ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook — *Second Quarter, 2013*

For the second quarter in a row, US stocks were one of the only games in town as foreign stocks, gold and bonds all declined in value.

INDEX	June, 2013	Last 3 Months	Last 6 Months
US STOCKS			
S&P 500 Index (large-cap stocks)	(1.34)	2.91	15.75
Russell 2000 Index (small-cap stocks)	(0.51)	3.08	18.26
FOREIGN STOCKS			
MSCI EAFE Index (developed foreign markets)	(3.55)	(0.99)	3.99
MSCI Emerging Markets Index	(6.37)	(7.88)	(9.57)
MSCI BRIC Index (Brazil, Russia, India, China)	(8.14)	(9.89)	(12.60)
COMMODITIES			
London Gold PM Fix	(14.52)	(25.42)	(28.08)
London Silver Fix Price	(16.44)	(34.15)	(37.45)
GSCI Commodity Total Return Index	0.23	(5.93)	(5.10)
BONDS			
BarCap US Aggregate Bond (investment-grade bonds)	(1.55)	(2.32)	(2.54)
BarCap US 20+ Yr Treas Bd Idx (long-term US treas)	(3.30)	(5.81)	(9.38)
S&P Nat'l AMT-Free Muni Bond Index (municipal bonds)	(3.04)	(3.22)	(2.87)
iBoxx Liquid Inv Grade Idx (inv.-grade corp. bonds)	(3.38)	(4.34)	(5.09)
iBoxx Liquid High Yield Index (high-yield/"junk" bonds)	(2.86)	(1.87)	0.22
S&P/Citi Intern'l Treas Bond Ex-US (foreign bonds)	(1.16)	(2.62)	(5.47)

Source: iShares.com

After a period of relative calm, volatility returned to global financial markets in May and June. Core investment-grade bonds lost 3.3% from May 1 through June 30 – one of the worst two-month declines in the benchmark's 37-year history. Long-term Treasury bonds (as represented by the iShares Barclays 20+ Year Treasury Bond Fund) lost 9.8% in the last two months of the quarter. Emerging market local-currency bonds dropped 10.4% from May 8 (their intra-quarter peak) through June 30, while emerging market stocks lost 11.4% and developed international stocks dropped 6.5% over the same time period. Bucking the trend to a large extent were large-cap US stocks, which fell only 0.8% over that same period. Gold, which is typically viewed as a safe haven during periods of market turmoil, was not spared – losing 18% from May 1 through June 30, and melting 28% year-to-date.

Interestingly, these developments had (to varying degrees) the same underlying driver: pronouncements from the Federal Reserve about the future course of monetary policy, and, specifically, the Fed's plans to begin "tapering" its QE (quantitative easing) bond-buying program.

This is a theme we've written about in the past: the unusually heavy influence of monetary policy on the financial markets in the aftermath of the 2008 financial crisis, and the strong sensitivity of markets to perceived

changes to such policy. We've noted how Fed policy – by repressing interest rates to all-time lows and aggressively purchasing government and mortgage-backed bonds via QE – actively encouraged investors to move out on the investment risk spectrum into higher-yielding, though riskier, asset classes. This boosted the US stock market to levels beyond what was justified by the longer-term economic fundamentals.

This behavior has continued in a self-reinforcing cycle because the markets believed two things: 1) that the Fed would maintain its stimulative policies, and 2) that such policies were necessarily positive for stocks rather than indicative of the severity of our economic problems. As the markets moved higher, more and more investors reallocated assets into the stock market, propelling the market still higher and further divorcing it from its underlying longer-term economic fundamentals. In other words, the market could continue to overshoot to the upside, driven by short-term and ultimately unsustainable factors.

Exhibit 1: Interest Rates Spike Higher
10-Year Treasury Note Yield (%)

Source: Bloomberg

Exhibit 2: Long-Term Rates During Era of QE

Source: Bloomberg

On May 2, 2013, the 10-year Treasury bond yield hit a low of 1.63% for the year. The yield then rose steadily through May, ending the month at a 12-month high of 2.16%. After holding steady during the first half of June, the yield surged higher again, hitting 2.6% on June 24 – its highest level since early August 2011 (Exhibits 1 and 2). As noted earlier, the rise in interest rates resulted in significant capital losses for bond investors (rising bond yields mean falling bond prices), reaching into the high single digits for long-term Treasury and TIPS bonds, and low single-digit losses for the core bond index.

