ACCESS FINANCIAL SERVICES, INC.

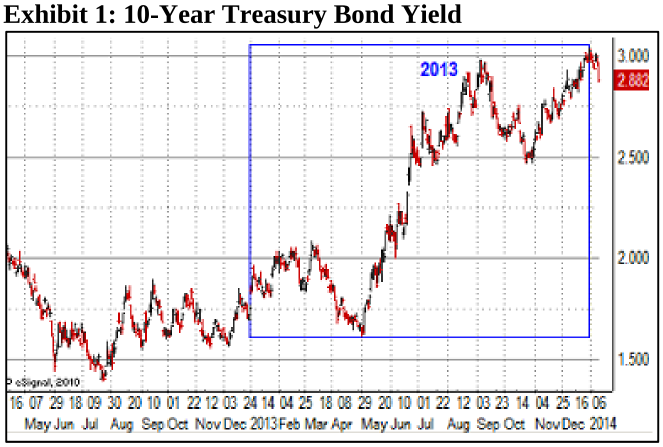
Quarterly Review and Outlook — Fourth Quarter, 2013

INDEX	4th Quarter, 2013	Last 6-Months	Year-To-Date
US STOCKS			
S&P 500 Index (large-cap stocks)	10.51	16.31	32.39
Russell 2000 Index (small-cap stocks)	8.72	19.82	38.82
FOREIGN STOCKS			
MSCI EAFE Index (developed foreign markets)	5.72	17.95	22.79
MSCI Emerging Markets Index	1.83	7.60	(2.60)
COMMODITIES			
US Dollar Index	(0.19)	(3.10)	0.02
London Gold PM Fix	(6.68)	(3.08)	(27.33)
London Silver Fix Price	(10.14)	0.31	(34.89)
GSCI Commodity Total Return Index	(0.33)	4.43	(1.22)
BONDS			
BarCap US Aggregate Bond (investment-grade bonds)	(0.14)	0.43	(2.02)
BarCap US 20+ Yr Treas Bd Idx (long-term US treas)	(3.23)	(5.85)	(13.88)
S&P Nat'l AMT-Free Muni Bond Index (municipal bonds)	0.23	(0.41)	(3.28)
BarCap US Interm. Credit Idx (inv.-grade corp. bonds)	0.68	1.70	(0.17)
iBoxx Liquid High Yield Index (high-yield/"junk" bonds)	3.35	5.70	5.93
S&P/Citi Intern'l Treas Bond Ex-US (foreign bonds)	0.07	4.25	(1.27)

Source: iShares.com & Bloomberg

Stock market returns in the US and developed foreign markets during the fourth-quarter of 2013 looked much like the year overall: very strong. For the full year, the S&P 500 posted its best showing since 1997. On a risk adjusted basis (as measured by its Sharpe ratio[1]), 2013 was the 4th best for the index in over 80 years. Core, investment-grade bonds, on the other hand, suffered a rare calendar-year loss as interest rates rose rather substantially during the year (Exhibit 1).

Exhibit 1: 10-Year Treasury Bond Yield



Source: eSignal

I am a believer that liquidity is the most important macro driver of the financial cycle and 2013 was a year that could not have been scripted to better support the old Wall Street adage "don't fight the Fed" as global central bank induced "portfolio balance channel"[2] actually did encourage large amounts of risk taking that translated into remarkable gains for developed market stock indices (Exhibit 2).

Exhibit 2: S&P 500 Index & Size of Fed's Balance Sheet

Source: Bloomberg

The debt ceiling induced pull-back we anticipated near the end of the year never materialized, and even though global growth was soft, 2013 worked out much better than we expected from a financial markets point of view and the liquidity punchbowl remains in place as the Fed's balance sheet expansion is set to persist well into 2014. This will likely continue to support "risky" assets as the equity market remains in a sweet spot of plentiful liquidity, easy central bank policy and strengthening economic momentum.

For the last four years, the Fed has opened up the monetary spigots each time there was a threat to the recovery. While the markets never seemed to fully trust the Fed's actions between 2010 and 2012, in 2013 it became crystal clear how powerful the forces of quantitative easing (QE) really are. During the year, pull-backs became shallower and subsequent rallies became stronger (Exhibit 3). During the Cyprus crisis and the fiscal crisis, risk assets barely budged to the downside.

