Altamont Wealth Management

Second Quarter 2013 Performance

"To an imagination of any scope the most far-reaching form of power is not money, it is the command of ideas."

Oliver Wendall Holmes Jr.

The first quarter's market rally continued through April and into May but then the markets got spooked. So though the markets hit record highs they backed off in the latter half of the quarter, and the markets sold off broadly. The market decline was due to speculation that the U.S. Federal Reserve would soon begin to cease its bond market support.

The S&P500 Index, which represents the Large Cap U.S. stock market, touched a record high in early 2013 but traded down 3.8% from May 21 to June 30. Although the markets were rocky, the S&P500 still managed to rise 2.9% in the Second Quarter.

Second Quarter 2013 Benchmark Index Returns

	Second Quarter	Year- to-Date
Large-Cap Benchmarks		
S&P 500 iShares	2.9%	13.8%
S&P 500 Growth iShares	2.4%	11.9%
S&P 500 Value iShares	3.3%	15.6%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	0.8%	14.6%
S&P 400 Mid Growth iShares	0.9%	13.2%
S&P 400 Midcap Value iShares	0.8%	15.9%
Small-Cap Benchmarks		
S&P 600 iShares	4.0%	16.3%
S&P 600 Growth iShares	3.4%	15.8%
S&P 600 Value iShares	4.3%	16.4%
Other Benchmarks		
MSCI EAFE Int'l iShares	-0.9%	4.1%
MSCI EM Int'l iShares	-8.3%	-13.6%
Vanguard Total Bond ETF	-2.4%	-2.6%
DJ-UBS Commodities iPath ETF	-10.2%	-11.4%

Emerging markets were among the hardest hit in the Second Quarter. The MSCI EM International Index was down 8.3% for the quarter and 13.6% year-to-date. In China, which is a major emerging market country, concerns about growth and continuing governmental support of its nascent markets sent its markets plunging 14% in June. Volatility in the emerging markets continues to be a concern.

Bonds fell during the Second Quarter across all sectors, sparked by the threat of a reduction in Fed's bond purchases. The Vanguard Total Bond ETF is a good representation of the total bond market. It fell 2.4% during the quarter and is down 2.6% for the year. The threat of Fed reducing its bond purchases sent yields sharply higher and this sent bond values falling. Intermediate Treasuries were heavily impacted with the 10 year Treasury moving the most. Its yield rose from 1.6% in May to 2.6% at the end of June. The swing in high yield bonds (these are risky low grade bonds) was even more dramatic. Yields for these below-investment-grade bonds touched historic lows in May, below 5%. The sell-off drove yields up to a more reasonable 6.7%.