The driver of the sharp rise in yields was comments from Federal Reserve policymakers – culminating with Chairman Ben Bernanke's June 19 press conference – indicating that the Fed *might* begin to slow ("taper") the pace of its monthly bond purchases sooner than had been expected, perhaps as early as this September. (As a reminder, under the current open-ended QE program, which was launched last fall, the Fed has been buying $85 billion of Treasury bonds and government agency mortgage-backed securities each month. The goal is to suppress borrowing costs and stimulate economic growth and employment.)

Specifically, Bernanke said:

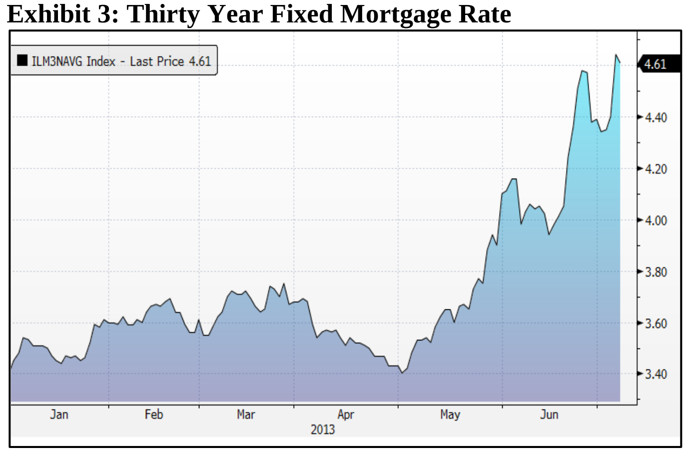
> *The committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases later this year; and if the subsequent data remain broadly aligned with our current expectations for the economy, we would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear. In this scenario, when asset purchases ultimately come to an end, the unemployment rate would likely be in the vicinity of 7%, with solid economic growth supporting further job gains.*

Bernanke likened tapering to "letting up a bit on the gas pedal as the car (i.e., economy) picks up speed." He also tried to make it clear (again) that this tapering road map is not set in stone and would be contingent on incoming economic data. He specifically said that if the Fed's growth and employment forecasts turned out to be too optimistic (as they have consistently been since the financial crisis), the Fed could stop tapering and even increase its bond purchases again. He also reiterated that even with a cessation of QE in mid-2014, monetary policy would remain stimulative for a considerable period because the Fed would not begin to increase short-term interest rates (i.e., step on the brakes) from their current near-zero percent level until unemployment fell to at least 6.5%, as long as inflation and inflation expectations remain low (in the 2% - 2.5% range). The current consensus among the Federal Reserve Board members is that such a rate hike won't happen until 2015.

Despite Bernanke's best efforts to manage market expectations and communicate that the process of ending QE does not mean an actual tightening of monetary policy, investors saw it a different way, resulting in the bond market sell-off and a spike in interest rates. In a nutshell, investors' fears that rates would rise (and bond prices fall) as a result of a less-expansive Fed policy caused them to sell bonds, thereby causing rates to rise just as they feared. As TrimTabs Investment Research recently reported, bond mutual funds and exchange-traded funds had $72.8 billion in outflows from June 1 through June 25, smashing the previous record monthly outflow of $41.8 billion in October 2008, during the depths of the financial crisis. Prior to June, bond funds had registered net inflows for 21 consecutive months.

Thirty-year fixed mortgage rates, which are a specific target of QE, also jumped sharply from a low of 3.4% on May 1 to 4.6% on June 25 (Exhibit 3). Thus, the Fed's optimism about economic growth/recovery, which led Fed policymakers to conclude they could begin ending QE, might in fact become a headwind to that growth. Rising borrowing costs and falling asset prices could ultimately short-circuit the economic recovery and, in turn, the tapering process.

