ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook — Third Quarter, 2013

The bull market in stocks continued during the third-quarter, 2013 (Exhibit 1) – albeit with more volatility than the first half of the year (Exhibit 2) as stocks moved sharply higher in July on decent corporate earnings news, sold off a bit in August on geopolitical news and events in Syria, and advanced again through September 18 when the market peaked on the Fed's unexpected decision to not reduce the pace of quantitative easing (QE). Shortly thereafter, monetary policy was upstaged by fiscal policy as Congress clashed over the budget and veered toward a government shutdown (which began just after the quarter ended).

Exhibit 1

INDEX	3rd Quarter, 2013	Last 6-Months	Year-To-Date
US STOCKS			
S&P 500 Index (large-cap stocks)	5.24	8.31	19.79
Russell 2000 Index (small-cap stocks)	10.21	13.61	27.69
FOREIGN STOCKS			
MSCI EAFE Index (developed foreign markets)	11.56	10.47	16.14
MSCI Emerging Markets Index	5.77	(2.78)	(4.35)
MSCI BRIC Index (Brazil, Russia, India, China)	8.58	(2.20)	(5.11)
COMMODITIES			
US Dollar Index	(3.51)	(3.32)	0.57
London Gold PM Fix	11.28	(17.00)	(20.28)
London Silver Fix Price	14.95	(24.30)	(27.61)
GSCI Commodity Total Return Index	4.78	(1.44)	(0.89)
BONDS			
BarCap US Aggregate Bond (investment-grade bonds)	0.57	(1.77)	(1.89)
BarCap US 20+ Yr Treas Bd Idx (long-term US treas)	(2.70)	(8.35)	(11.00)
S&P Nat'l AMT-Free Muni Bond Index (municipal bonds)	(0.64)	(3.84)	(3.51)
BarCap US Interm. Credit Idx (inv.-grade corp. bonds)	1.01	(1.32)	(0.85)
iBoxx Liquid High Yield Index (high-yield/"junk" bonds)	2.28	0.37	2.50
S&P/Citi Intern'l Treas Bond Ex-US (foreign bonds)	4.18	1.44	(1.34)

Source: iShares.com (except US Dollar Index: Bloomberg)

During the third-quarter, foreign stocks (developed markets) generally out-performed those in the US and precious metals generated strong returns. Bonds in aggregate were modestly positive thanks in large part to strong performance in September as both the Fed's decision to leave its program of QE unchanged and increased investor risk aversion in the face of an impending budget stalemate (and looming debt-ceiling standoff) were positive for the asset class.

After months of being off of investors' radar, political leaders in Washington have returned to center stage with the government shutdown. Republicans are demanding that Obamacare be delayed for a year in exchange for the passage of a continuing resolution (CR) that would restore all federal functions. For their part, President Obama and the Democrats insist that only a "clean" CR maintaining current levels of spending will be acceptable.

Exhibit 2: S&P 500 Year-To-Date

Source: eSignal

In the near term, however, investors are rightfully most concerned about the debt ceiling. Since the shutdown began, our view has become less negative in terms of the potential market risk. We believe both parties will do what it takes to avoid triggering a default or getting as close to the precipice as they did in August 2011.

In the end, these issues should prove transitory and the potential for additional gains in stocks has not been derailed. Economic activity and monetary policy, rather than political theater, will ultimately dictate the trend in equities.

On this front, the Fed's surprising decision to postpone "tapering" its QE programs and increasing signs of a synchronized upturn among the four important economies – the US, Eurozone, China and Japan – should support additional gains in global stocks.

Growth Outlook

Over the last four years the global economy has demonstrated uneven and largely desynchronized dynamics: the US economy has been mostly stable since the recovery began four years ago, even though growth has been sub-trend; Europe slumped into a "double dip" recession; Japan's economy struggled and barely stayed above water; and the Chinese economy moved from a strong upswing during 2009-2010 to a pronounced growth slowdown since 2011.

It now appears that the Chinese economy made a turn for the better this past summer, Europe also quietly made a bottom when pessimism toward the region became the dominant emotion in the investment community. For the US, the economy cruised through the sequester cuts without missing a beat.

A number of indicators are becoming increasingly upbeat (Exhibit 3):

- In the US, a number of major macro indicators show the economy is gathering broad based momentum (Institute for Supply Management reports, rising capital goods orders and falling unemployment claims).
- The European economy is showing signs of a broad-based bottom.
- Stimulus in Japan is having a positive impact. The economy is beginning to exit from deflation and growth is showing signs of a revival. Economic surveys are showing strength, business and consumer confidence is surging and capital investment has turned higher.
- In China, the government has quietly been easing monetary conditions, while continuing to pursue various supply side reforms. The economy has stabilized and leading indicators such as electricity consumption, rail freight and export growth have all turned up. Capital spending and consumer demand are also expanding.
- Measures of economic surprises are positive for both the major economies and the emerging markets.