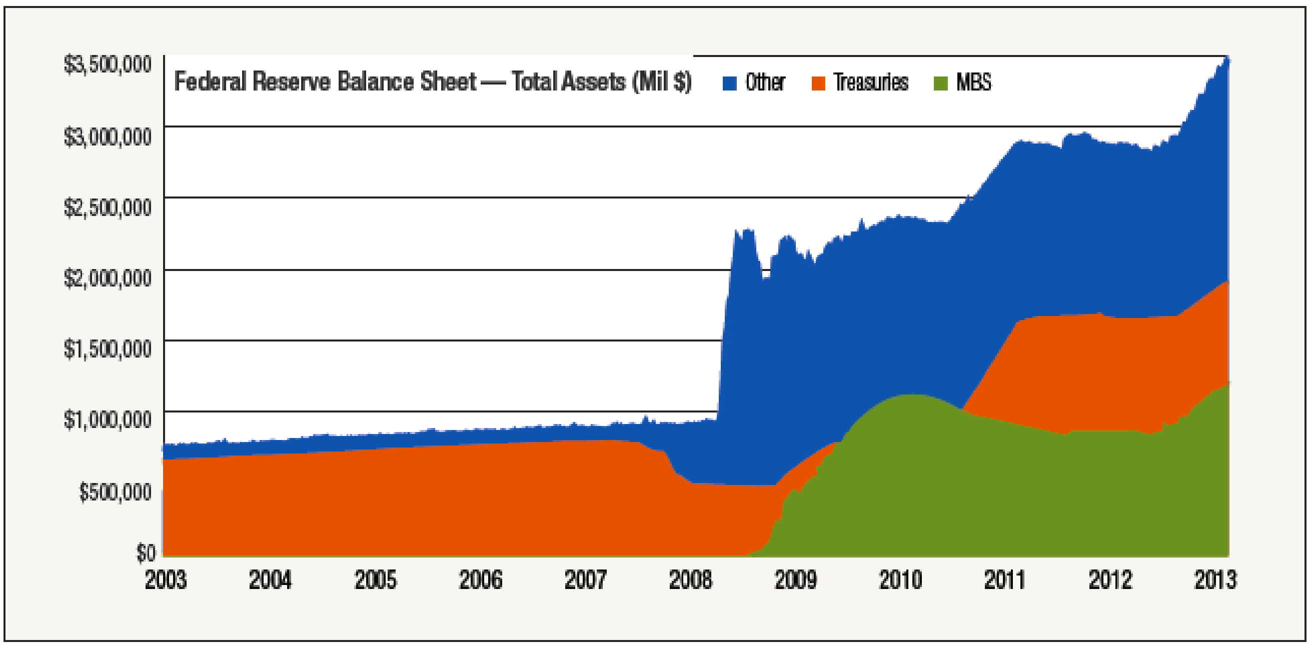
The segment of the bond portfolio that was hit the hardest was TIPS (Treasury Inflation Protected Securities), which sold off sharply. The potential for more aggressive policy pullback by the Federal Reserve reduced inflation expectations and caused a selloff of TIPS. Technical factors exacerbated the selloff due to massive liquidations, risk-parity funds and passive ETFs. The selloff was overdone and the Federal Reserve has since given guidance that it plans to continue buying bonds and supporting the bond market.

While inflation is expected to remain low, TIPS serve as well-priced check against a sudden rise in prices, since interest and principal are explicitly tied to inflation.

Commodities have been weakening since their peak in September 2012 over concerns that the pace of global economic growth is slowing and in specific countries failed to revive. The Dow Jones UBS Commodities Index iPath ETF declined 10% in the Second Quarter. Gold has been especially hit hard, falling to a 3 year low of $1,180 per ounce.

Fed Intervention

Since the financial crisis, the Federal Reserve and other central banks around the world have been aggressively deploying any strategy available to inject liquidity into the economy and stimulate growth. In the U.S. the Fed has pursued two paths. The first is to keep interest rates at almost zero and the second was to support the markets by purchasing massive amounts of bonds (including Treasuries and Mortgage-backed Securities) since December 2012. Its market intervention has been dubbed Quantitative easing. The effect of all this buying is significant as seen below in this chart showing the change in the Fed's holdings (Balance sheet) through the end of May 2013.



Intervention by all the central banks has succeeded in suppressing market volatility and encouraged investors to invest in riskier assets such as stocks. In response the stock market has surged through April 2013.