Exhibit 3: Thirty Year Fixed Mortgage Rate

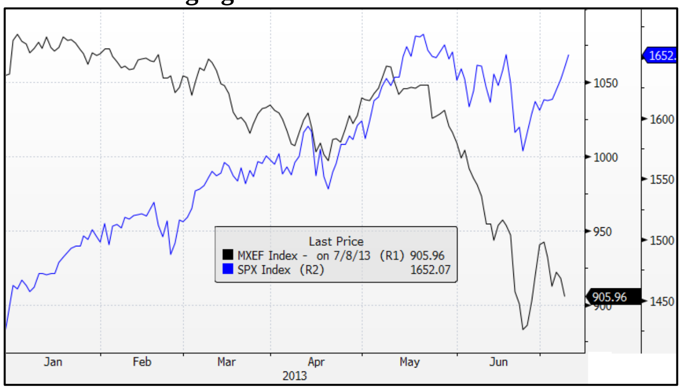


Source: Bloomberg/BankRate.com

The rise in interest rates and the Fed's tapering announcements were also key factors behind the sharp sell-off in emerging markets stocks and bonds. These developments, along with news that the Japanese central bank was not planning to further expand its own QE program, triggered a general unwinding of the "carry trade," in which investors (mostly short-term traders and hedge funds) borrow the currencies of countries with low-yielding debt and/or depreciating currencies (such as the Japanese yen) and invest in higher-yielding/appreciating currency investments, such as emerging markets local-currency bonds. As the carry trade unwound, prices on these bonds dropped, yields rose, and emerging markets currencies depreciated against the dollar.

In addition to the markets' worries about reduced central bank liquidity, ongoing concerns about a general slowdown in emerging-markets growth and disappointing economic data out of China in particular, as well as fears of a liquidity/credit crunch there (with interbank short-term lending rates spiking to record highs), weighed on emerging-markets stocks during the quarter (Exhibit 4). In contrast, investors seemed to be getting more optimistic about U.S. economic and growth prospects, lending support to the U.S. market.

Exhibit 4: Emerging Market Stocks & US Stocks

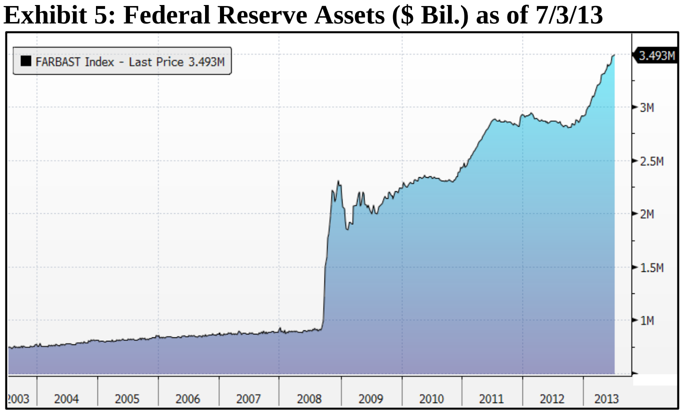


Source: Bloomberg

So, the Fed's asset purchase plan has been a key driver of both low interest rates and strong stock market returns – along with very low volatility in both the US stock and bond markets. Market expectations of large scale and ongoing quantitative easing (QE) were being projected well into the future. However, the latest Fed guidance on potentially tapering its purchases was interpreted as hawkish relative to the Fed's own economic outlook and suggests that policymakers are growing increasingly uncomfortable with QE's potential effects on financial stability (unintended consequences).

Actually, the Fed does not view ending QE as tightening policy. Bernanke highlighted recently that policy will still be highly stimulative even after QE ends because the size of the Fed's balance sheet will be enormous for some time (Exhibit 5).

