these pressures. **On average, equity markets are expected to experience three corrections of more than five percent, annually.** Through the middle of June, there had been no such correction and volatility had been unusually subdued, in spite of pressure from bond prices.

In large measure, this reduced volatility in the stock market is a result of Federal Reserve Bank policy. The recent round of quantitative easing has the Fed purchasing mortgage backed securities. Mortgages are different from other fixed income securities. Because their duration (the time it takes to recover the initial investment) is dependent on borrowers' prepayments and prepayments are inversely correlated to the level of interest rates (e.g., if you lock in a low rate on your mortgage, you are less likely to refinance than if you are borrowing at a higher rate), mortgage-backed security prices are much more sensitive to changes in interest rates than Treasury securities. **With its aggressive purchase of mortgage-backed securities, the Fed has effectively suppressed volatility**. In theory, through the use of various hedging vehicles, all volatility is related; hence, financial markets in general, and equity markets in particular, have displayed little volatility until recently.

For quite some time we have talked about the Federal Reserve policy of providing the liquidity to fuel the economic recovery and how it has been neutralized by regulations and fiscal policies which impede the circulation of money. **The current strategy of suppressing volatility, on top of the additional liquidity available, has made equity valuations even more attractive**. So much so that recent talk about "tapering" or ending quantitative easing, as well as talk about Chairman Bernanke stepping down, has had the consequence of reducing the exuberance in the equity markets and precipitating our first five percent correction of the year.

There is no question that monetary policy has provided the stimulus which has driven the current economic recovery. Can the Federal Reserve continue to stimulate at the current rate of $85 billion a month indefinitely? Of course it can not. **But when quantitative easing subsides, the impact on economic growth, inflation, and interest rates is not entirely clear**. Inevitably, the impact will be increasingly dependent on the willingness and ability of investors, companies, and individuals to spend and invest the money which has remained in reserve due to uncertainty. With more transparent prospects, money will again circulate and the velocity of money can begin to replace Federal Reserve Bank stimulation. At least, that appears to be the Fed's strategy.

Meanwhile, we remain constructively optimistic regarding the potential for returns from equities. The fundamentals of the underlying companies are intact, valuation levels are attractive, and stocks have the ability to adjust to moderate increases in inflation. The market apparently agrees with our assessment, as it has quickly rebounded from the first five percent correction of the year.

Fixed Income Market

It has been a challenging quarter for bond investors. May 2013 was the worst month for bonds in nine years. **The 10-year U.S. Treasury rate went from 1.67% on April 30th to 2.16% at the end of May, and increased further to 2.50% as of the writing of this newsletter.** This translated into lower bond prices across almost all fixed income sectors.

The main concern of bond holders is the aforementioned actions by the Federal Reserve to begin "tapering" the bond-buying program known as "quantitative easing." In the most recent Federal Open Market Committee meeting, **Chairman Bernanke laid out the Fed's plan to slow the pace of bond buying in late 2013 and possibly**

end the program by the middle of 2014. Of course, he predicated this action on the continued improvement of the economy, particularly regarding unemployment and inflation.

He further described the action in the press conference as analogous to "taking the foot off the pedal", further explaining that the Fed is nowhere close to raising rates, or "applying the brakes." Despite the expectation that the Fed would systematically end its policy of injecting liquidity into the economy, the markets reacted negatively to the news and the 10-year Treasury yield went up 0.14% that day, with the Dow falling 200 points.

Given such a rapid increase in rates, investors are justified in questioning the rise and whether it will sustain such a blistering pace. On the first note, it appears much of the rise in rates was due to levered investors unwinding positions that were exposed to interest rate risk, and locking in some of the gains up to this point. **The era of a continuously easing monetary policy seems to be coming to an end. However, the Fed is unlikely to take any actions that will harm the recovering economy, and it has clarified that its actions will be data driven and flexible should indicators change**. With recent GDP revised to 1.8% for the first quarter and unemployment still at 7.6%, rates seem unlikely to keep rising at this pace.

The advice to our clients remains the same despite this interest rate volatility. We buy and hold our individual bonds to a relatively short maturity, thus removing the potential for loss of principal based on interest rate movements. **Staying on course toward long term goals remains the prudent strategy.**

International Market

Civil unrest characterizes the global markets of late. An unprecedented eruption of nationwide outrage spread in Turkey over a police crackdown on opposition movements against development plans in Istanbul's Taksim Square. In Brazil, a rally against a 20-centavo increase in bus fare has turned into the country's biggest civil disobedience in more than two decades. A protest against the government's plan to alleviate budget deficits by slashing fuel subsidies has sparked massive demonstrations outside the parliament building in Jakarta, Indonesia. **What is happening thousands of miles apart in these three economies seems unrelated, but in fact, they share a common denominator, the rising prices of basic necessities.** The effects of these rising prices may not be as pronounced in the U.S., but inflation is indeed alive and well, and poses a real threat in emerging markets.

Roots of this unrest can be attributed to the financial crisis of 2008. **As countries utilized easing policies to combat one of the worst financial crises in modern times, they built up huge fiscal deficits. To fix these deficits, the solution is simple: either spend less or earn more.** Though austerity measures (spend less) can address the fiscal deficits, they are politically unpopular and utilized only as a last resort by politicians. Therefore, these countries will most likely pay down debts by going into current account surplus (earn more) by devaluing their currencies.

This results in episodes of "competitive devaluation." **Competitive devaluation involves countries devaluing their own currencies to gain competitive advantage for their domestic industries in the global arena.** One recent example is an almost 12 percent slide in the yen against the dollar in the past six months. This devaluation stoked criticism from trade partners, including South Korea, that Japan's monetary stimulus is distorting commerce. **Such aggressive devaluation is problematic because a weak currency also increases the cost of imports, thus introducing an unintended but real threat, inflation**. If not managed properly, higher rates of inflation can hinder growth, further weakening the emerging economies which use devaluation as a tool.

China in recent years has become one of the major practitioners of competitive devaluation by buying U.S. dollar denominated assets in order to cheapen the yuan, hence, making it vulnerable to inflation. **For an extended period of time, Chinese regulators have been carrying out a campaign to control home prices, but results are mixed.** Banks – mainly smaller regional banks – still engage in speculative lending, using short-term interbank borrowing to finance purchases of higher-yield, longer-term assets. To send a clear message, the Chinese central bank has refrained from using reverse-repurchase agreements to inject funds into the interbank market, leading to the recent surge of the one-day repurchase rate. **Therefore, the widely reported cash shortage and liquidity squeeze should be viewed as the government's determination to stamp out speculation funded by cheap money and pave the way for necessary structural reforms**, as stated by the new Premier Li Keqiang in his statement to the State Council.

Historical evidence and empirical research has taught us that higher rates of inflation, once started, take on lives of their own. There is not yet an effective solution for the problem. Therefore, before inflation becomes uncontrollable, governments have to utilize various tools to keep it in check. **Although tools to control inflation are necessary for the long-term wellbeing of a nation, such measures often lead to civil unrest and have a negative impact on financial markets.**

Investors in the global marketplace need to achieve a delicate balance between the risk of additional uncertainty and the potential of higher growth. We emphasize that threats and opportunities in emerging markets should be closely scrutinized. **With the "European sovereign debt crisis" affecting developed markets, many established global companies are becoming more attractive because of their low valuation and solid fundamentals**. Hence, as our clients may have noticed, the investment focus for our international exposure has been gradually shifting from emerging to developed markets.