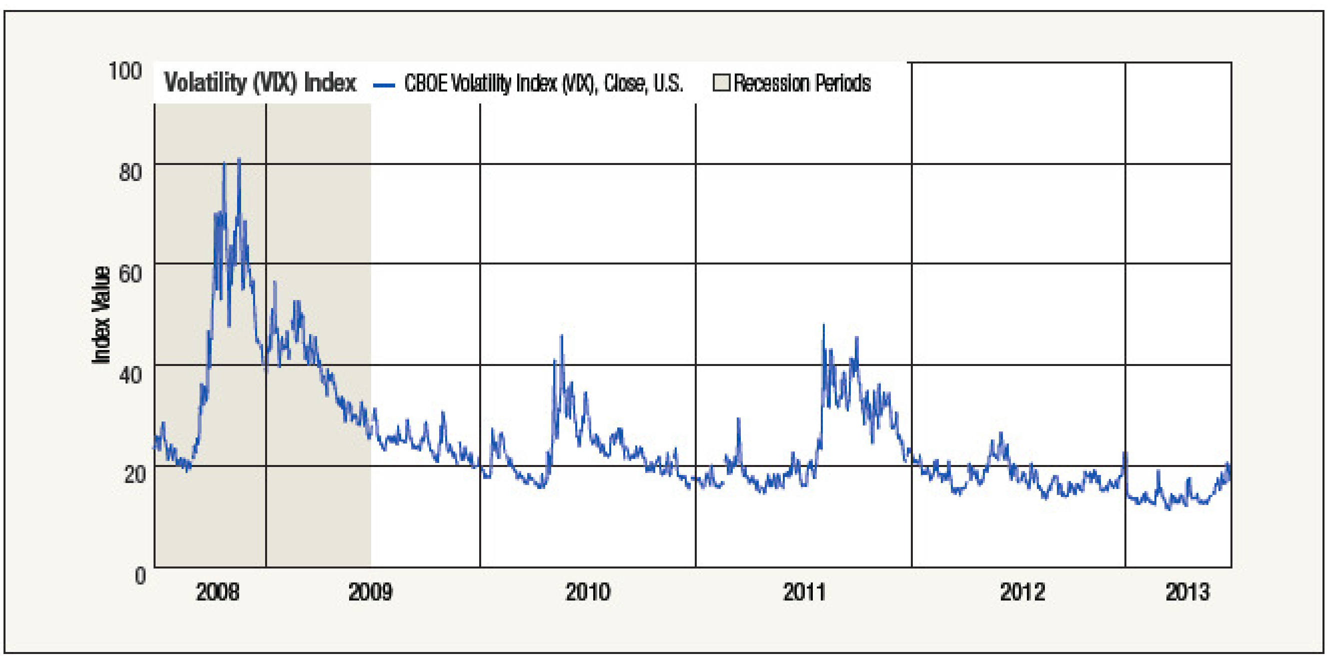
For some time market watchers have expressed concerns about the growing risks of Fed's aggressive intervention in the markets. The economy had not recovered as quickly and as robustly as hoped. This has led to a widening gap between valuations and economic fundamentals. The growth rate built into the stock prices is much higher than the rate the economy is growing. While the surge in stock prices does not approach 2006 levels, assets are frothy. To replicate the situation, either the economy's growth rate must increase and/or stock prices must fall to reflect the actual rate of growth.

Given this imbalance it is not surprising that unexpected guidance in May, from the Fed Chairman Ben Bernanke on how the Fed plans to taper its market support, rocked the markets. Bernanke outlined how the Fed will taper its activities as the economy hits certain growth targets and recommitted to holding down the Fed's intra bank lending rates through mid-2015. The markets reacted dramatically to the Fed, exiting the bond market. When combined with the market and interest rate instability in Japan, the markets fell as a broad sell-off across all asset classes hit the U.S.