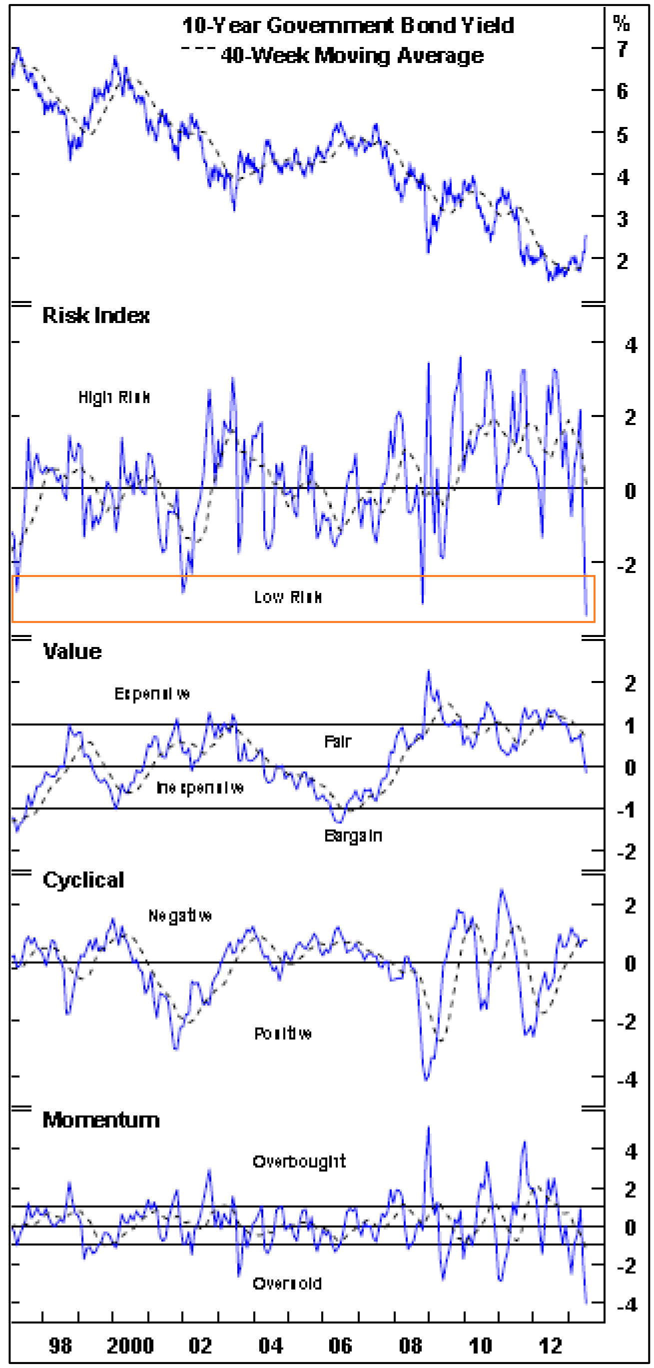
Exhibit 5: Federal Reserve Assets ($ Bil.) as of 7/3/13



Source: Bloomberg

The Fed appears to be assuming that growth will gain momentum and that inflation will stop falling within the next couple of months. We believe that these two conditions may not be met and the Fed will need to push back its plans by several months. If we are correct, it implies that the market has now moved the timing of the eventual rate hike process too far forward and that the recent backup in interest rates is overdone – at least temporarily. This is also consistent with objective models of the bond market's risk/reward outlook (Exhibit 6) and the outlook of a number of highly respected fixed-income investors.

