ACCESS FINANCIAL SERVICES, INC.

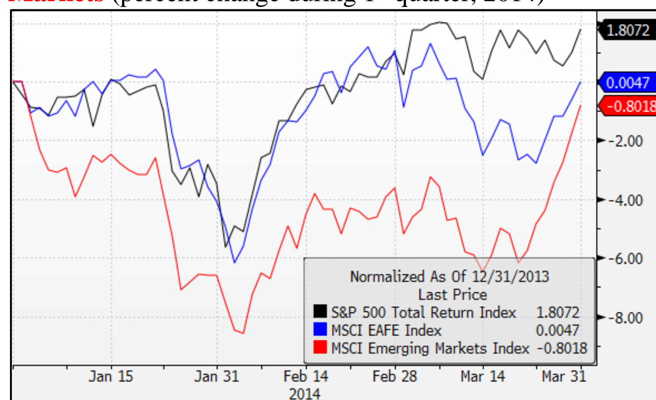
Quarterly Review and Outlook — First Quarter, 2014

INDEX	1st Quarter, 2014	Last 6-Months	Last 12-Months
US STOCKS			
S&P 500 Index (large-cap stocks)	1.81	12.51	21.86
Russell 2000 Index (small-cap stocks)	1.12	9.94	24.90
FOREIGN STOCKS			
MSCI EAFE Index (developed foreign markets)	0.66	6.41	17.56
MSCI Emerging Markets Index	(0.43)	1.39	(1.43)
MSCI BRIC Index (Brazil, Russia, India, China)	(2.91)	(1.29)	(3.46)
COMMODITIES			
US Dollar Index	0.08	(0.15)	(3.18)
London Gold PM Fix	7.24	(2.62)	(19.18)
London Silver Fix Price	2.41	(7.89)	(30.27)
GSCI Commodity Total Return Index	2.94	2.61	1.13
BONDS			
BarCap US Aggregate Bond (investment-grade bonds)	1.84	1.70	(0.10)
BarCap US 20+ Yr Treas Bd Idx (long-term US treas)	8.11	4.44	(4.18)
S&P Nat'l AMT-Free Muni Bond Index (municipal bonds)	3.37	3.61	(0.37)
BarCap US Interm. Credit Idx (inv.-grade corp. bonds)	1.63	2.33	0.98
iBoxx Liquid High Yield Index (high-yield/"junk" bonds)	2.68	6.12	6.50
S&P/Citi Intern'l Treas Bond Ex-US (foreign bonds)	3.53	3.59	5.09

Source: iShares.com & Bloomberg

After a very strong 2013, global stock markets declined early in the first-quarter, but ended mostly positive (Exhibit 1) despite developments such as Russia's annexation of Crimea, further evidence that China's growth is slowing amidst government efforts to manage a potential credit bubble, the changeover in Federal Reserve leadership, and a general continuation of the slow economic recovery in the United States and Europe.

Exhibit 1: S&P 500, MSCI EAFE & MSCI Emerging Markets (percent change during 1st quarter, 2014)



Source: Bloomberg

Developed international stocks were flat, largely due to a sizeable decline in Japan. In the midst of slow growth but still-high unemployment and very low inflation, many European markets rose (Exhibit 2).

Exhibit 2: MSCI EAFE, EURO STOXX & JAPANESE NIKKEI (percent change during 1st quarter, 2014)

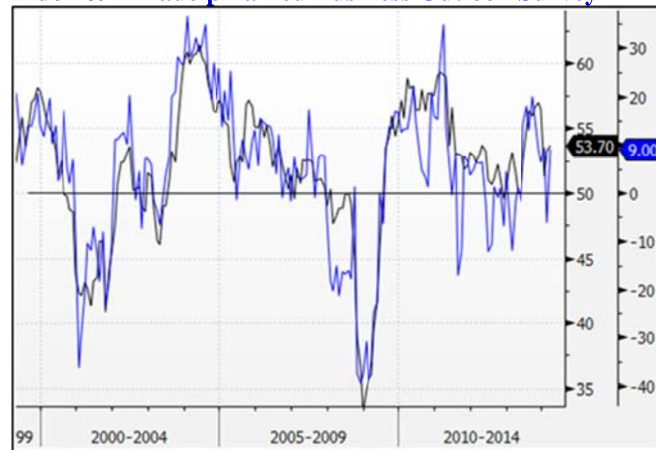
Source: Bloomberg

Emerging markets have been plagued by ongoing concerns about economic growth alongside macroeconomic instability in countries such as Ukraine and Turkey. These issues have been a headwind over the past year and led to a small first quarter loss for emerging-markets stocks.

