2013 2nd Quarter

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PERFORMANCE WEIGHTED ASSET ALLOCATION REPORT

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ADVISOR'S THOUGHTS

Concerns over a change in federal reserve interest rate policy and weak overseas growth contributed to soft returns for stock and bond markets in the 2nd quarter. On the positive side were the returns in the US stock market. **The S&P 500 increased a modest 2.36%** as shown in the table below after starting out strong in April and then retreating some at the end of June. For the past six and twelve months, **strong returns in the US stock market** have been the primary driver of the **positive performance in your investment accounts,** as can be seen on your statement(s).

Stock market returns outside the US were negative in the 2nd quarter. The MSCI EAFE declined by 2.11% reflecting the **weak economy in Europe**. Emerging market stocks suffered more substantial declines as fears over the growth rate of China and Brazil contributed to investors pulling money out of these and other emerging market stocks. The broad based MSCI Emerging Markets index declined 9.14% last quarter.

Returns from most bond investments were negative in the 2nd quarter as the long decline in interest rates stalled, and has begun to reverse itself. Recall that **when interest rates rise the value of existing bonds will fall** - this is what happened in May and June. Particularly hard hit were government bonds. The Barclays Long Bond Index declined 5.55% in just the last three months, while the Barclays Intermediate Bond Index lost 2.14%. Going forward the **potential for bonds to see price appreciation is limited and we continue to favor stocks over bonds** in your accounts.

TOTAL RETURN THROUGH 6/30/2013

	3 Mo.	6 Mo.	12 Mo.
DJIA	2.27%	13.78%	15.76%
S&P 500	2.36%	12.63%	17.92%
Nasdaq	4.15%	12.71%	15.95%
MSCI EAFE	-2.11%	2.17%	15.14%
MSCI Emerging Markets	-9.14%	-10.93%	0.32%
Barclays Inter-term Bond	-2.14%	-2.10%	-1.68%
Barclays Long-term Bond	-5.55%	-8.96%	-8.05%

Source: Wall Street Journal
Does not include reinvestment of dividends

DJIA: A price weighted average of 30 stocks.

S & P 500: A market value weighted index of 500 stocks.

NASDAQ Composite: Market value weighted index of approximately 2,082 companies.

MSCI EAFE: A stock market index designed to measure the equity market performance of developed markets outside US and Canada.

MSCI Emerging Markets: A stock market which captures large and mid cap representation across 21 Emerging Market countries..

Barclays Capital Treasury Intermediate-Term Bond Index: An index comprised of US Treasury securities with maturities between 2 and 10 years.

Barclays Capital Treasury Long-Term Bond Index: An index comprised of US Treasury securities with maturities of 10 years or longer.

The **job market has been**, and will continue to be, a **key driver for a continuing recovery** in the economy. For an employer to commit to hire a new employee they must be confident about the future and that employee's ability to help improve the company's profitability. Before they can think about growing they must first be able to survive. At the onset of the "great" recession businesses were in the survival mode and made massive layoffs to try and cut costs.

