ACCESS FINANCIAL SERVICES, INC.

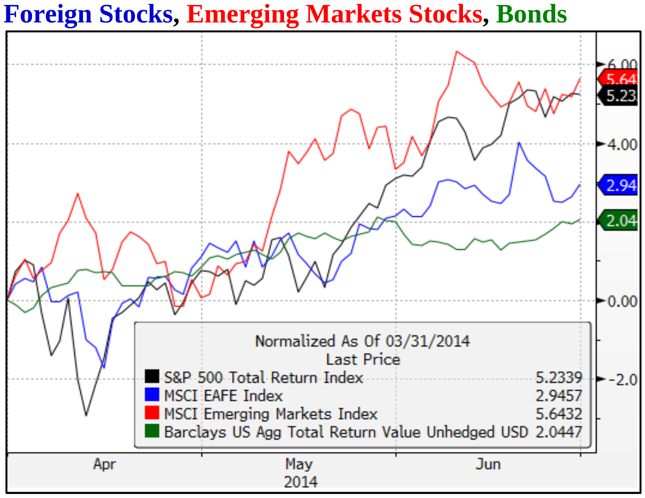
Quarterly Review and Outlook — Second Quarter, 2014

INDEX	2nd Quarter, 2014	Last 6-Months	Last 12-Months
US STOCKS			
S&P 500 Index (large-cap stocks)	5.24	7.14	24.62
Russell 2000 Index (small-cap stocks)	2.04	3.18	23.63
FOREIGN STOCKS			
MSCI EAFE Index (developed foreign markets)	4.08	4.77	23.57
MSCI Emerging Markets Index	6.59	6.14	14.31
MSCI BRIC Index (Brazil, Russia, India, China)	6.25	2.91	12.63
COMMODITIES			
US Dollar Index	(0.41)	(0.33)	(4.04)
Gold Spot $/oz.	3.37	10.46	7.52
Silver Spot $/oz.	6.37	8.02	6.90
GSCI Commodity Total Return Index	2.69	5.71	10.40
BONDS			
BarCap US Aggregate Bond (investment-grade bonds)	2.04	3.92	4.38
BarCap US 20+ Yr Treas Bd Idx (long-term US treas)	5.06	13.19	6.57
Barclays Municipal Bond Total Return Index	2.59	6.00	6.14
Barclays US Credit Bond Index (corporate bonds)	2.71	5.70	7.44
Barclays US Corp. High Yield	2.41	5.46	11.73
S&P/Citi Intern'l Treas Bond Ex-US (foreign bonds)	2.80	6.28	8.76

Source: Morningstar & Bloomberg

After a slight pullback in early-April for US and foreign stocks, most markets advanced steadily to the upside during the second-quarter (Exhibit 1 and table above) generating strong returns despite another quarter of lackluster economic growth.

Exhibit 1: 2nd Quarter Returns: US Stocks, Developed Foreign Stocks, Emerging Markets Stocks, Bonds



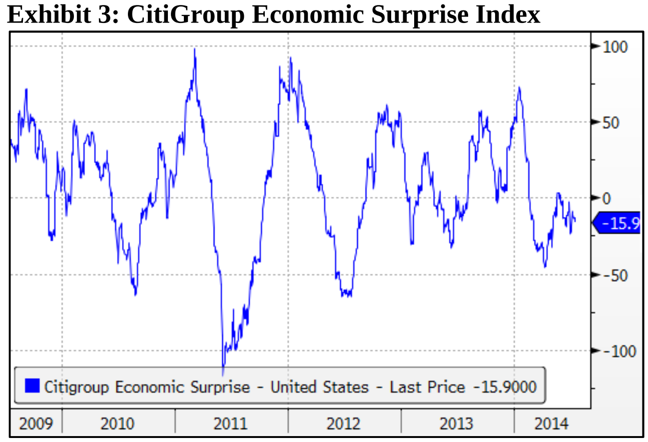
Source: Bloomberg

As part of the process of writing our Quarterly Review and Outlook, I like to review our prior quarter's commentary. This quarter – more so than most – our characterization of the financial markets has changed very little as the markets continue to advance despite weak economic growth, slowing corporate earnings, still higher valuations (Exhibit 2), economic surprises that have generally been to the downside (Exhibit 3), and even lower market volatility (Exhibit 4).