Core bonds were among the quarter's stronger performers, reinforcing the important role they play in a diversified portfolio.

GLOBAL ECONOMY

Exhibit 3: ISM Manufacturing Purchasing Managers Index & Philadelphia Fed Business Outlook Survey



Source: Bloomberg

US economic data for the first quarter were somewhat disappointing, but this was largely due to unusually cold weather, which depressed a number of the short-term

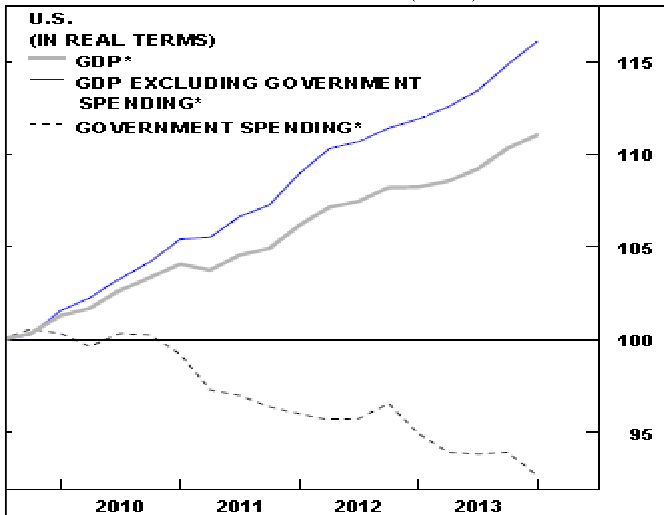
indicators of the economy's health (construction activity, consumer purchases, etc.). Nevertheless, the economy appears to be passing this soft patch. The latest Institute for Supply Management reading shows a rebound and the most recent Philadelphia Fed survey also displays renewed acceleration (Exhibit 3). In the meantime, the labor market continues to strengthen, with unemployment insurance claims registering persistent declines (Exhibit 4). Overall, the picture remains one of modest but steady economic growth.

Exhibit 4: Persons Claiming Unemployment (Total)

Source: Bloomberg

The US economic recovery has also been rather broad-based and stronger than headline gross domestic product (GDP) suggests. Exhibit 5 shows that the private sector has delivered average annual GDP growth of 3.3% since 2009, far better than headline GDP growth of 2.4% over the same period. This subdued GDP growth has been caused primarily by retrenchment in public-sector spending, which has been contracting 1.6% per year. With the US public sector no longer initiating spending cuts, overall economic growth should begin to gravitate toward the speed set by the private sector.

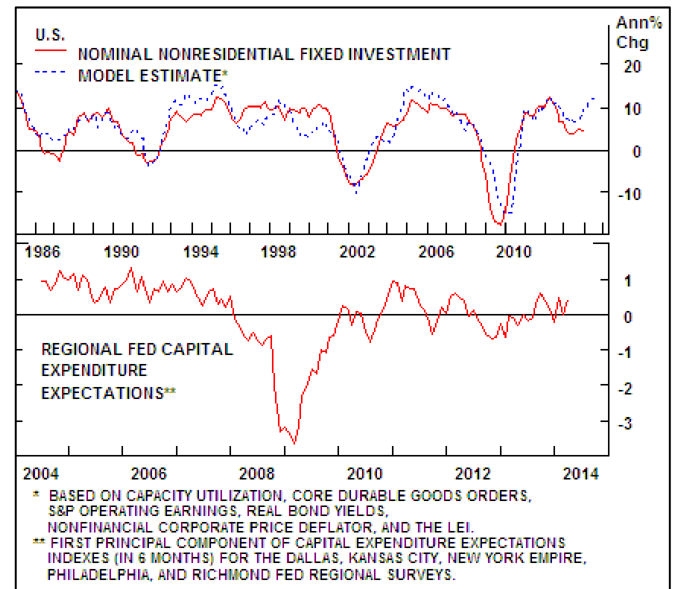
Exhibit 5: Gross Domestic Product (GDP)



Source: BCA Research

Meanwhile, the corporate sector has under-spent and over-saved. A pickup in capital spending could easily push overall GDP growth even higher. Exhibit 6 shows a corporate capital expenditure (capex) model which points toward a meaningful pickup in capital spending. Other forward-looking indicators are also encouraging. In particular, both the NFIB small business survey and a composite indicator of capex expectations from five regional Fed surveys point to a pickup in capex later this year. Consistent with this top-down assessment, a recent bottom-up analysis by Goldman Sachs found that S&P 500 companies expected to boost capex spending by 7% this year (based on guidance provided during recent quarterly earnings conference calls), a solid increase over the 2% growth recorded last year. With economic uncertainty diminishing and capital costs falling, capex growth should quicken.