EMPLOYMENT

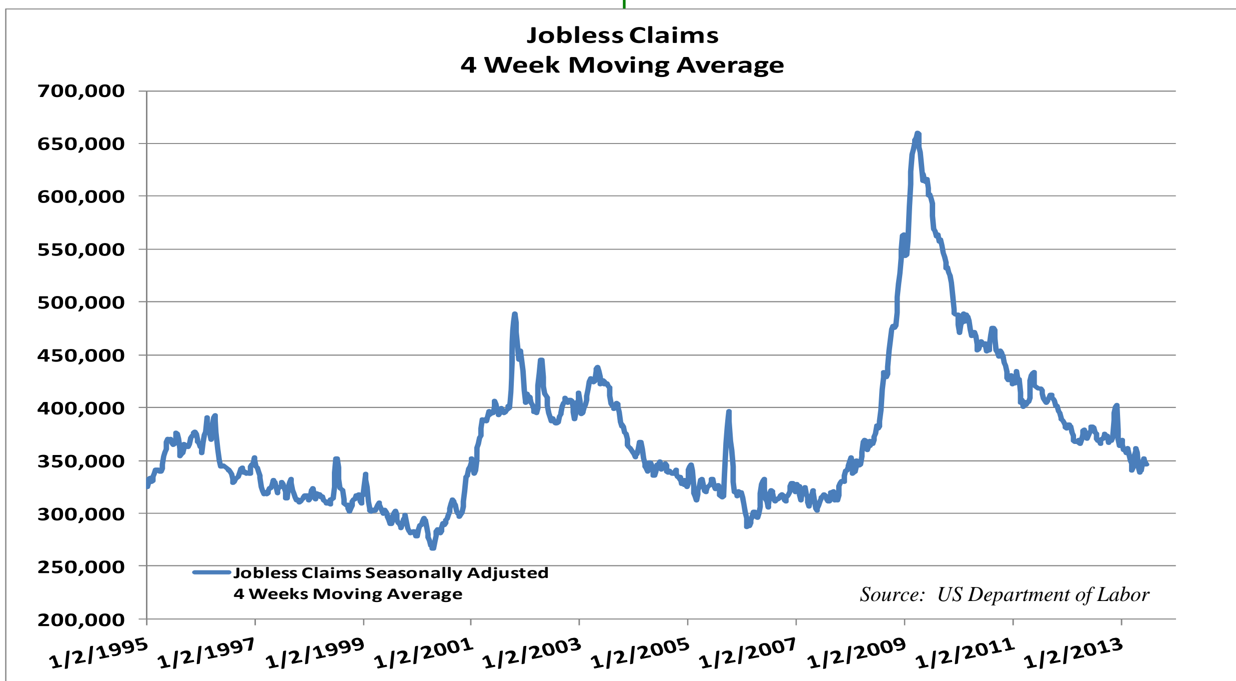
In the chart below one can see the **huge spike in weekly jobless claims beginning in 2008** and continuing through 2009. Because of the volatile week to week nature of jobless claims it is often looked at by economists over a four week period as a way to smooth out the noise of weekly numbers. The Four Week Moving Average (seasonally adjusted) of Weekly Jobless Claims peaked at 660,000 in March 2009. Not surprisingly, hiring was extremely weak during this period and the unemployment rate spiked. **Total Non-Farm payroll shrank by a whopping 8,600,000 from 2008 through 2009.**

Today, however, the picture looks much brighter. Weekly jobless claims have continued to decline since 2009 and are returning to levels last seen in 2007. It appears that we may be entering an employment period similar to the 2004 through 2007 time period when weekly jobless claims were fairly stable at around 300,000 to 350,000. That was a time period when Total Non-Farm Payroll (seasonally adjusted) or net job growth was growing at over 2,000,000 jobs per year. In fact, the last month that the Total Non-Farm Payroll saw a decline was nearly three years ago in September of 2010. For the first half of this year, the economy is averaging an increase of 202,000 jobs per month or approximately 2,400,000 for the year. Any **further improvement in the economy will go a long way to improving the employment picture in the US.**

HOUSING

An improving job market is having a direct impact on the housing market. Just as businesses look to hunker down in a shrinking economy so do individuals. Whether out of necessity or being cautious, spending shrunk precipitously in the depths of the recession and there is no bigger purchase for most people than their home.

