ACCESS FINANCIAL SERVICES, INC.

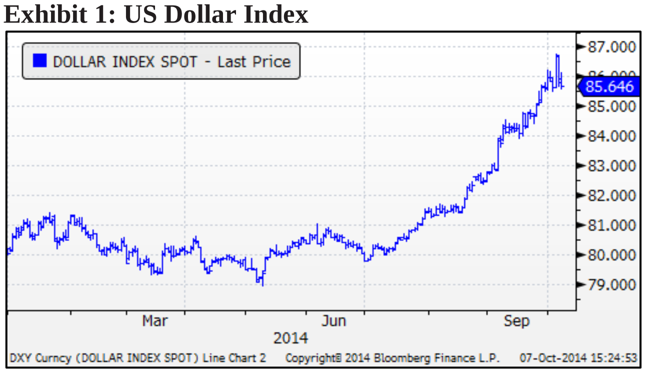
Quarterly Review and Outlook — Third Quarter, 2014

INDEX	3rd Quarter, 2014	Year-To-Date	Last 12-Months
US STOCKS			
S&P 500 Index (large-cap stocks)	1.13	8.34	19.73
Russell 2000 Index (small-cap stocks)	(7.36)	(4.41)	3.93
FOREIGN STOCKS			
MSCI EAFE Index (developed foreign markets)	(5.88)	(1.38)	4.25
MSCI Emerging Markets Index	(3.50)	2.43	4.30
MSCI BRIC Index (Brazil, Russia, India, China)	(3.25)	1.29	2.97
COMMODITIES			
US Dollar Index	7.72	7.37	7.13
London Gold PM Fix	(7.49)	1.00	(8.29)
London Silver Fix Price	(18.02)	(12.26)	(21.08)
GSCI Commodity Total Return Index	(12.46)	(7.46)	(7.76)
BONDS			
BarCap US Aggregate Bond (investment-grade bonds)	0.17	4.10	3.96
BarCap US 20+ Yr Treas Bd Idx (long-term US treas)	3.00	16.58	12.81
S&P Nat'l AMT-Free Muni Bond Index (municipal bonds)	1.56	7.57	7.82
BarCap US Interm. Credit Idx (inv.-grade corp. bonds)	(0.03)	5.67	6.64
iBoxx Liquid High Yield Index (high-yield/"junk" bonds)	(2.39)	2.53	5.96
S&P/Citi Intern'l Treas Bond Ex-US (foreign bonds)	(5.27)	0.59	0.65

Source: iShares.com & Bloomberg

US large-cap stocks posted modest gains during the third-quarter while most other stock and commodity markets declined meaningfully on the back of growing concern over the impact of the Fed's transition from large amounts of stimulus to neutral, a strong rally in the US dollar (Exhibit 1), and ongoing geopolitical events.

Exhibit 1: US Dollar Index



Source: Bloomberg

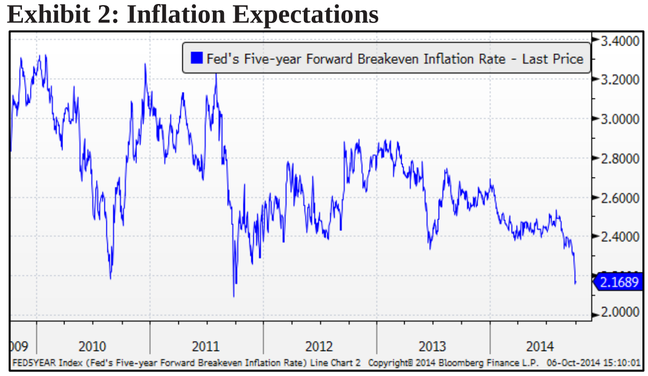
As we move into the final quarter of the year, the global economy continues to make slow progress. The US economy has re-emerged as a growth leader, while the rest of the world is operating at a subpar rate.

Going forward, this uneven global growth is unlikely to change anytime soon. Reflective of this backdrop, central bank policy cycles between the US and the rest of the world's key central banks will continue to be out of sync.

Over the past few months, a healthy dose of fear has reentered the financial markets and it seems reasonable to believe we are entering a new period of higher volatility as the end of interest rate suppression draws nearer and its distorting effect on asset prices weakens. The changing outlook for interest rates is impacting a number of markets, and restoring the volatility that has been absent for so long.

