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# Second Quarter 2013

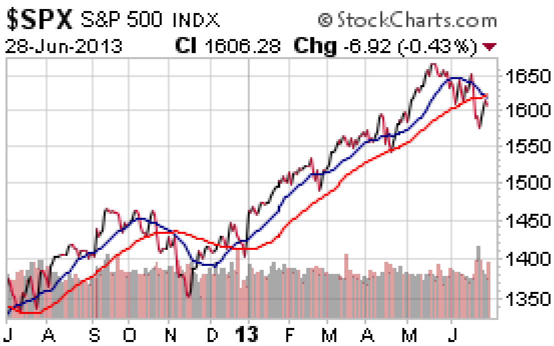


Fig. 1 – S&P 500

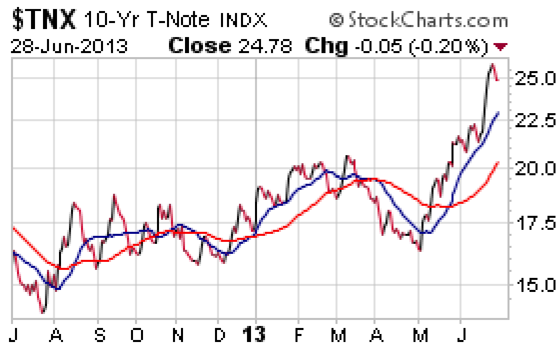


Fig. 2 – 10 Year U.S. Treasury Yield

U.S. stocks continued their advance in the second quarter, as the S&P 500 reached another record high in mid-May before pulling back on concerns over higher interest rates. The large cap S&P 500 gained 2.9% (**Figure 1**) while the Russell 2000 Small Cap index finished 3.1% higher. International indices logged weaker results, with emerging markets falling hard. The MSCI Europe, Australia and Far East Index lost 1%, and MSCI's Emerging Markets Index dropped 8.0%.

According to Factset, 70% of S&P 500 companies exceeded first quarter earnings expectations but only 46% beat revenue estimates. Earnings grew for the second straight quarter, rising 3.3% over last year following a gain of 4.2% in the fourth quarter of 2012. Nine of the S&P 500's ten sectors reported higher earnings relative to last year, with Information Technology the only sector to report a decline.

The second quarter saw the continuation of many of the trends noted in the prior quarter, including the divergence of U.S. and foreign stock returns and economies. Economic readings at home were generally positive. The housing market showed strength with both higher home prices and the strongest sales since 2006. In addition, employers gradually added new jobs, although still at a slower pace than found in most recoveries. Manufacturing did cool mid-quarter, however, possibly in response to lower demand overseas. Much of Europe remains in recession, and several of the largest developing countries were beset by social and economic difficulties:

- Protesters took to the streets in Brazil demanding political and economic change;
- Inflation drove the Indian rupee to an all-time low vs. the U.S. dollar, increasing import costs significantly;
- Chinese banks experienced a cash squeeze, forcing China's central bank to provide liquidity.

These concerns were reflected in stock prices **(Figure 3)**, as investors pulled out funds in search of safer havens.

***Index returns taken from iShares.com by BlackRock***.

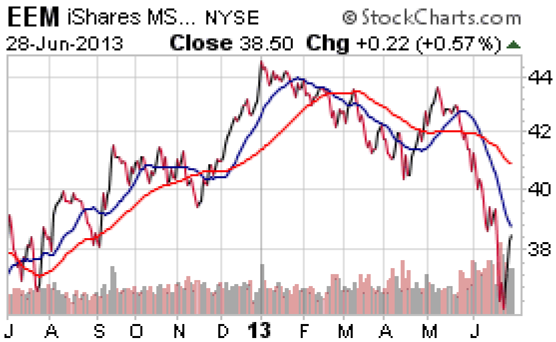


**Fig. 3 – iShares MSCI Emerging Markets**

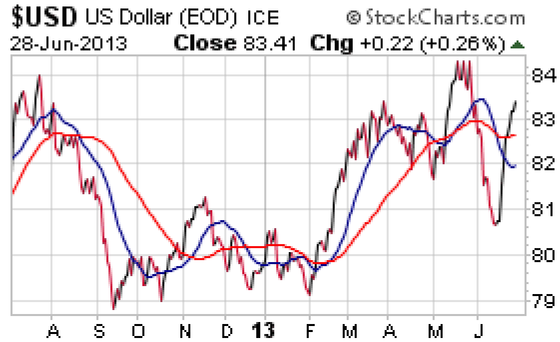


**Fig. 4 – US Dollar Index**

In May, Federal Reserve governors began publicly discussing the prospect of ending or reducing the Fed's purchases of bonds (QE3), which have helped to keep long term interest rates low. Investors began to reduce their fixed income holdings and yields rose sharply (**Figure 2**). Bond selling reached a crescendo following Fed Chairman Ben Bernanke's press conference on June 23, in which he delineated specific criteria for tapering and ending the bond buying program. Stocks dropped with bonds on fears that higher interest rates would further hamper the economic recovery and squeeze corporate earnings, before recovering somewhat in the last week of the quarter.

The change in the Fed's stance has left both stock and bond investors pondering the future. As of this writing, the U.S. economy seems likely to continue its slow recovery. Most manufacturing surveys released at the end of June showed modest improvement from May, retail sales have generally exceeded analyst expectations, private employment has grown each month, and the housing and automotive sectors have shown solid growth. The U.S. dollar has also strengthened this year relative to most other currencies (**Figure 4)**, as investor confidence in dollar-denominated investments has increased. This trend has been reinforced by the likelihood of rising U.S. interest rates, because rates will only rise if the Federal Reserve believes that the economy is strong enough to withstand the increase. In this environment, good news in the economy should provide support for the Fed to taper bond purchases, and U.S. equities should continue to produce solid returns. Foreign stocks may continue to lag, although European economies, already in recession, may bottom before their emerging market counterparts.

Bond values fell suddenly in the second quarter, shaking investor faith in what has been a very consistent asset class. Some investors have exited fixed income positions to hold cash, fearing that interest rates will climb further. While it is very difficult to predict interest rate movements, the pressures that usually force yields higher are not present at this time. Economic growth is tepid and inflation is below the Fed's target of 2%. In addition, bond volatility has historically been much lower than the fluctuations experienced by stock investors. For investors seeking lower portfolio volatility, bonds are likely to remain a steadying component of asset allocation, preferable to cash which yields almost nothing.

We hope that you are enjoying your summer, and look forward to speaking with you soon.

Sincerely,

Kenneth M. Bernard, CFA