

Newsletter – October 2013

Third Quarter 2013 Market Recap

MARKET TRENDS 09/30/2013

<u>US Stock Markets</u>	<u>Q3</u>	<u>YTD</u>
S&P 500 Index	5.2%	19.8%
S&P MidCap 400 Index	7.5%	23.2%
Russell 2000 Index	10.2%	27.7%

<u>Int'l Stock Markets</u>		
EAFE Index	11.6%	16.1%
Emerging Mkts Index	5.8%	-4.4%

<u>Fixed Income</u>		
Barclays Intermediate		
Gov't/Credit Bond Index	0.6%	-0.8%
Barclays Capital Muni Bond		
3 Year Index	0.8%	0.7%

<u>Commodities</u>		
SPDR Gold Shares (NAV)	11.2%	-20.5%
Goldman Sachs		
Commodities	4.8%	-0.9%

<u>Real Estate</u>		
Dow Jones US REIT Index	-2.9%	1.8%

<u>Yields</u>	<u>12/31/2012</u>	<u>9/30/2013</u>
T-Bills	0.04%	0.01%
10 Yr UST	1.76%	2.61%

Sources: Total Returns from WSJ Market Data Group, Standard & Poor's, Barclays

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Despite continued uncertainty about the health of the global economy and the future of monetary policy, U.S. stocks reached all-time highs in the third quarter before pulling back slightly in September. The market's focus was on the Federal Reserve ("Fed") again this quarter with the expectation that the Fed would start reducing bond purchases after its September meeting. However, to the market's surprise, the Fed decided to maintain the current buying program. The Fed cited mixed economic data and the uncertainty around the fiscal issues – government budget and debt ceiling deadline – as the primary reasons for not tapering. The market reaction was a spike in volatility for both stocks and bonds. The yield on the U.S. Treasury 10 year bond gyrated wildly during the quarter, starting at 2.5%, almost reaching 3%, and then finishing at 2.6%.

Overall, equities shrugged off the Fed's delay in tapering and the unresolved fiscal issues in Washington to generate strong returns in the quarter. Developed international markets (+11.6%) led the way with small caps (+10.2%) close behind. Mid caps (+7.5%) and large caps (+5.2%) also produced strong returns. Emerging market equities rebounded (+5.8%) in the quarter but are still down for 2013. So far this year, domestic small caps (+27.7%) are the leader followed by mid caps (+23.2%), large caps (+19.8%), international developed markets (+16.1%), and emerging markets (-4.4%). The equity market was resilient in light of a mixed economic backdrop, slowing corporate profits, interest rate and fiscal policy uncertainty, and the U.S. debt ceiling deadline. Equity mutual funds experienced positive cash flows during the past few months, although in relatively small amounts, especially compared to the significant outflows that equity funds experienced over the last few years.

After experiencing negative returns in the second quarter, bonds produced positive returns for the third quarter but with more volatility than normal. **For example, 10 Year U.S. Treasuries had a 20% move intra-quarter – more like equity price movements!** Although various bond sectors generated positive returns for the quarter, it was a different story for several others: intermediate governments, longer-dated municipals, U.S. Inflation Protected Securities, international and emerging market debt, are all in negative territory for the year. The bond sectors with positive returns for the first three quarters are high yield corporate and leveraged loan funds, which are up (+3%), and shorter-maturity municipals after the third quarter rebound. The positive returns in lower quality bonds may reflect an optimistic view of economic growth or may be symptomatic of "reaching for yield" by investors.

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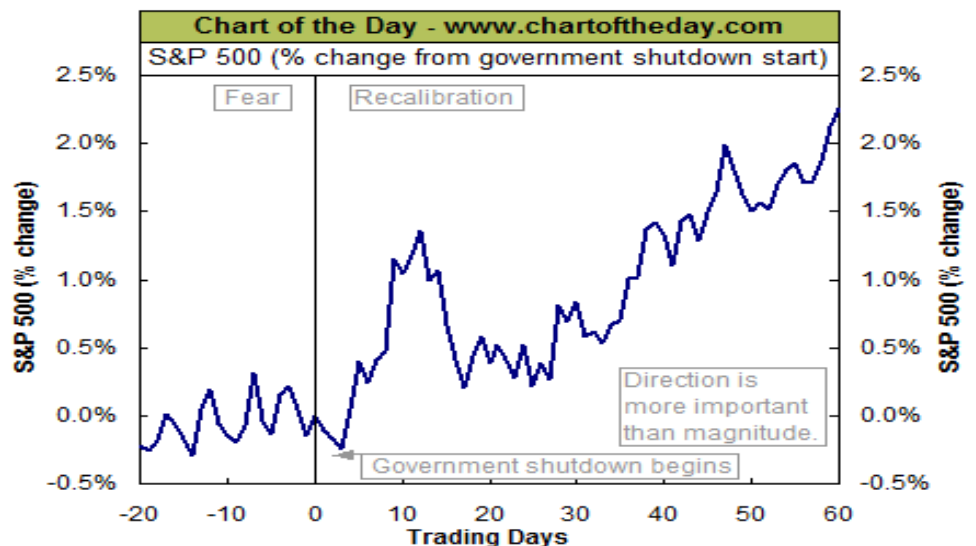
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For the quarter, commodities rebounded (+4.8%) even with weakening global economic growth, but are still slightly down (-0.9%) for the year. Gold prices were up sharply (+11.2%) although still down (-20.5%) for all of 2013. For the second quarter in a row, real estate investment trusts retreated (-2.9%) while still slightly up for the year (+1.8%). The real estate pullback likely reflects a concern for higher inflation and interest rates by financial markets.