In December, the Fed announced that it will taper (slow its purchases of Treasury and Agency securities) by a modest $10 billion per month starting in January, which means it

[1] Annual S&P 500 price return less 3-month t-bill return, divided by equity volatility

[2] By purchasing Treasury and Agency securities, the Fed reduces the amount of the securities that the private sector holds, displacing some investors and reducing the holdings of others. This encourages substitution of riskier, higher yielding securities. This pattern is often referred to as the portfolio balance channel.

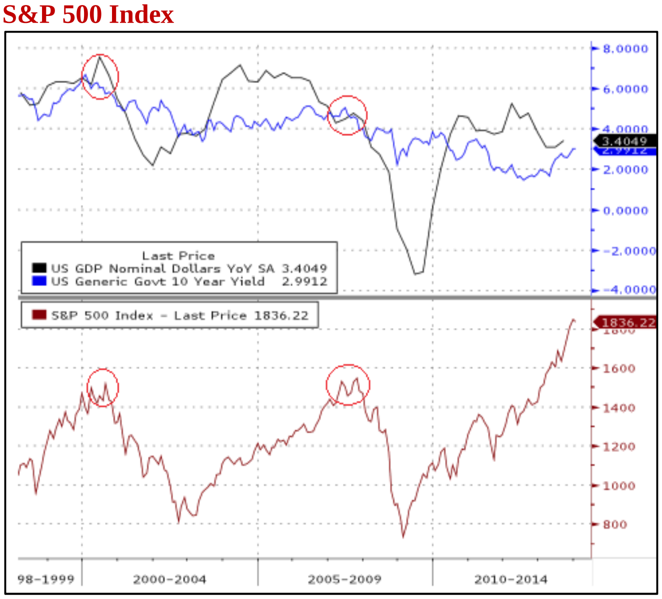
will continue plowing $75 billion per month into the banking system and economy for the time being. The Fed remains very reluctant to remove its accommodation prematurely and reiterated that it will only make further adjustments at a gradual pace. The markets interpreted this policy transition as a vote of confidence in the recovery, endorsed by the Fed.

Exhibit 3: S&P 500 Drawdowns

Source: Bloomberg

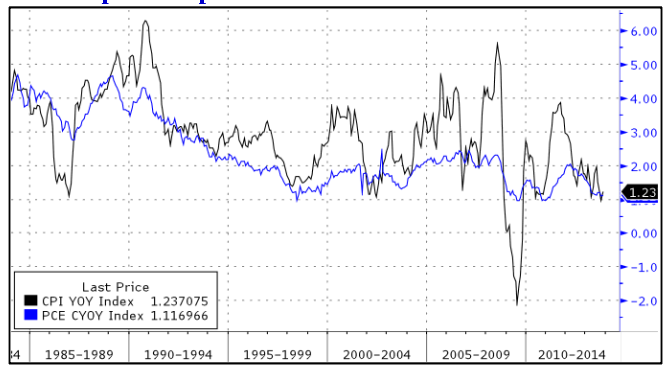
Even though longer-term interest rates have moved higher, they have not yet reached a choke point for the economy. Exhibit 4 shows nominal GDP growth remains above the level of 10-year Treasury yields. The past two cyclical bear markets have ended after Treasury yields climbed above the rate of GDP growth, pushed up by inflationary pressures. That removed excess liquidity and preceded economic weakness ahead. In the current cycle, there is little sign of inflationary pressures (Exhibit 5), underscoring that the Fed can maintain its accommodative policy for an extended period.

Exhibit 4: Nominal GDP Growth, 10-Yr. Treasury Yield, S&P 500 Index



Source: Bloomberg

Exhibit 5: Consumer Price Index, Core Personal Consumption Expenditure Index

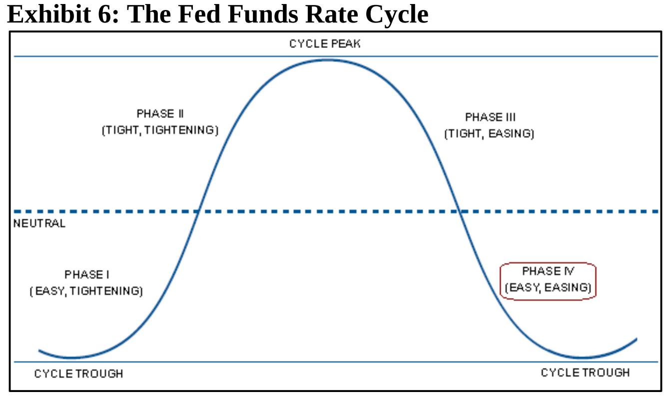


Source: Bloomberg

Since monetary policy has such a strong influence on financial markets, it makes sense to consider where we are at in the current cycle in order to get an idea of what to expect going forward. A basic framework is to view the fed funds cycle in four phases defined with reference to the fed funds rate relative to its equilibrium/neutral level (accommodative or restrictive) and the direction of its last move (up or down) (Exhibit 6):