Exhibit 6: Bond Market Risk Model

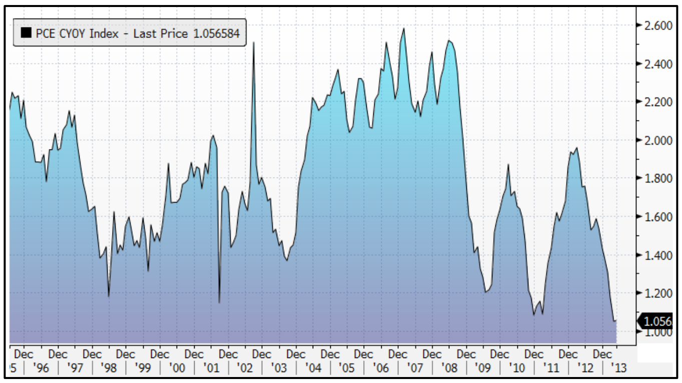


Source: BCA Research

The Fed's latest economic forecasts appear to be on the optimistic side with the mid-point of its projections implying real GDP (nominal GDP minus inflation) growth of 3.2% in the second-half of this year and in 2014 (Bloomberg consensus forecasts are for: 1.9% in 2013; 2.7% in 2014; and 3.0% in 2015). But, the Fed has made it clear that its actions will be dictated more by labor market trends and inflation expectations than GDP growth rates.

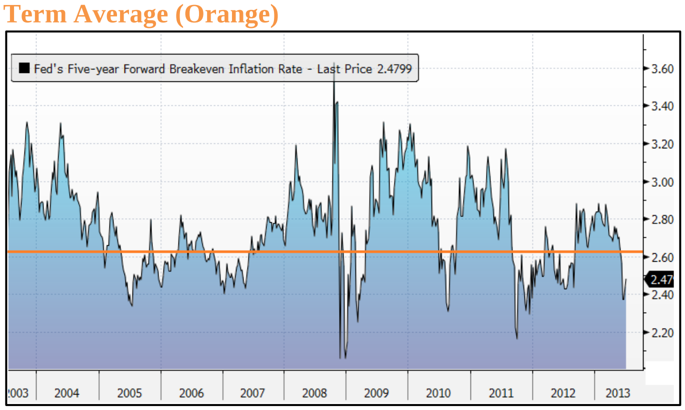
The core inflation rate, according to the Fed's preferred measure (US core personal consumption expenditure inflation), is at a 50-year low of just above 1% (Exhibit 7). Long-term inflation expectations are also very low (Exhibit 8). In a world of sub-par growth and excess capacity, there is more of a deflationary than inflationary tone to the overall economic environment and Ben Bernanke has a deeply-engrained fear of deflation. He would not be comfortable easing back on the accelerator (i.e. tapering) in September, or even December, if the trend in inflation is still headed lower.

Exhibit 7: US Core PCE Inflation



Source: Bloomberg

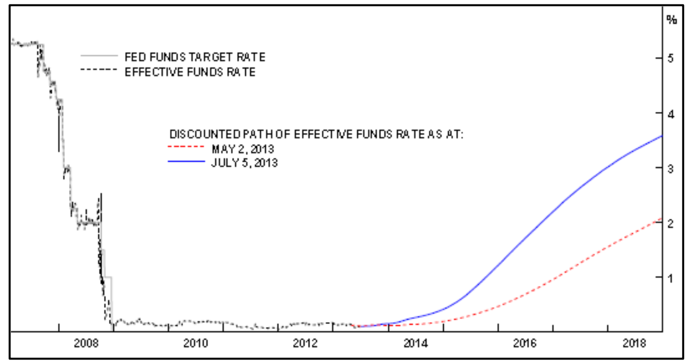
Exhibit 8: Long-Term Inflation Expectations & Longer-Term Average (Orange)



Source: Bloomberg

Just two months ago, the markets expected the fed funds rate (currently 0% to 0.25%) to be only 0.5% at the end of 2015 and 1% at the end of 2016. That was most likely too optimistic and there was a dramatic repricing following Bernanke's press conference. The market now expects the funds rate to be 0.4% by end-2014, 1.2% at end-2015 and 2.2% at end-2016. That seems like a much more realistic path for 2015 and beyond, but we doubt that the first rate hike will occur as soon as end-2014. Expectations for the near run path of the funds rate could be revised back down in the months ahead, settling somewhere between the two lines in Exhibit 9.

Exhibit 9: Expected Future Path of Short-Term Interest Rates



Source: BCA Research

The irony is that the market will be better served with improved economic activity and higher interest rates than by weak growth and ongoing QE. Nonetheless, the knee-jerk reaction to the coming end of QE has been for markets to struggle.