US stocks appear to have hit a wall on the back of tighter monetary conditions: the difference between corporate bond interest rates and government bond interest rates are widening, and the dollar has soared. The latter means the US is importing deflation which is weighing on the profit outlook. While the Fed is beginning to acknowledge the tightening effect of the stronger dollar, inflation expectations continue to fall (Exhibit 2).

Exhibit 2: Inflation Expectations



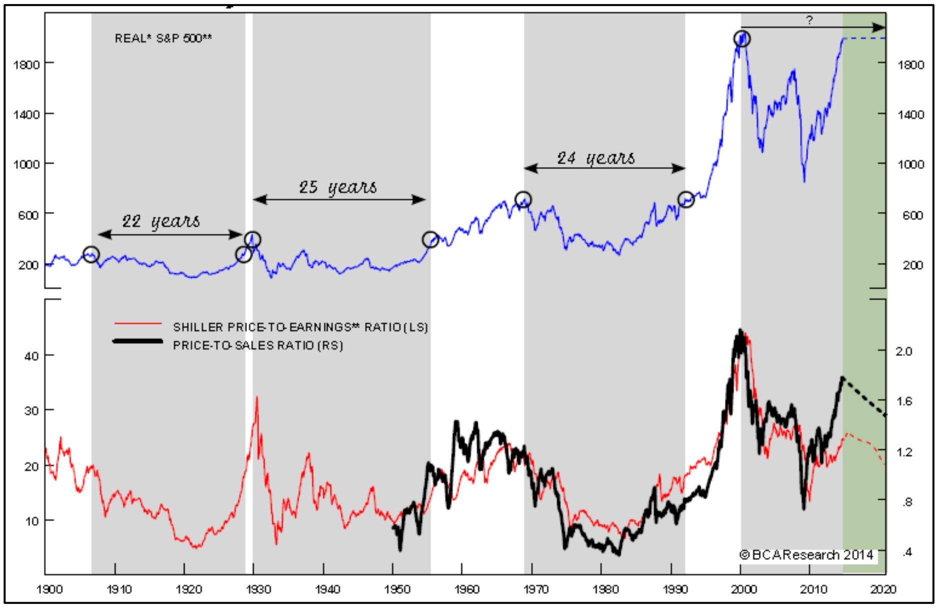
Source: Bloomberg

While the strengthening dollar is providing a welcome easing of monetary conditions abroad, its impact on US corporate sector profitability is likely to be negative. Net earnings revisions have a strong *negative* correlation with the US dollar. Companies in the S&P 500 receive more than 30% of revenues abroad, and roughly 40% of earnings. Analysts have only just started paring back estimates and there could be a meaningful adjustment if the dollar continues its advance. We expect the impact on corporate earnings to become more meaningful when fourth-quarter results are reported in early-2015.

Investors continue to debate the longer-term outlook for US stocks. The bulls point to reasonable economic growth and the likelihood that the Fed will maintain an accommodative monetary stance for a lot longer. The bears worry about stretched valuations, peak profit margins, and the prospect of rate hikes next year.

It's possible – even probable – that both sides are wrong and that US stocks have entered a "sideways" market where neither view is validated. History suggests that such an outcome is not only possible, but is actually quite likely. It has typically taken 20 to 25 years for *real* (inflation adjusted) stock prices to return to their prior bull market peaks (Exhibit 3). For example, US stocks did not surpass their 1906 peak until 1928 – a 22-year interval. It took 25 years for US stocks to return to their 1929 peak, and 24 years for stocks to advance beyond their 1968 peak.

Exhibit 3



Source: BCA Research; dashed lines are projections

The rally in equity prices since 2009 has pushed the real level of the S&P 500 back to its 2000 high. As such, if history is any guide, real stock prices could now begin to trade sideways at least until the end of the decade. So, it may turn out that while the selloff in equities during the financial crisis and the subsequent rebound was dramatic, it may only be a temporary deviation in a much longer sideways market that began in 2000.

Another reason to think this sideways market may persist well into the next decade is that valuations were more stretched in 2000 than at any prior market top. This suggests that it may require more time than usual to bring valuations back to "normal" levels.

While many contend that today's above average valuations are justified by the fact that interest rates are low (and are likely to remain so for the foreseeable future), this overlooks a few key points.

First, today's low interest rates partly reflect the fact that trend growth has slowed. The Congressional Budget Office expects potential GDP growth to be a full point lower over the next ten-years compared to the pre-crisis period (1980 to 2007 average: 3.1% vs. 2014 to 2024 average: 2.1%). Presumably, lower trend economic growth will also curb corporate earnings growth.