The chart on Page 3 depicts the dramatic run-up in the construction of new single family homes beginning in 2002 through 2006 and then the subsequent crash. Each point on the chart measures the actual number of new single family homes built for the previous twelve months. So for example **when the market peaked in January 2006 at 1,283,000 new single family homes sold**, this more precisely is measuring the monthly new home sales from February 2005 through January 2006. This chart illustrates the horrible decline in the sale of new single family homes and that portion of the economy. It truly was a



remarkable decline in housing. **Today we are just now entering a level that returns the market to the early 1990's sales volume.**

The absolute level of these numbers has certainly been a severe drag on the economy, but what is **most important for the economy today is the direction the numbers are headed.** The lowest monthly sales number occurred in January 2012 at a mere 23,000 units sold across the nation. This was followed several months later in May 2012 with the lowest 12 month sales volume of an anemic 295,000 new single family houses sold. Since that time **the market has been on a steady rise.** As can be seen in the chart, there were over 400,000 homes sold over the past twelve months and if one takes just the 2nd quarter of 2013 the new home industry is now on pace to sell over 500,000 units.

The improving housing market is strong evidence that people are feeling better about their future and this has been directly impacted by the job market. Once hiring began in earnest after the "great" recession, shortly thereafter the housing market began to improve.

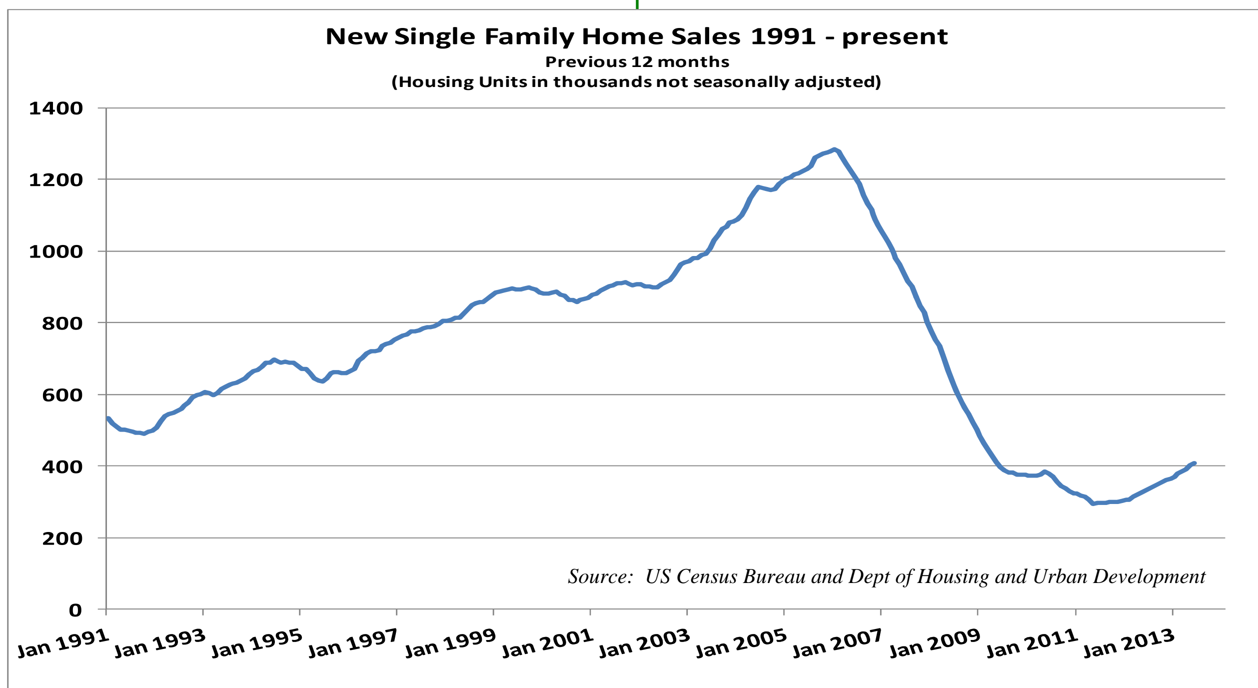
INTEREST RATES

Interest rates are also a major factor in the decision of whether to purchase a home or how much home can one afford. **Mortgage rates are largely determined by what is happening in the Treasury bond market.**

On May 2 the yield on a 10-year Treasury note reached a low for 2013 of 1.63%. Since that time it has seen a seen a substantial increase to around 2.5% today. Correspondingly, mortgage rates for 15 and 30 year mortgages have increased a similar amount. **Much of the move in interest rates may be attributed to various statements from the Federal Reserve** about a tapering (reduction) of their bond buying program. The Fed has been buying approximately $85 billion a month in either mortgage backed securities or Treasury securities. They are by far the largest buyer of these securities and **any reduction in their purchases could cause a rise in interest rates.** However, a reduction in their buying means they believe the economy is improving and in particular that the job market is improving.