Ben's Easing More Impactful to Markets than Government Shutdown

As you may remember, equity and bond markets sold off this June, officially pricing in the expected first taper of the Fed's monthly purchases of \$85 billion of government bonds and mortgages. Markets feared the start of the draining of liquidity. On September 18th, however, Bernanke and Co. promptly chose not to deliver what was expected. Instead they topped off the proverbial punch bowl of liquidity for another round. Without the much expected taper, markets were caught off guard, and both bonds and stocks promptly rallied. So much for the transparent Fed - maybe they were overly ambitious and should strive to be translucent?

Ben Bernanke's Fed has become arguably the most powerful driver of volatility in the equity and bond markets. As we know, the federal government was shut down, the pinnacle or nadir of Congress's self-aggrandized, selfish campaign of non-function and irresponsibility. The pundits reminded us daily that a shutdown hadn't occurred since the Clinton-Gingrich era 17 years ago. Yet the markets remained reasonably calm with equities selling off just 4-5% before rebounding to pre-shutdown highs. As has been the case with the 17 previous U.S. government shutdowns, we do not anticipate a lasting impact on the economy or markets.



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Not so with the taper; we have not seen central bank actions this dramatic ever before - or for this long. As Bernanke nears his expected retirement as the Fed Chairman, it appears that the great unwinding of the most massive easing in the history of the planet will be accomplished under someone else's watch. We believe that the market actually has this right. The actions of the Fed and its effects on interest rates are more significant than the government shutdown. In hindsight, the Fed delay in tapering seems appropriate considering the negative impact, the extent of which was unknown, to the economy of the government shutdown.

Ben's Retirement Party and Shorepoint's Long View on Interest Rates

Janet Yellen, a Fed Governor, was recently nominated by President Obama as Ben Bernanke's successor. She is believed to be at least as dovish as Bernanke with regard to interest rate policy. The market rallied briefly on the announcement of her nomination despite the overhang of a potential U.S. debt default. As we have seen, markets and crowds are wiser over time and prone to emotion and error in the short term. That's why we at Shorepoint try our best to constantly shape and reexamine our long term view. We believe that the long term is where the most acute risks lie and where the opportunities to make money reside. Yellen's Fed will be unwinding its historically massive liquidity policy for years to come. In past cycles, the Fed hasn't raised rates as quickly as needed to stave off inflation; we expect that may be the case again this time. But we are also coming back from the greatest loss of productivity and capital since the Great Depression. Our sense is that the Fed will be especially slow to respond to inflation in the next cycle for fear of tanking a still-fragile economy, and we are acting accordingly: reducing exposure to long bonds and the more interest rate sensitive investments like REITs and utilities.

The Mother Lode of Congressional Incompetence – The Risk of Technical Default

We at Shorepoint are not in the camp that the fears of technical default are overblown. We strongly believe that the United States' "good name", when it comes to its credit rating, should not be trifled with and are disgusted that technical default has become a political rope for tug of war – an economic noose for all of us more likely. We never would have imagined that so much time would need to be spent thinking about this eventuality - a very low probability one but with enormous potential negative consequences, many of which would be unpredictable. There are enough risks which can't be avoided through human conflict, and the turmoil of war, terrorism, or severe weather, and natural disasters. Through legislation or common

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sense leaders, we need to find a way out of this pernicious cycle of temporary government funding. Unfortunately, the recent Washington agreement is again temporary and sets up another potential battle in early 2014. However, we are hopeful and contrarian in our belief that we have hit a low of incompetence in Washington D.C. and some level of prudence will return in time.

Conclusion

Interest rates remain low. People are buying cars and houses. And consumer sentiment remains stable in the face of poor behavior by our elected representatives. The stock market has strengthened as have bonds of late. People are investing again versus just putting money in the banks. So now, we contrarians must worry! We see risks in bonds and rising rates coming in the future. The real economy is in decent shape and we expect continued stability but with increased volatility for the foreseeable future. Now is when we must focus on the micro to protect capital in the next recession or downturn by asking questions. How do price/earnings ratios and stock valuations look? Are free cash flow yields stable and/or increasing? How much are revenue and earnings growing? Are corporate debt levels prudent and manageable? Are bond yields increasing enough to warrant consideration? What is the impact of the new healthcare law and higher taxes on the consumer and businesses?

S&P 500 Index at Inflection Points

Characteristic	Mar-2000	Oct-2007	Sep-2013
Index level	1,527	➔ 1,565	➔ 1,682
P/E ratio (fwd.)	25.6x	➔ 15.2x	➔ 14.3x
Dividend yield	1.1%	➔ 1.8%	➔ 2.1%
10-yr. Treasury	6.2%	➔ 4.7%	➔ 2.6%

Not too expensive?

Source: J.P.Morgan Asset Management

It has been a good run for equity investors these past few years. However, we will be vigilant to protect capital and attempt to grow it in the future. We do not believe in altering long-term allocations for clients based on short-term, unpredictable factors. Our focus still remains on income generation which lowers portfolio risk and fulfills a clear need for clients. Markets will still correct, which is a normal functioning of financial markets. Shorepoint tries to be disciplined and use corrections as opportunities to position your portfolio for the future while considering your individual goals and objectives. Overall, we are still constructive on equities, especially relative to other investment options such as bonds, REITs, and cash.

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