Exhibit 6



Source: BCA Research

CENTRAL BANK POLICY

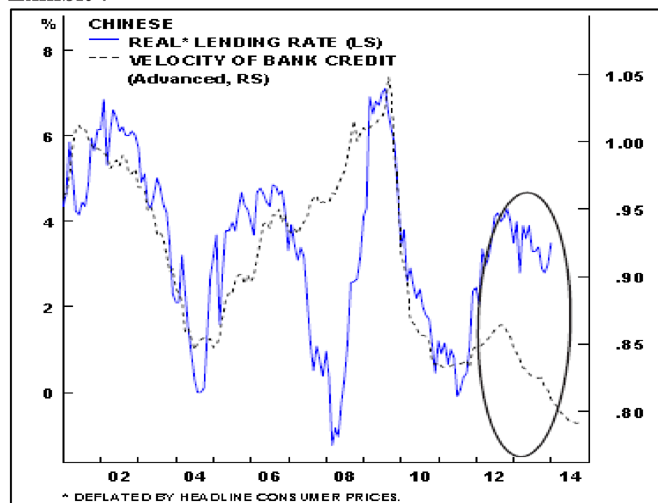
The Federal Reserve under Chair Janet Yellen relies on a set of qualitative assessments to determine its policy moves. She has made it clear that it will take a long time before the Fed begins to raise interest rates, that the pace of rate hikes will be gradual and that the terminal value of short-term interest rates will be lower than most anticipate.

At this point, the European Central Bank (ECB) is lagging behind the deflationary curve. Although inflation has already undershot its target, it does not necessarily guarantee additional easing of monetary policy. Signs of economic recovery have made it even less likely that the ECB will ease more. Nevertheless, European stock prices have performed strongly since last year, suggesting that tightening sovereign spreads (the difference in interest rates among the various countries in Europe) and low interest rates are probably more important than quantitative

easing in determining economic and asset-market performance.

Finally, a likely shift in China's monetary policy toward easing should have a positive impact on the world economy. This is mainly because the Chinese economy is a key marginal setter for global growth. Any expectation of growth reacceleration as a result of an easing in monetary policy would be interpreted favorably by the financial markets. Since the velocity of credit tends to lead interest rates, the recent meaningful decline in credit velocity suggests the downward pressure on Chinese interest rates is rising and predicts a fall in lending rates (Exhibit 7).

Exhibit 7



Source: BCA Research

Overall, monetary conditions will remain very stimulative. Although the Fed has tapered its asset purchases and the ECB has rolled back its balance sheet, China is likely to be the next to cut interest rates.

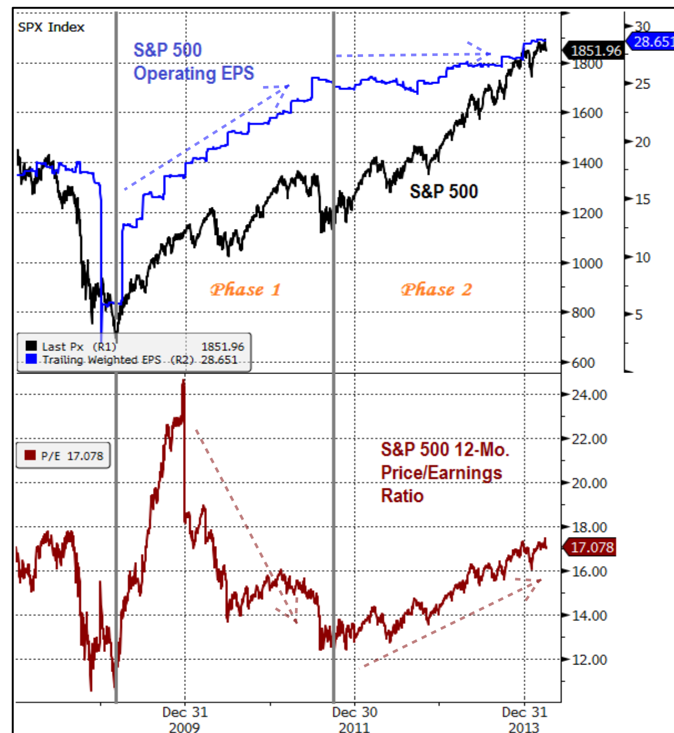
FINANCIAL MARKETS

As we noted in our third-quarter, 2013 report, the post-crash recovery in global stocks can be viewed as a two-phase process. The first phase developed in early 2009 and ended in late 2011. During this phase, global financial markets struggled with the aftershocks of the 2008 Great Recession and heightened fears of ongoing global shocks. At the same time, corporate earnings began growing rapidly (from *very* depressed levels). Valuations actually improved as corporate earnings grew faster than stock prices.