Phase I:	Fed *hikes* rates *from below neutral*
Phase II:	Rate *hikes* continue *past neutral into restrictive territory*
Phase III:	Fed *cuts* rates *from above neutral*
Phase IV:	Fed *cuts* rates *from below neutral*

Exhibit 6: The Fed Funds Rate Cycle



Source: BCA Research

The US economy has been in an easing environment since late-2007 and in Phase IV since early 2008.

For US stock market returns, the level of rates is more important than their direction. Returns during Phases I and IV, when policy is easy, dominate the returns in Phases II and III when policy is tight. Phase IV, the current extended policy state, is by far the best backdrop for US stock returns (Exhibit 7).

While this single factor analysis alone isn't enough to base an investment strategy on, the most straightforward implication for investors is that stocks are in the sweet spot of the policy rate cycle and could remain there for some time given the Fed's current guidance.

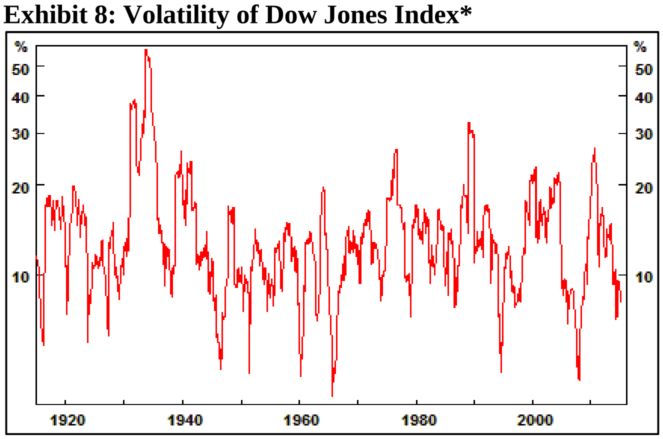
Exhibit 7: S&P 500 Returns During Rate Cycle Phases Since 1961

PHASE		S&P 500 COMPOUND ANNUAL GROWTH RATE		NUMBER OF PHASES
		MEAN	MEDIAN	
Phase I	(Easy, Hiking)	10.6%	6.8%	8
Phase II	(Tight, Hiking)	2.5%	6.2%	9 *
Phase III	(Tight, Cutting)	-8.7%	-9.1%	6 *
Phase IV	(Easy, Cutting)	23.0%	18.2%	8 *
Easy (Phases I and IV)		16.8%	7.6%	16
Tight (Phases II and III)		-2.0%	-0.4%	15

Source: BCA Research
**Table excludes the Phase III and Phase IV distorted by the technology stock bubble*

A counterbalance to the positive stock market outlook implied by this rate cycle analysis is that periods of low stock market volatility sow the seeds of their own destruction because they encourage complacency and an underpricing of risk. This is a scenario we are concerned about because the stock market's advance since early-2009 has increasingly become one directional as illustrated earlier.

