Market Update

June 30, 2013

Popular market averages are all up between 2.3% (Dow Jones) and 4.1% (NASDAQ) during the second quarter, the best relative performance for this quarter in the last several years. Economic indicators such as corporate profits, consumer spending and saving, and individuals' salaries, to name a few, grew at basically the same rate as during the first quarter of 2013. This will produce another quarter of Gross Domestic Product (GDP) growth of just under 2.0%. Corporate earnings reports are likely to be lackluster showing low single digit gains in earnings on a year-over-year basis. Economic reports are almost the same for both the first and second quarters, so why now are investors nervous? In my view the answer lies with Federal Reserve Chairman Ben Bernanke's comments in mid-June and the fixed income market's reaction to it.

Mr. Bernanke's comments about the conditions necessary to prompt the Federal Reserve to scale back its purchases of US Treasury and Agency Bonds (currently $85 billion per month) were unremarkable and hedged within the context of an Improving outlook for US economic growth. However, fixed income markets reacted swiftly and securities like the 10 year US Treasury Note dropped by almost 2.5% in price, resulting in a yield in excess of 2.6%.

In particular, Fixed income Exchange Traded Funds (ETFs), notably those with investments in long term bonds that employ leverage to increase their payout to fund investors, suffered much greater losses. An admittedly unscientific sample of Fixed Income ETFs which I monitor, shows the extent of the price declines in these funds. From December 31, 2012 through May 22, 2013 (the day equity indices hit their peak levels), one of those Fixed income ETFs declined by 3.4% in price, or about 2.0% when including its payout. From May 22 to June 30, 2013 the price decline was almost 6.0%, or just over a negative 5.0% return when including distributions.

An accelerating rate of change such as this, in any statistic, should prompt investor inquiry into the cause behind the change. In today's market investors seem to have used this information as a signal to sell these ETFs. During the last two weeks of the quarter billions of dollars flowed out of fixed income funds, exacerbating the price decline as fund managers were forced to raise large amounts of cash to cover redemptions.

I have indicated for the past three years that fixed income securities were at unsustainably low yields and would eventually produce negative results for investors. Up until this quarter I have been mistaken. However, the magnitude of the correction in the fixed income market during this quarter has been very large. As a result, the return advantage from investing in equities rather than bonds for the past three years has grown from moderate to substantial. In my opinion, bonds are still vulnerable to further price erosion while equities are likely to remain fairly valued with upside potential.

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