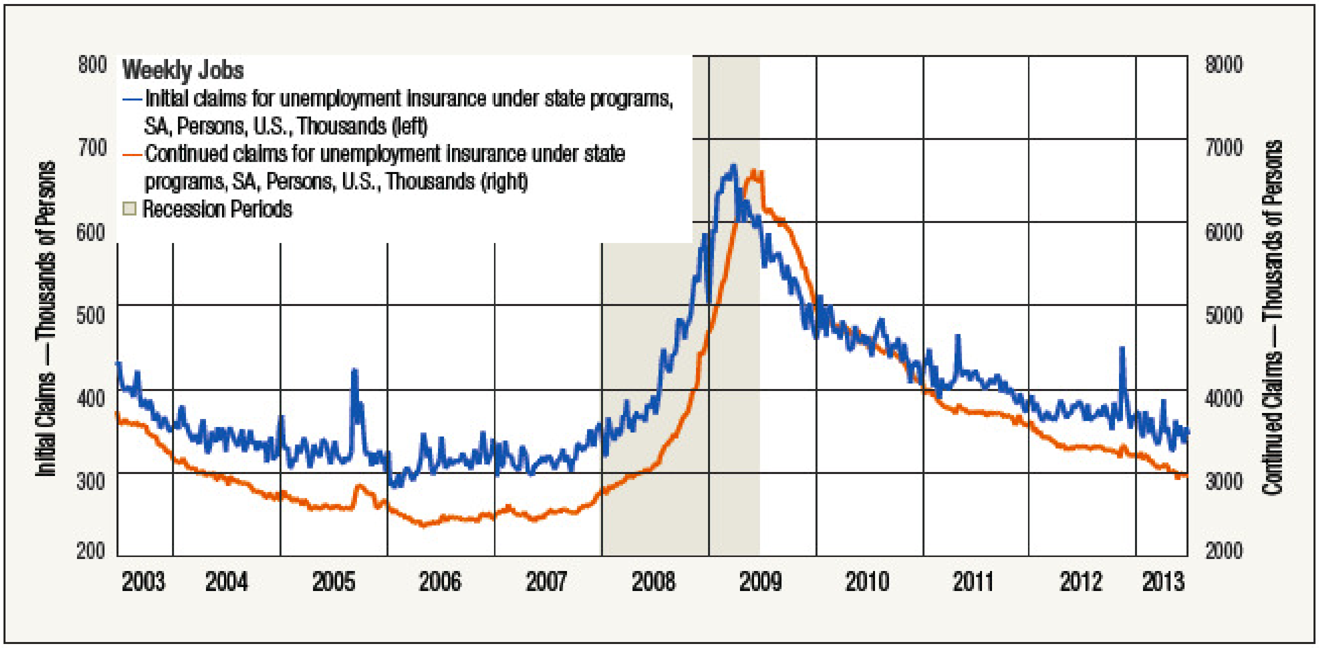
Virtually no sector was spared from late May through June, though some were hit more than others. Emerging market stocks and bonds, U.S. Treasuries, especially TIPS, and mortgage-backed bonds were hit particularly hard. Though I thought we might be due for a correction I was surprised by the depth of the decline in the bond sector. For instance intermediate Treasuries which are traditionally a safe haven during periods of turbulence sold off more strongly than other parts of the yield curve. In light of recent market volatility some of the defensive positions to reduce credit risk took a hit, (e.g. avoiding long term maturities and focusing on countries and issuers with healthier balance sheets). For instance, Pimco Global Multi Asset fund fell 8% during the quarter because of its holdings in TIPS and international stocks and bonds.

The Outlook

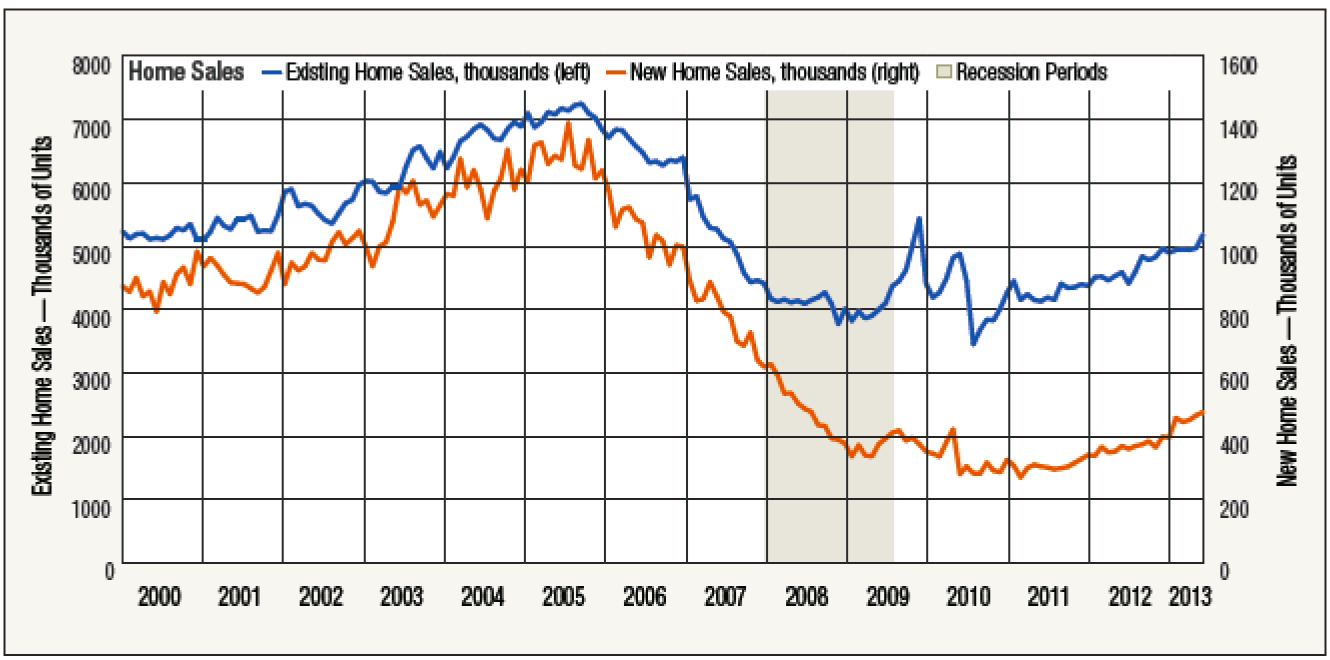
The VIX Index shows how volatility climbed to over 20 towards the end of the Second Quarter. The VIX shows the implied risk of the S&P500 Index Options which are traded on the Chicago Board Options Exchange. It hint at the market's expectations for the next 30 days, and when it rises it indicates the markets may decline; hence, it is often called the fear index. Since the end of the quarter volatility has fallen slightly but is still worrisome.