These developments suggest that the world economy as a whole will likely exhibit stronger undertones in the coming months.

Needless to say, this call is not without risks. So far, the improvements have mostly been confirmed by various indicators, while the actual economic performance has not yet confirmed an upturn. Nevertheless, an increasing number of indicators seem to be pointing in the right direction. The implication is that an acceleration in business activity is a growing possibility (although the magnitude remains uncertain).

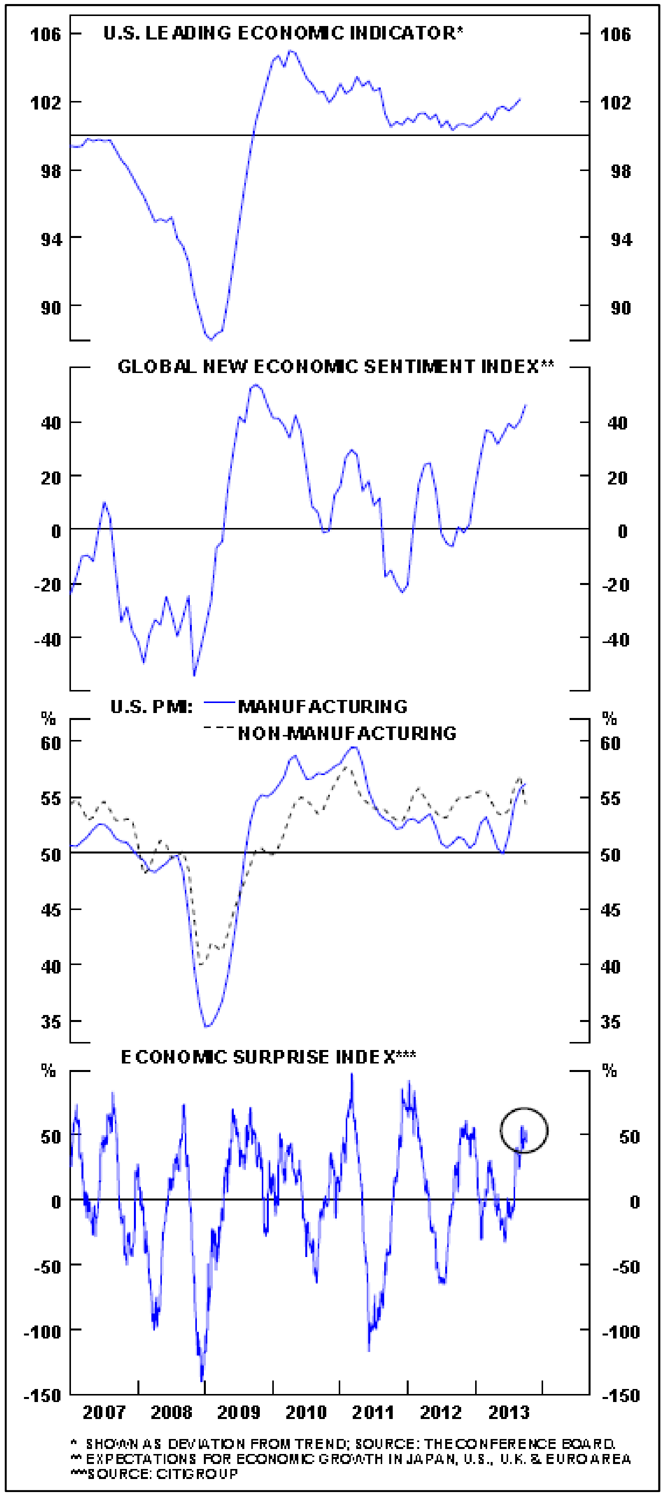
Stronger global growth should be good news for corporate profits. Earnings growth has slowed since 2011 for many reasons. For instance, the post-crash surge was too steep, setting the stage for a sharp deceleration, but weak global growth has also been a key headwind for profits. Going forward, a synchronized global growth acceleration would help extend growth in profits which, in turn, should help sustain the advance in risk assets.

As shown in Exhibit 4, an objective earnings model (based on the change in quality spreads, new orders and the gap between productivity growth and personal income growth-per-capita) also suggests that income growth will accelerate in 2014.