Second, today's corporate earnings are being boosted by record-high profit margins (Exhibit 4). It is estimated that if the average S&P 500 company's profit margin over the past ten-years had been equal to what it was during the 1990s, the Shiller price/earnings ratio (the price/earnings ratio of the overall market based on average inflation-adjusted earnings over the previous ten-years) would currently be close to the levels seen around the technology bubble market peak in 2000.

Another way of seeing this is to look at price-to-sales (P/S) ratios. The S&P 500 currently trades at a P/S ratio of 1.8, 73% above its post-1960 median, and not much lower than the peak of 2.1 registered in 2000. However, even this understates the breadth of overvaluation today. If one were to rank each individual stock in the S&P 500 based on its P/S ratio, the median stock would currently trade at a higher price-to-sales ratio than in 2000. This is also true if one looks at industry groups. Of the 48 S&P 500 industry groups for which enough data are available, 54% trade at a higher price-to-sales ratio than in March 2000.

Exhibit 4: S&P 500 Operating Margin

Source: Bloomberg

The good news is that even though stocks are unlikely to experience the kind of upside they've seen over the last five-years, bear markets have historically coincided with recessions and the preconditions for another major recession are not in place.

Economic recoveries do not die of old age, but of imbalances that build up over time. In the 1970s and early

1980s, inflation accelerated due to a series of oil shocks that occurred against a backdrop of poorly anchored inflation expectations and tight labor market conditions. This prompted the Fed to tighten monetary policy, triggering two deep recessions. In the early 1990s, a spike in oil prices following Iraq's invasion of Kuwait tipped an already weak economy that was battling the effects of the Savings and Loan crisis into recession. In the late 1990s, soaring stock prices led to a massive boom in capital expenditures, which eventually turned into bust when the tech bubble popped. And, of course, the debt-fueled housing bubble of the 2000s set the stage for the financial crisis.

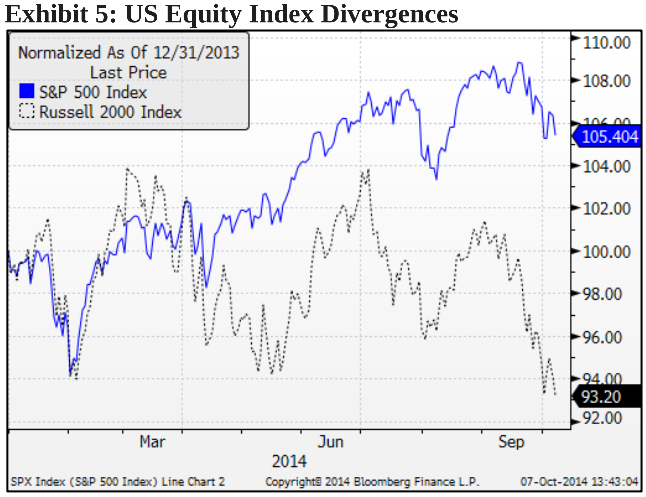
None of these vulnerabilities of the past are present now. Stock prices have rallied off their 2009 lows, but capital expenditures have remained restrained. Similarly, residential investment remains depressed, while spending on consumer durables has yet to return to pre-recession levels. Corporate balance sheets are also in fairly good shape and the ratio of bank capital-to-assets is at the highest level in the post-war era.

The risk that the Fed will be forced to raise interest rates aggressively also seems low to us. While the headline unemployment rate is closing in on the Fed's target, there are still 3.4 million more workers who are working part time that would prefer to work full time than there were in 2007. There are also probably another three million potential workers who have dropped out of the labor force, but will eventually seek employment as job prospects improve.

We do worry somewhat that the Fed may be misjudging the ability of the economy to stomach higher interest rates. The median forecast in the Summary of Economic Projections released on September 17 implies that FOMC members expect that the fed funds rate will rise to 3.75% by the end of 2017. This may not sound all that high, but keep in mind that the *real* fed funds rate averaged only 1% during the 2001-07 business cycle – a period in which potential growth was faster than it is today – and demand was being lifted by soaring home prices, rising debt, a falling dollar, strong emerging markets growth, as well as fiscal stimulus in the form of the Bush tax cuts and increased military expenditures.