The second phase of the bull market started in the fall of 2011 and continues today. During this phase stock prices have risen much faster than corporate earnings and valuations have deteriorated as a result. Exhibit 8 illustrates these two phases.

The counter-argument to rich valuations is the extreme liquidity environment. Last quarter, we looked at a basic four-phase framework for judging where we are in the fed funds interest rate cycle based on where interest rates currently are relative to their equilibrium/natural level (accommodative or restrictive) and the direction of the Fed's last move (up or down). We noted that the current phase (accommodative and down) is by far the best backdrop for US stock returns.

Exhibit 8



Source: Bloomberg

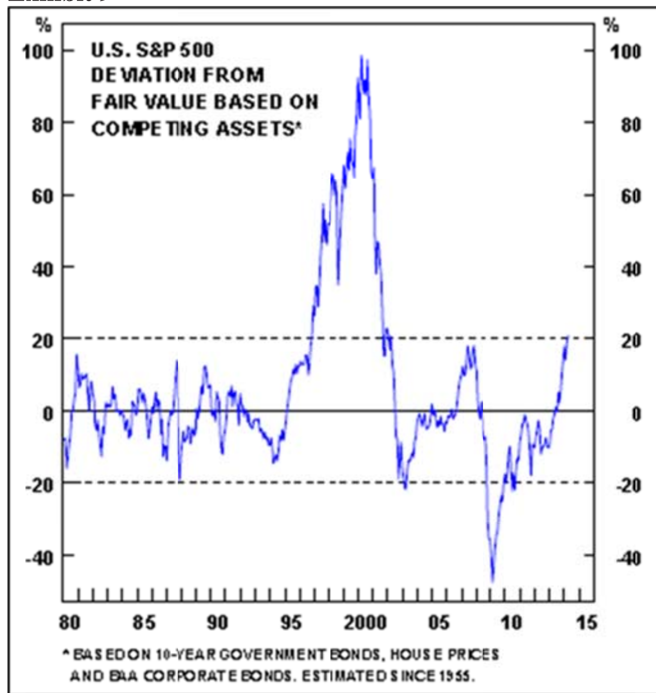
While we may have entered a testing phase where the expansion of valuations goes on hold for a while, it seems reasonable to expect that the equity bull market may soon move into a third, perhaps final stage, which will be characterized by even greater valuation expansion, intensification of speculation and ultimately, formation of asset bubbles. This is a much more difficult environment than before because stock prices have risen substantially and a lot of good news has already been discounted by the marketplace. By most valuation measures, stocks in developed markets are no longer a compelling value.

Even though most measures do not point to the market being at historical extremes, a valuation index based on relative values of competing assets suggests that the equity market is about 20% overvalued (Exhibit 9). Similarly, using the Shiller P/E (price/earnings ratio based on average inflation-adjusted earnings from the previous 10 years), the stock market is also overvalued relative to its historical average (Exhibit 10). Further price gains in excess of corporate profit growth will take the market into an even more overvalued stage. Nevertheless, there are a number of reasons to expect asset prices to move still higher:

First, prolonged zero interest rates will continue to fuel asset-price inflation by eliminating investment alternatives. Risk-free assets either offer a guaranteed loss or a zero return in real (inflation adjusted) terms. This means that any asset with a real yield greater than zero becomes a viable alternative or even an attractive investment. Investors are forced to invest in risky assets to extract "excess yield" even though asset valuations continue to deteriorate.

At present, financial markets do not expect any Fed rate hikes until 2015 and real short-term interest rates are expected to stay negative until 2017, suggesting that asset speculation and yield-searching activities will only intensify over time.

Exhibit 9



Source: BCA Research

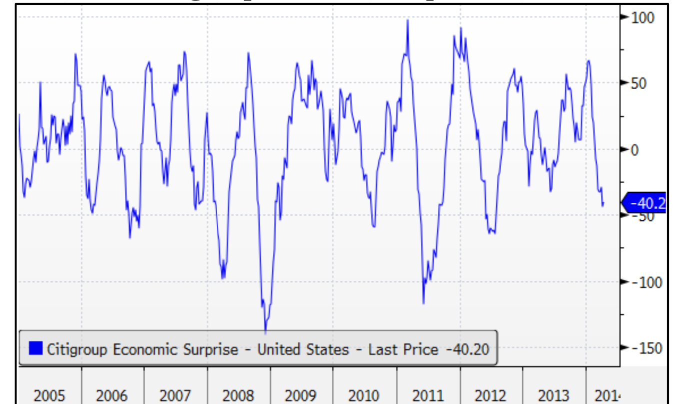
Exhibit 10: Shiller Price/Earnings Ratio