CONCLUSION

There is some concern that the housing market will be derailed by rising interest rates. It certainly has been an important contributor to the new and resale housing market to have rates at historical lows. However, **rising rates will more than likely be accompanied by an improving economy.** In our view, over **the long term, the job market is far more important to the housing market than maintaining these historically low interest rates.**



DETROIT SHINES SPOTLIGHT ON MUNICIPAL BONDS

"Issuer" risk to investing in municipal bonds reaches national awareness with the bankruptcy filing of Detroit on July 18, 2013. Much like the bankruptcy filing in Stockton that we discussed in our newsletter last quarter, **Detroit's bankruptcy could have national implications in the municipal bond market.**

The city has $18 billion in long-term liabilities. Based on the city's current population of around 700,000 the amount each citizen would have to pay to clear the $18 billion debt is $25,714. Included in the city's long term debt is $3.5 billion currently owed to city pensions and another $6.4 billion is due to other employee benefits, primarily health care for retirees. This means that **nearly $10 billion of their long term debt has no direct benefit on city services.** Their hole was enormous and bankruptcy was determined to be their only way out.

At stake in the Chapter 9 Federal bankruptcy is **how public employee pensions and health benefits will be treated in relation** to other creditors and the **protection afforded different types of municipal bonds.**

Due to the sheer size of the problem, as stated above, **there appears to be no reasonable way to solve their problem without addressing pensions and retiree health benefits**. Pension holders will continue to make the case that their benefits are protected by Michigan State Constitution. However, the bankruptcy is under Chapter 9 of Federal Bankruptcy code and Detroit's emergency manager Kevin Orr and the Governor of Michigan, Rick Snyder believe **restructuring retiree benefits are on the table**.

There are also **big concerns within the municipal bond industry that some of the city's general obligation bonds will be treated as an unsecured debt**. This has been proposed by Mr. Orr under a restructuring plan he submitted in June that calls for repayment of only pennies on the dollar for some "unlimited tax general obligation bonds." **These types of bonds are generally considered one of the safest types of municipal bonds** because they are backed by the government's "full faith and credit" pledge to raise taxes.

Not surprisingly, **the day after the bankruptcy filing investors sold Detroit general-obligation bonds.** One specific bond traded below 85 cents on the dollar after trading at 95 cents the day before, even though it is insured by a bond-insurance company according to Electronic Municipal Market Access. Some 10-year uninsured general-obligation bonds had an average price of 39 cents on the dollar that had earlier this month traded at 70 cents, according to pricing service Markit. **Clearly the bankruptcy changed the perception of risk for many investors holding certain Detroit municipal bonds.**

Over the years one of the more common misperceptions we have observed from individual investors is the assumption that because municipal bonds are issued by a government entity that they are safe. While historically they have been relatively safe, this safety is not assured. **More and more cities such as Detroit and Stockton have shown that there can be risk with municipal bond investing.** How a governmental entity manages their affairs will have an impact on their long term credit worthiness. A city or other municipality may have been high quality when they issued a bond, but they may become a higher risk over time.

Just as with all investing, **one should maintain proper diversification to reduce the risk of any one security** becoming too large a percentage of their account. In addition, one should **continue to monitor what they own and be prepared to make adjustments if warranted.** In your accounts we are currently **not invested in any municipal bond** mutual funds or Exchange Traded Funds (ETFs)

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