Exhibit 2: S&P 500 Price/Earnings Ratio

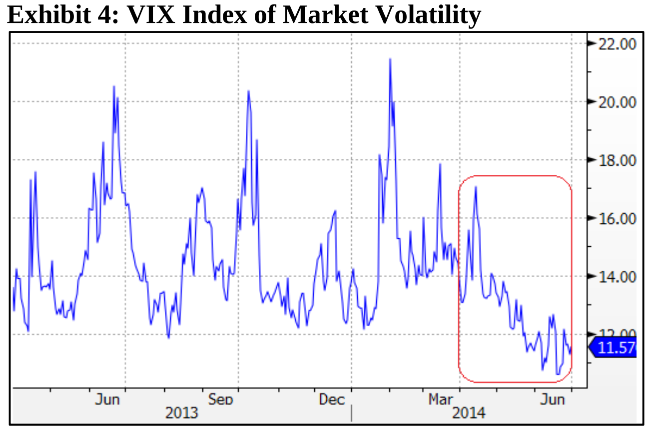
Source: Bloomberg

Exhibit 3: CitiGroup Economic Surprise Index



Source: Bloomberg

Exhibit 4: VIX Index of Market Volatility



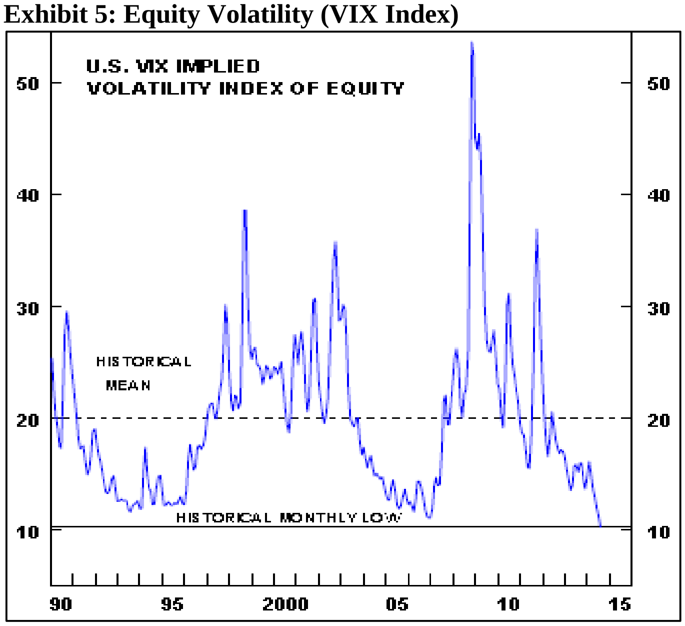
Source: Bloomberg

After passing through the "winter swoon", the US economy is beginning to grow again. However, there remains little reason to expect a sudden growth acceleration. Consumers seem to have reduced their pace of spending over the last few quarters, and businesses remain cautious. However, with the job market continuing to improve, economic growth should remain slow and steady. By and large, we expect muted but steady growth for the remainder of the year with the economy probably on track for 2.5% growth for 2014.

Despite the ongoing sub-par economic recovery, risk assets in most developed economies have had a good run over the past few years. While the bull market in stocks and other risk assets remains intact, the risk-reward profile has continued to worsen by the recent sharp price gains. US corporate earnings growth is flattening out and market breadth (the number of stocks involved in a market move compared to the total number listed) has deteriorated as the indices are being driven by a handful of mega-cap stocks. Meanwhile, investor sentiment – while not yet "exuberant" – has risen to levels that warrant a more cautious outlook.