One bright spot in the economy is jobs growth. The employment situation continues to improve. In the Second Quarter, approximately 600,000 jobs were created. Also, initial claims for unemployment benefits have continued to fall as the chart below highlights. For the week of June 29th, initial jobless claims fell to 343,000 compared to the trend at the end of first quarter 2013 of 388,000. Employment growth is crucial to the economy, and although the current trend is heartening, it is still considered anemic.



Home sales recovery continues as the graph below demonstrates. Not only are sales of existing homes increasing but new home sales are on the rise as well. In fact, housing starts and new permits reached levels not seen since June 2008. However, since the end of the quarter sales of existing homes have slowed.



Now for the bleaker news - the Chicago Fed National Activity Index (a forward-looking metric that has historically done a good job of forecasting future growth) came in weaker than expected. This marked the fourth month that this index had a negative reading, and it suggests that after a weak first quarter and an even weaker second quarter, the third quarter is off to a sluggish start.

The weaker trend in economic data (especially almost non-existent increase in U.S. capital expenditures (CAPEX)) has raised the prospects that corporate earnings may be growing slower than anticipated. So far the corporate earnings in the Second Quarter have been mixed, with a few beating already lowered expectations. The guidance that we have been getting from mutual fund portfolio managers is that Third and Fourth Quarter corporate earnings estimates need to be scaled back. This creates a risk in U.S. markets since the growth rates built into the stock price of most corporations is higher than the currently estimated earnings growth rate which needs to be revised down. In the long run this inequity cannot be sustained, and either stock prices need to fall and/or corporations need to grow faster.

There is better news for global markets. In Europe, Spanish labor market and German business data suggest that the region is stabilizing. Europe represents one-fifth of the global economy so should this economic warming trend continue it would remove a tremendous drag on the world economic growth.

The markets will likely continue to be choppy over the short run for numerous reasons (uncertainty over Fed leadership, recent drop in the Japanese stock market, mixed earnings and lackluster revenues, and political shenanigans that disrupts corporate planning and hence the economy, sluggish CAPEX….). Beyond the short term and all that noise, the economy is improving. Positive factors such as the improving housing market and employment will outlast the negative fiscal impacts caused by the Fed over the next 12 months. Over the last few weeks the financial markets appear to have adjusted to the notion that the Fed will begin backing away from Quantitative Easing program sometime in the near future. The end to the Fed's balance sheet expansion (buying bonds) will refocus investor attention on profitability. So in the next twelve months market performance will primarily depend on corporate earnings and revenues. Watch for signs of economic growth and corporate growth. If the economic garden planted by the Fed Reserve Chairman stays well-tended then the economy will flourish and so will the markets.