Exhibit 8: Volatility of Dow Jones Index*

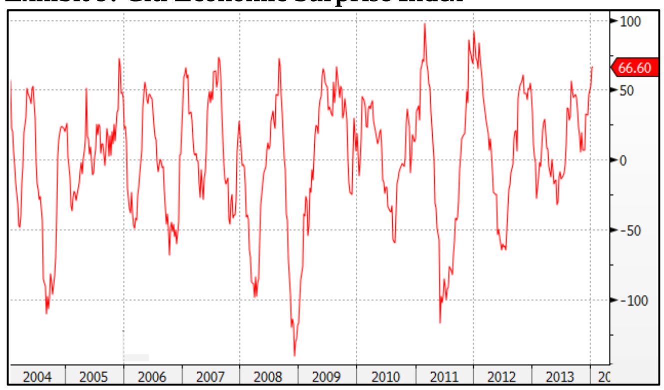


**Annualized standard deviation of monthly returns over rolling 12-month periods*
Source: BCA Research

If there is a universal truth in economics and financial markets, it is that periods of subdued volatility do not last. This is true for the economy, but it is especially true for the stock market. Volatility has no long-term trend and always and inevitably mean-reverts[3] (Exhibit 8). It is true across different geographies and economic eras. Nevertheless, despite the long-term consistency of volatility swinging from one extreme to the other, periods of calm continue to seduce politicians, economists and investors into complacency where the risks of a major draw-down are minimized and outsized performance is projected well into the future. Further, with the growing prevalence of institutional investors using volatility as a critical input into their asset allocation decisions, sales that feed spikes in volatility can beget more sales, leading to more volatility, and so on. Though it can't be definitively proven, it appears that this effect exacerbated the selloff last spring.

The market's advance has boosted investor confidence and various measures of investor sentiment confirm rising optimism about the stock market's potential gains going forward. The steady increase in optimism has tracked not only the move higher in stocks, but also the strong readings in the Economic Surprise Index – another mean-reverting series (Exhibit 9), and the decline in volatility. Taken together, these and other indicators imply a healthy level of skepticism is warranted.

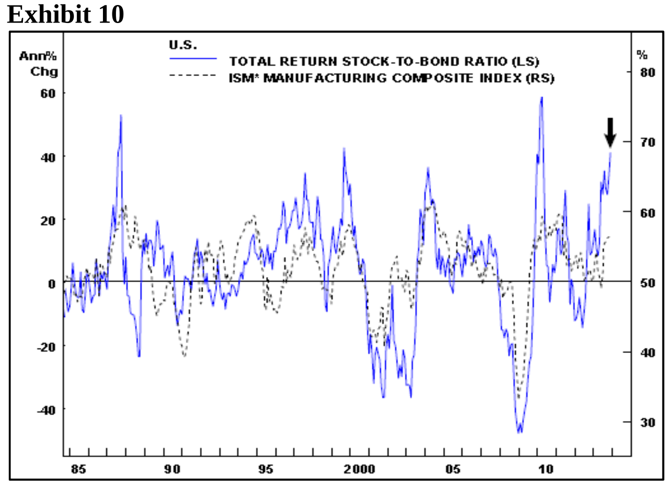
Exhibit 9: Citi Economic Surprise Index



Source: Bloomberg; Index measures data surprises relative to market expectations

The reality is that the risk/reward profile of the US equity market has likely deteriorated as prices have climbed significantly higher. Exhibit 10 shows that the total return ratio for stocks versus bonds has surged since mid-2012. In fact, it has only reached current levels on three previous occasions since the 1970s. While ultra-easy monetary policy and interest rate repression has played a role in the surge, it is fair to say that the US stock market may have already priced in overoptimistic assumptions of growth from here.

Exhibit 10



Source: BCA Research

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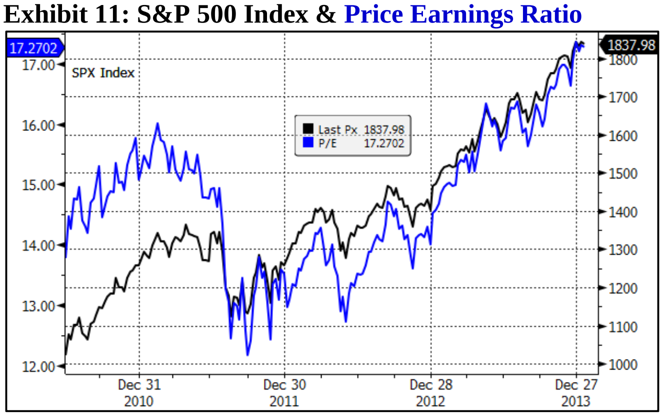
3 Mean reversion is a theory suggesting that prices and returns eventually move back towards their mean or average.

In sum, even though monetary policy remains supportive, our growing concern is that the ongoing surge in stock prices has pushed the US equity market into overshoot territory. This sets the stage for a setback. We are not predicting a bear market, but a sharp correction has become a growing possibility. Identifying the catalyst is, however, always very difficult.

Another increasing concern is the valuation of the US stock market. While it makes sense to be optimistic about the outlook for stock prices when they are cheap and earnings growth is likely to be strong, that does not appear to be the situation in the US and several other major markets.