Stocks: Earnings and Valuations

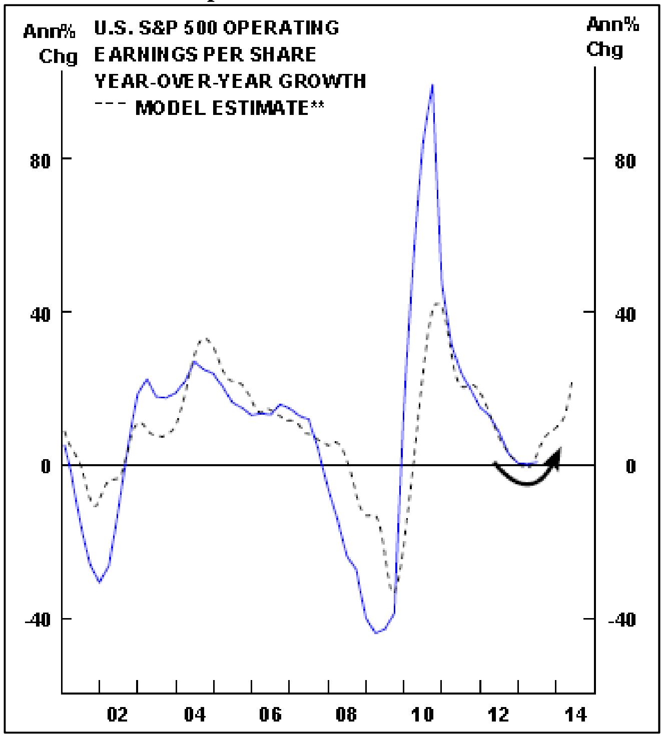
The current bull market in stocks that began in March 2009 has largely proceeded in two phases. The first phase was from early-2009 to mid-2011 when the advance in share prices was driven by earning growth. In other words, corporate earnings grew faster that stock prices, leading to improving valuations even as share prices increased. The second phase began in late-2011 and continues today. During this stage, stock prices have risen much faster than earnings. The result has been a deterioration in valuations. Exhibit 5 illustrates the two phases.

Exhibit 3: Data Have Been Good



Source: BCA Research

Exhibit 4: US Corporate Profit Model



Source: BCA Research

Going forward, stock market returns will be largely dependent on valuations, although we do expect earnings to grow as well. The Fed's decision not to taper its asset purchases in September was a surprise to the marketplace. This action – or inaction – indicates that the central bank wants to protect growth, encourage risk taking and promote higher asset prices. In the meantime – and assuming the indicators mentioned earlier hold up – corporate profits will likely begin to firm in the coming months reflecting a stronger world economy.

In recent history, valuations have been positively correlated with the shape/steepness of the yield curve (the difference in interest rates between short-term bonds and long-term bonds): a steepening curve tends to coincide with rising valuations, and vice versa (Exhibit 6).

Although the yield curve has already steepened substantially since May 2012, it has the potential to become even steeper as longer-term interest rates rise and the Fed keeps short-term interest rates near zero – potentially well into 2015. This may also have positive implications for sustained higher stock market valuations.

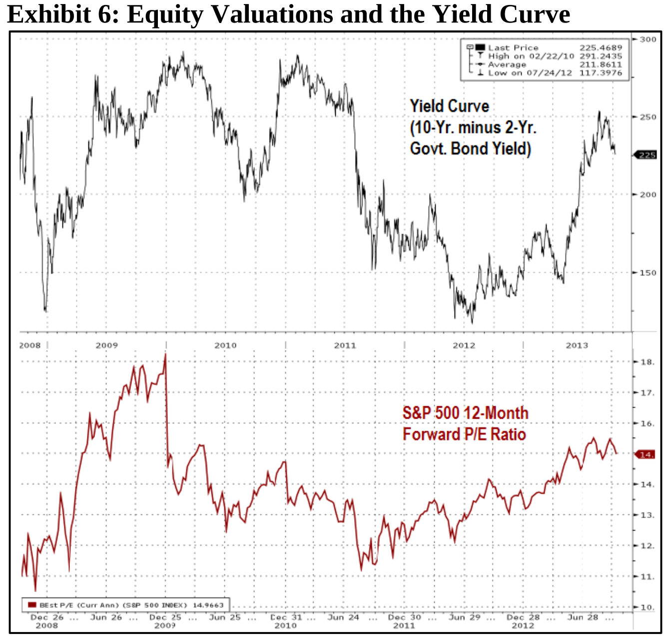
Ultimately, we have to contend with this the issue of trying to determine the equilibrium stock market valuation in a time of suppressed interest rates, weak but strengthening growth and high policy uncertainty. It's a number that is impossible to know. There are as many answers as there are methods. With that said, we haven't seen any that indicate stocks are cheap. Most reasonable methods point to a US stock market that is fairly valued to somewhat rich.