Reflecting the improvement in investor sentiment, market volatility has fallen to unsustainably low levels for almost all asset classes, suggesting possible turbulence in the second half of the year. The VIX index, which tracks the cost of protecting against stock market declines, is near its all-time low (Exhibit 5), about half its average over its 24-year history. The Bank of America MOVE index, which measures Treasury price swings based on options, is also near its record low. As well-known economist Dr. Hyman Minsky wrote, "stability begets instability...the more stable things appear, the more dangerous the ultimate outcome will be, because people start to assume everything will be all right and end up doing stupid things."

Exhibit 5: Equity Volatility (VIX Index)



Source: BCA Research

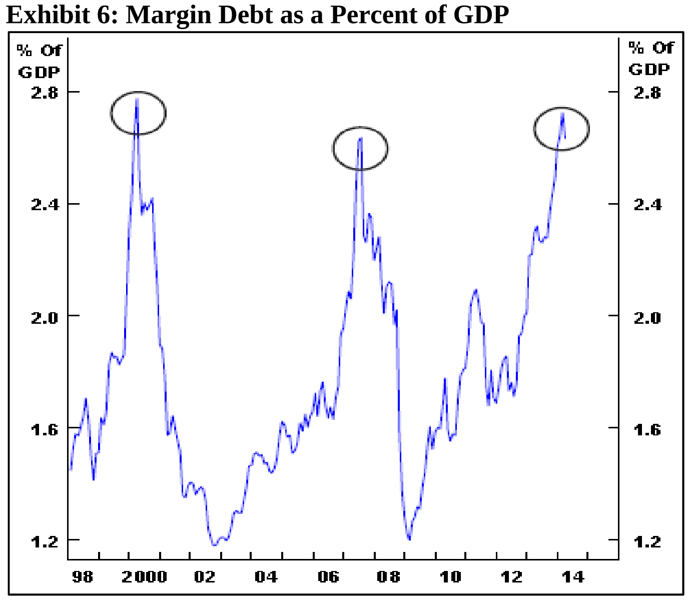
Excessive risk taking appears to an increasing concern at the Federal Reserve too. Minutes from the June meeting show some Fed policymakers voicing concern about investor complacency and that they're on the lookout for excessive risk taking. They also expressed concern about low volatility in equity, currency and bond markets, saying investors aren't factoring enough uncertainty into the outlook for the economy and monetary policy.

There is no way to tell when a stock market correction can or will occur, but the current backdrop implies the odds are getting higher. It is entirely possible that stocks will remain around their current levels for the remainder of the year on low volatility, low interest rates and low but stable global growth. Nevertheless, with complacency setting in and large amounts of cash having already moved back into equities, the risk of a correction or even significant shakeout will only grow.

At this point, the consensus seems to be that risk will continue to be embraced, speculation will become more intense and risk assets will be driven higher. With yields on all fixed-income assets having collapsed, stocks are the default choice for most investors even as a growing number believe stocks are either fully valued or border on overvaluation. Extremely low volatility in stocks, bonds and currencies has emboldened a growing number of investors to lever up their risk exposure to squeeze out more returns.

An additional concern is the escalation of financial leverage in the marketplace. Margin debt (debt used to finance the purchase of securities) has been rising for some time and the margin debt/GDP ratio is approaching an all-time high in the US (Exhibit 6). There is no data available on financial leverage in the fixed income markets, but the narrowing in various risk spreads (the difference in yields between high risk and low risk bonds) has mirrored the rise in financial leverage.