Monetary policy has pumped up asset prices, so some air will no doubt come out of the equity market once the monetary normalization process begins. However, we think we have reached a stage where the bull market in risk assets is more in need of better economic growth than continued monetary stimulus. Corporate profits performed extraordinarily well during the past few years, despite an unusually tepid economic recovery, but are now starting to struggle. Earlier gains in profits were helped by one-off cost-cutting and the steep drop in interest rates, but those benefits are largely over. Without faster economic growth, profits will head lower, creating trouble for stock prices.

It is understandable that markets are nervous about an eventual shift away from current extreme monetary activism. There is an addiction to easy money that may be painful to break, along with the added problem that the Fed has not figured out how to manage its eventual exit strategy. The cliché that policy is in "uncharted territory" is appropriate because it means that there are no maps to guide the way forward.

The transition back to "normal" has never been done before, and the end of the QE1 and QE2 purchase programs coincided with stock market weakness and an economic soft patch. With this history fresh in mind, equity investors' knee-jerk reaction to any Fed announcement signaling the intention to phase out QE may be to take some money off the table and shift to "wait and see" mode.

The US stock market had looked ripe for a correction following an almost straight-line 23% rise in the six-months to mid-June (Exhibit 10). The Fed's comments provided the excuse for a long-awaited setback, but the scale of the decline was extremely modest by the standards of normal corrections. The market suffered a peak-to-trough drop of only 5.8% and has subsequently recouped most of those losses. In other words, there is considerable potential for further weakness, even in the context of a mild corrective phase. The market is still overextended from a technical perspective.

Exhibit 10: S&P 500 – 1 year

Source: Bloomberg

The four-year cyclical bull market has been underpinned by the powerful combination of strong gains in earnings and highly-stimulative monetary policy. However, the profit picture has deteriorated because many of the forces that helped drive earnings higher are no longer in place:

- Productivity growth has fallen sharply after a temporary but dramatic spike in 2009-10;
- Interest costs are no longer falling because the corporate sector has been re-leveraging;
- The effective tax rate has been creeping higher after earlier tax breaks ran their course;
- Depreciation charges have stabilized in response to a revival in capital spending;
- The firmness in the dollar is helping take the edge off the growth in overseas profits.

Profit margins are still holding at an elevated level because the corporate sector is keeping a tight lid on wages and the level of productivity is still good. However, it is clear that overall economic growth in the region of 2% is no longer good enough to sustain high margins. Even if QE continues, the stock market needs faster economic growth in order to hold up. And with growth unlikely to improve much until later in the year, the stock market could face a few rocky months.

From a valuation perspective, the stock market is not cheap. The forward price/earnings multiple has expanded by over 30% since October, 2011 (Exhibit 11) and – as we mentioned last quarter – the advance in US stocks since 2012 has been almost exclusively as a result of expanding valuations (i.e. stocks are getting more expensive relative to various measures of their earnings). Low interest rates have supported the market's rising valuations. With real interest rates now rising, one of the main supports of this leg of the bull market is diminishing.

Exhibit 11: S&P 500 and Price/Earnings Ratio

Source: Bloomberg

This is not an easy investment environment and there are several risks to the outlook. The one that recently bothered the markets – stronger economic growth and an earlier-than-expected rise in interest rates – seems the least pressing. The greater risk is that the economy disappoints, delaying the timing rather than accelerating the timing of a Fed exit. While this would be unambiguously bullish for bonds, it would be equity bearish given that profits are now struggling. As noted above, stocks now need better growth more than they need continued monetary easing in our view. The global situation also holds several risks, ranging from the lingering problems in the euro area to geopolitical unrest in the Middle East and uncertainties about the success of policy in Japan.

In this environment, investors are left with the choice of accepting negative real returns from cash or near-cash assets, or accepting the discomfort of investing in riskier assets at a time of great economic and policy uncertainty. We believe a well-diversified, balanced portfolio is a rational response to the current environment since much of the down-side should be behind us in the bond market and without stronger economic growth, stocks are unlikely to continue posting stronger-than-normal gains.

-Brant Kairies
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Please see additional disclosures enclosed with the accompanying reports.