If a 1% real rate was broadly consistent with full employment back then, it stands to reason that the neutral real rate may be even lower today. Uncertainty about the level of the neutral fed funds rate is likely to prompt the Fed to raise rates only gradually. Still, given the lags between higher rates and weaker growth, there is a risk that the Fed may find itself "ahead of the curve" in the sense of having raised rates too soon and by too much. If such a mistake were to occur, it would not necessarily lead to a recession because the Fed could simply lower rates to spur the economy, but against the backdrop of elevated equity valuations and compressed credit spreads, it could easily lead to a temporary downdraft in risk asset prices. While it's likely that US stocks have entered a prolonged sideways market that could last for a number of years, the recent corrective phase is probably about halfway through. Small-cap stocks, in particular, have already taken a beating with the Russell 2000 down approximately 10% since July 1 (Exhibit 5). It may now be large-caps' turn. The upshot is that the broad market – including foreign stocks – have already corrected more than the S&P 500 suggests, and most stocks are "oversold" from a technical perspective implying that the selloff is close to having run its course.

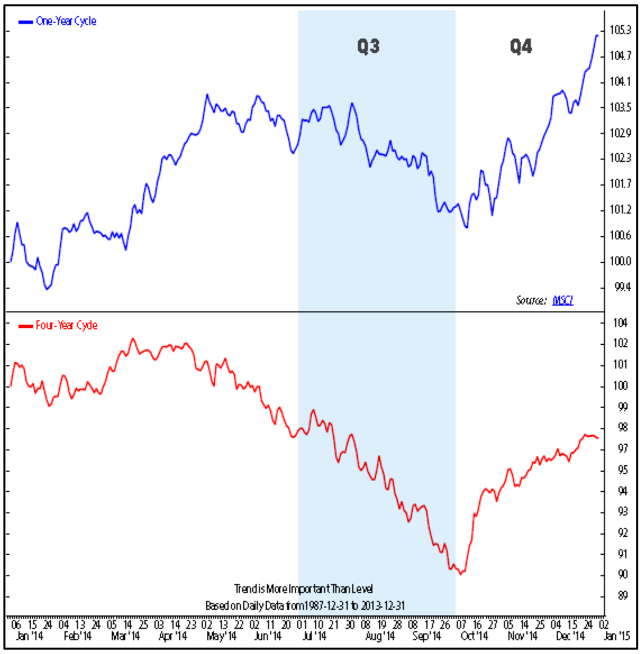
Exhibit 5: US Equity Index Divergences



Source: Bloomberg

Also, stock market seasonality is improving as the market transitions out of the often unfriendly third-quarter – a stretch that has tended to be especially unfriendly to stocks during the second year of the four year presidential cycle (Exhibit 6).

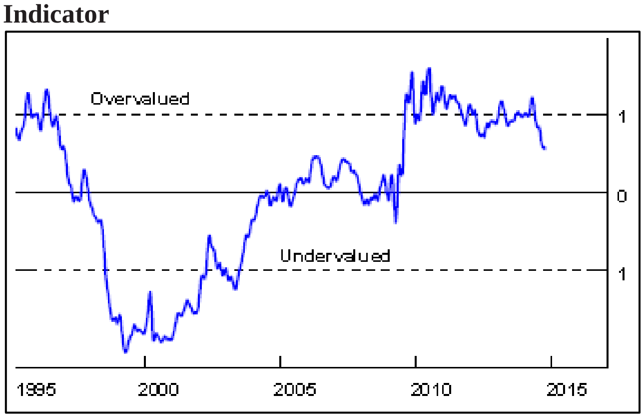
Exhibit 6: All Country World Index One-Year and Four-Year Cycles



Source: Ned Davis Research Group

In this environment, we will continue overweighting large-cap US equities (where the value is more compelling than small-caps – Exhibit 7) and targeting sectors that tend to have a positive correlation with the US dollar (financials, technology, health care, consumer staples and telecom).

Exhibit 7: Small-Cap vs. Large-Cap Valuation Indicator



Source: BCA Research

In a sideways market, income-producing assets such as dividend paying stocks and real estate investment trusts (REITs) should also fare well, especially if interest rates stay low, as is likely. These are also areas we believe we'll be adding to going forward.

The investment environment is set to become more difficult as central bank policy shifts, global currency markets adjust, and slower earnings growth begins to weigh on elevated valuations – all of which should result in higher levels of volatility than we've become accustomed to over the last five-plus years. Our intention is to capitalize on this expected volatility as opportunities present themselves.

-Brant Kairies

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