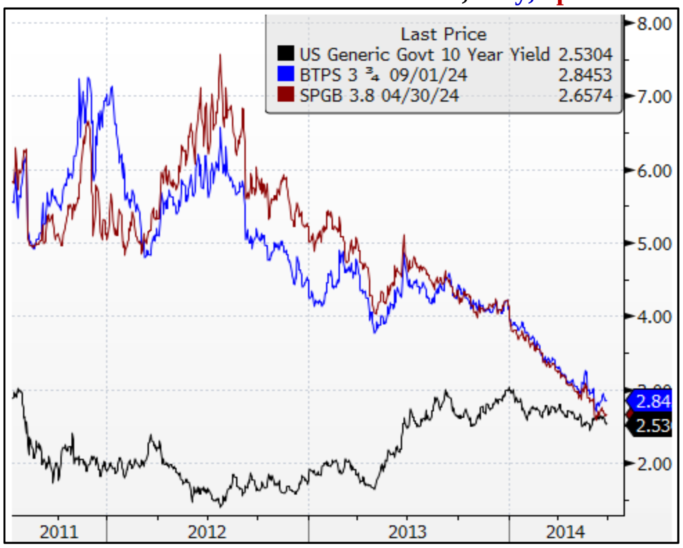
Exhibit 6: Margin Debt as a Percent of GDP



Source: BCA Research

In fact, the extent of speculation in the fixed income markets may have already reached the "bubble" stage. The expected annual total returns on high-yield/junk bonds is a mere 2.6%, after adjusting for the risk of default and the expected recovery rate. Additionally, Spanish and Italian government bond yields are around those of US Treasuries (Exhibit 7) reflective of ever growing demand for yield and little concern for credit risk.

Exhibit 7: 10-Yr. Gov't Bond Yields: US, Italy, Spain

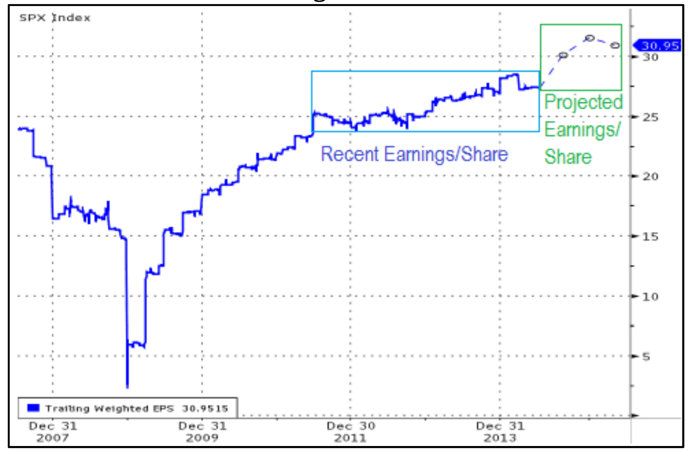


Source: Bloomberg

To summarize, financial markets have priced in a good earnings rebound (Exhibit 8), very low inflation, an extended period of zero rates and a negative real (inflation adjusted) interest rate until at least 2017. These projections could easily play out, further inflating asset prices in the months or even years to come. Nevertheless, almost by definition, this line of thought also suggests that "surprises" have a high likelihood of being to the downside which could upset market expectations. For instance, a growth slump may upset earnings assumptions. Or, an inflationary surprise could cause interest rate expectations to shift. Either could prompt a fall in stock prices. In fact, any sudden shift in sentiment, perceived risks or policy expectations could trigger rapid de-risking causing large market moves. In the end, the risk associated with financial leverage is always the same. The question is not if, but when the current tranquil environment will be disturbed.

To be clear, we are not predicting a major bear market in either stocks or bonds. However, if all of this accurately captures today's investment reality, then global financial markets may begin a transition toward a much more volatile environment as long periods of tranquility are always a precondition of rising volatility, and bull markets never progress in a straight line.

Exhibit 8: S&P 500 Earnings Per Share



Source: Bloomberg

For now, we remain at benchmark equity weightings for most clients as we watch for signs of change in the investment environment.

-Brant Kairies
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