As illustrated in Exhibit 11 below, the advance in stocks since mid-2010 has seen valuations (as measured by the market's price/earnings ratio) expand significantly as earning growth has been relatively weak.

Exhibit 11: S&P 500 Index & Price Earnings Ratio



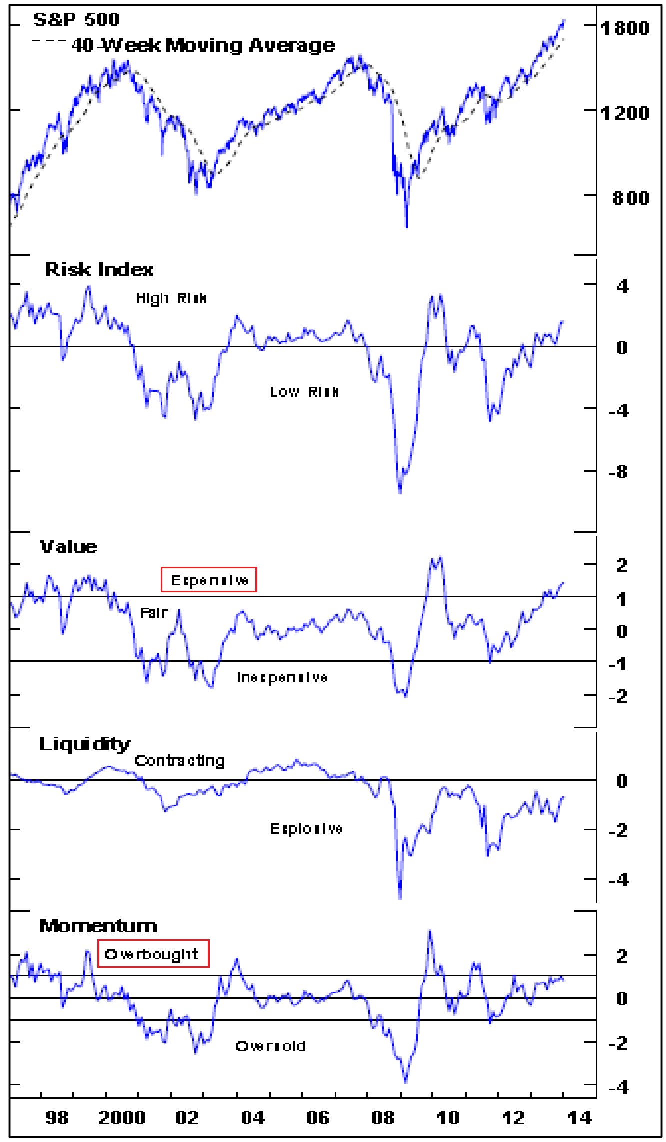
Source: Bloomberg

Even based on analysts' consensus *expected* earnings (which are reliably overoptimistic) – currently $121 for the S&P 500 (which assumes 10% growth in earnings for 2014) – the *forward* price/earnings (P/E) ratio would be 16.5 at an S&P 500 level of 2,000 (only about 8% higher than its current level of 1,850). For reference, this ratio has never been as high as 17 in the 45-years of the series' existence except during the late-1990s TMT (tech, media and telecom) bubble. If actual earnings growth turns out to be just 7%, 2014 earnings would be $117.70, and S&P 2,000 would represent 17 times forward earnings. Looking for further stock market gains from valuation expansion beyond the 16.5 to 17.0 forward P/E range doesn't appeal to us.

Pulling it all together, the case for believing in further out-sized gains from stocks is that the conditions for a major overshoot are in place (aggressive monetary policy and increasing investor optimism) as neither value nor momentum look attractive at these levels (Exhibit 12). This is a scenario that warrants a healthy level of skepticism as market opinion seems to be getting increasingly one-sided. While the current environment characterized by low volatility, strong momentum and rising valuations will not last forever, it can certainly persist for a while longer.

Our investment strategy is to remain at or below benchmark equity weightings with an emphasis on large cap stocks in developed global markets. Our outlook for bonds tends to be less pessimistic than the market's consensus outlook seems to be. We believe there has been a significant reduction in risk in the bond market now that interest rates have moved higher and that bonds will be a valuable asset class in the event of a setback in the stock market. Therefore, they remain a key component in balanced portfolios.

Exhibit 12



Source: BCA Research

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952-885-2732