Source: http://www.multpl.com/shiller-pe/

Second, macroeconomic conditions could also become conducive for creating asset bubbles. Improving global growth will likely lead to a reacceleration in corporate earnings, which could encourage more risk-taking. The embedded bottom-up analyst's estimates have put 12-month forward earnings growth at 11%. Even if 10%+ earnings growth doesn't fully materialize, a rebound in profit growth almost always boosts investor confidence.

Third, recent economic surprises have been to the downside (as measured by the Citigroup Economic Surprise Index[1] – Exhibit 11). As disappointments naturally drive expectations lower, the likelihood of positive surprises relative to new/revised lower expectations increases. This can be seen in the mean-reverting tendency of the Surprise Index.

Exhibit 11: Citigroup Economic Surprise Index



Source: Bloomberg

Finally, the implied price volatility for the S&P 500 has trended lower since early 2009 (Exhibit 12). When low interest rates are combined with falling price volatility, financial leverage takes off as investors are drawn into levered bets because of the perceived stability. Usually financial leverage continues growing until interest rates begin to rise. Assuming that the Fed will only slowly nudge rates higher in early 2015, there is time for leverage to grow, even though by some measures financial markets are already highly geared.

Exhibit 12: CBOE S&P 500 Volatility Index

Source: Bloomberg

[1] The Citi Economic Surprise Index measure data surprises relative to market expectations/consensus estimates. A positive reading means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected.

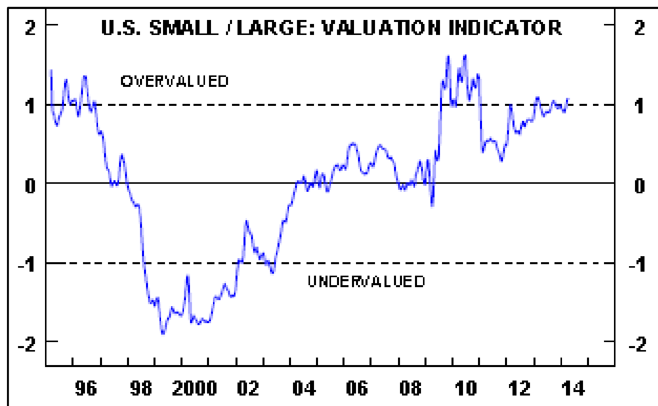
Bottom Line: Although asset prices have become expensive, monetary, economic and financial conditions all continue to evolve in a direction that is stimulative for asset prices.

INVESTMENT STRATEGY

Overall, stocks appear to be in the midst of what is referred to as a continuation pattern, spending some time backing and filling before getting back to the business of extending the established trend. We believe earnings and economic growth will continue, and expect some further expansion of valuations.

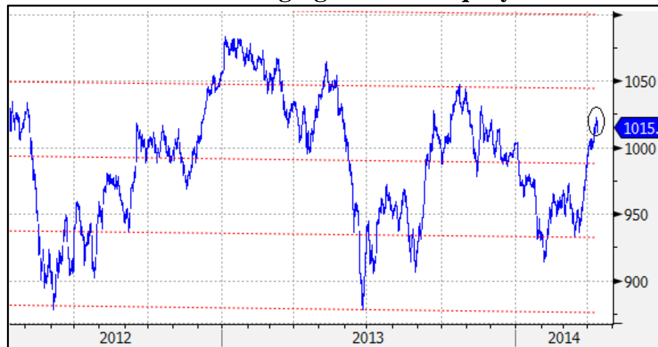
In most cases, we are fully invested (as of April 10) at our benchmark weightings for stocks and bonds. Within equities, we are overweight European stocks because they offer high dividend yields and low valuations, and underweight US small-caps for the opposite reasons (Exhibit 13). We have slightly reduced our emerging markets exposure into the recent advance (Exhibit 14) and believe we will rebuild our exposure when China eases monetary policy and Chinese growth is more likely to rebound.

Exhibit 13



Source: BCA Research

Exhibit 14: MSCI Emerging Markets Equity Index



Source: Bloomberg

Within fixed-income, we are underweight US treasuries and "core" intermediate-term bonds, and overweight high-yield, floating-rate and tactical strategies.

Overall, we're not expecting stock market returns anywhere close to what we experienced last year, but also do not believe the advance that started in 2009 is complete.

-Brant Kairies
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