Therefore, any further price gains in excess of underlying earnings growth could push stocks into the overvalued range. However, it is important to remember that stock market valuations never tell us anything about the timing of turning points in share prices.

Exhibit 5: A Two-Stage Bull Market

Source: Bloomberg

Exhibit 6: Equity Valuations and the Yield Curve



Source: Bloomberg

Investment Strategy Outlook

Generally speaking, our clients' portfolios are somewhat underweight stocks relative to a "neutral" allocation. While the trend of many indicators we follow is improving which would imply a fully invested stance, the major force influencing the financial markets at *this* point in time (early-October) is the circus in Washington DC which is weighing on stocks. As of today, US stocks have declined by almost 4% since making a new all-time closing high on September 18.

The government shutdown *on its own* is not a game-changer for the recovery as long as it doesn't drag out much longer. Historically, short shutdowns had little impact on the stock market. The pain increased, however, when the shutdown lasted longer.

The worst-case scenario for markets is that the shutdown lasts until mid-October, causing the debate to join with discussions on the debt ceiling. The exhaustion of the Treasury's borrowing capacity under the debt limit is estimated to occur on or near October 17.

The debt ceiling is a more explosive problem than the shutdown, as we know from the August 2011 episode. Financial markets largely ignored the looming ceiling deadline until the last minute, at which point investor panic sent the 10-year Treasury yield down by about 80 basis points in the space of just eight trading days. One might have expected that the prospect of missed interest payments would undermine Treasury prices. Nonetheless, the more important factor is that the government must balance the budget virtually overnight if the Treasury can no longer issue debt, implying an immediate and massive fiscal contraction. This risk is what caused investors to flock to Treasurys as a safe-haven.

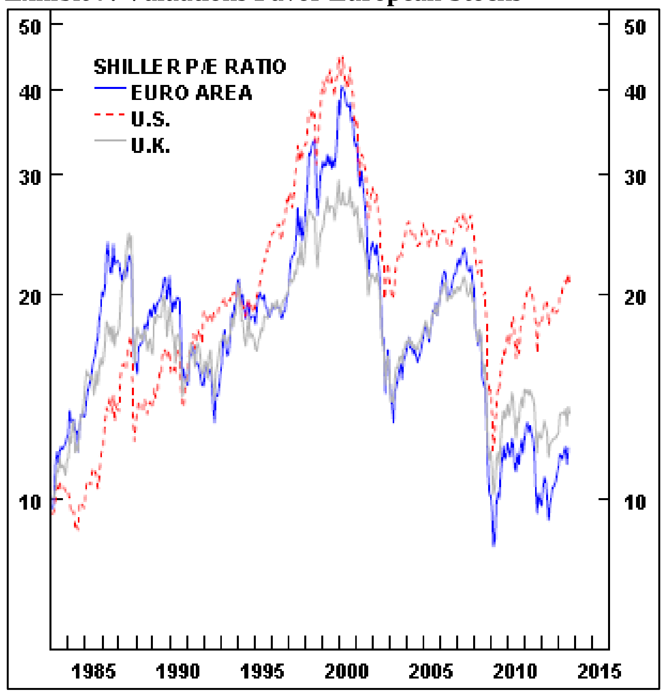
With the 2011 experience in mind, perhaps investors might react differently this time and "look through" the debt ceiling debate, knowing that a last minute resolution is inevitable. On the other hand, investors may still be unnerved if the debate goes down to the wire.

Fortunately for markets, the chances are that House Republicans will capitulate before October 17. Pressure is already mounting. Surveys show that the GOP is getting the lion's share of the blame for the shutdown. Tea Party Republicans are willing to withstand the negative press associated with a shutdown and even the debt ceiling in some cases, but they remain the minority in the party. The pain threshold for most other GOP members is much lower, particularly with midterm elections around the corner. Wall Street firms have already made their case to end the stand-off quickly and the Republican leadership will be sensitive to negative market reaction.

Ultimately, a US government default is a *very* low probability event. While the financial markets may ultimately have to force the hand of policymakers, we believe an agreement will be reached. In other words, financial markets are clearly vulnerable to US politics in the short-term; ultimately, however, it will be economic growth and monetary policy that determine the future path of financial asset prices.

Given our outlook, we anticipate using the debt ceiling induced pull-back as an opportunity to bring our clients' equity allocation up to "normal", or slightly higher. We will continue overweighting US large-cap stocks and developed foreign stocks – European shares in particular based on much better valuations (Exhibit 7).

Exhibit 7: Valuations Favor European Stocks



Source: BCA Research and Thompson Reuters

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