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Economic & Market Summary
July 2013

U.S. economic uncertainty continues to be driven by the second-order effects of an ongoing recession in Europe, slow growth in the BRIC countries, and lack of consensus on federal spending and entitlement reform. While these concerns have been highlighted endlessly throughout this four year expansion, real GDP growth has remained positive thanks to a strong consumer. Consumer spending growth has resulted from increased employment and compensation rates, stock market gains, savings rate reduction, and increased borrowing even in the face of modest headwinds from higher tax rates and reduced government spending. Despite robust housing growth, starts remain below household formation and with approximately 60% of U.S. inventory over 30 years old there is an implicit maintenance cycle. Additionally, firmer housing prices are making maintenance projects more palatable. Evidence shows that birth and marriage rates are growing slightly after years of declines, further increasing household formation. Business investment still only reflects maintenance projects rather than unabashed risk taking, portending higher future growth as confidence improves. Capital for growth projects is in place. In addition to personal consumption growth, we believe modest inventory replenishment, robust energy production, business investment in equipment and software, and residential investment gains are driving the U.S. economy forward and support our 2013 GDP growth expectation of 2%.

Late in the second quarter the Federal Reserve outlined a path to reducing its quantitative easing (QE) program. Going relatively unacknowledged was the caveat that economic data will dictate the decision, implying the economy would be on stronger footing before accommodation was reduced. Market reaction was significant in the bond market with the yield to maturity on the 10-year Treasury increasing from 1.6% to 2.6%, representing a loss of approximately 9%. Comparatively, the S&P 500 declined from its May peak of 1669 to 1570 representing a loss of nearly 6%. We have long expected the Fed to return to normal interest rates and believe there will be a digestion period in the markets. We expect stocks to fare better than bonds as stock valuations are much more sensible and empirical evidence shows stocks outperform bonds by a significant margin during periods of rising interest rates.

Globally, Japan is embarking on a QE program along with potential labor and regulatory reform. This bears watching as Japan is the third largest economy in the world. China's GDP growth is expected to be approximately 7.5% this year, but concerns are surfacing about lending practices and credit growth. China remains predominantly a state-run economy, so if problems become significant they may take time to resolve. Europe remains in recession, but major policy changes seem unlikely until after September elections in Germany. The U.S. is a net importer, lessening the effect of a global slowdown on domestic growth.

Through the first six months of 2013, the S&P 500's total return was 13.8%. S&P 500 consensus earnings estimates have declined 2% from three months ago to $109, likely reflecting global growth concerns and currency translation, resulting in a 14x price-to-earnings multiple. We anticipate modest corporate earnings growth going forward. Broadly speaking, equities offer good long-term value at these levels. Macroeconomic and geopolitical uncertainties are omnipresent and impossible to consistently predict. In contrast, our bottoms-up process focuses on investment in individual companies that demonstrate consistent and predictable earnings growth, priced at discounts to intrinsic value. While the reduction of monetary accommodation will create market volatility, the rationale for equity ownership remains firmly in place.

Thomas H. Rippl, CFA

To request our SEC Form ADV Part II, please contact Michael L. Wise, Chief Compliance Officer, at the address above.