PRAETORIAN GUARD℠

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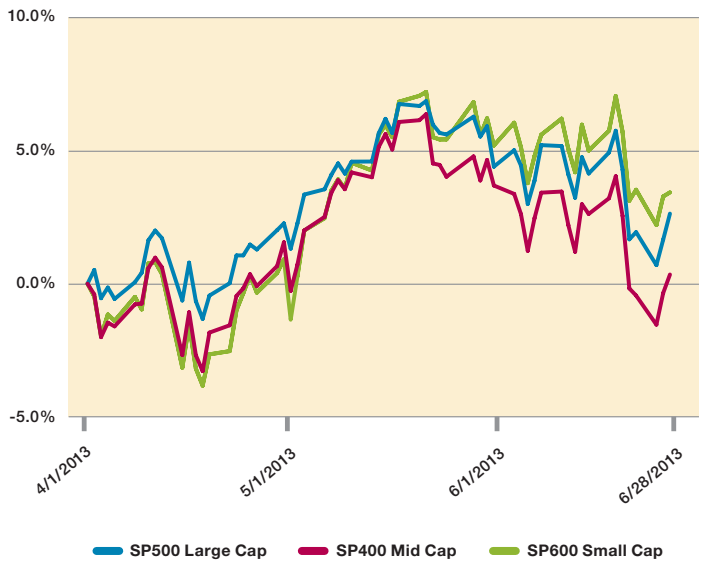
SECOND QUARTER MARKET REVIEW AND DISCUSSION

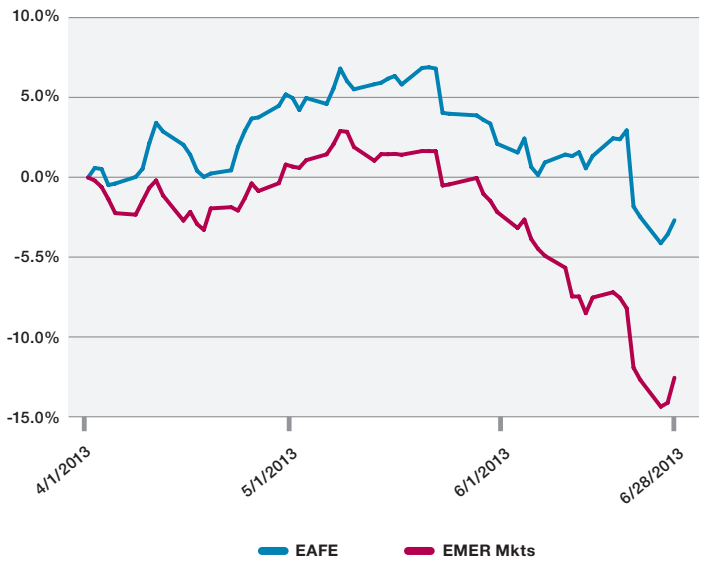
The second quarter saw a return to slower, yet still positive growth in US domestic markets with just enough excitement in the month of June to keep things interesting. The torrid pace of Q1 slowed overall, which is not unexpected given the great start of the first quarter. We are entering a 6-24 month period where the Federal Reserve removes some of the accommodation from the economy as *things get better*. A monetary policy in transition (from accommodation to normalization) is always challenging, but as stated on the opposite page, it's time for the US economy to grow without excessive stimulation.

US Equity Market Performance Q2



Source: The Financials.com

International Equity Market Performance Q2



Source: MSCI

US markets gave back some of the record highs reached in mid-May, but still had positive returns for the quarter, which built on the solid gains of the first quarter. We expect the third quarter will be more like Q2—bumpy, increased volatility and overreaction.

International markets continued to be a place largely to avoid and we expect that will be the case for some time. Developed Europe bumps along but has not yet resolved debt issues with its Southern members—band-aids and tourniquets are in place to avoid contagion but there is no sign of an economic resurgence on the horizon for a *long* time. Japan is trying yet another solution to get the economy growing on a sustained basis and Emerging Markets are struggling as China's economy continues its slowdown.

Bottom line for the upcoming quarter: US markets will return very low, but positive returns in the 1-3% range with developed International markets being flat and emerging markets continuing to struggle.

President's Commentary

One of the most amazing things to watch are market "lemmings" at work. I acknowledge that lemmings do *not* commit mass suicide as oftentimes thought, but they do engage in mass migration for reasons largely unknown.

So it is with too many "investors." Reacting emotionally to a few data releases or because everyone else is selling (buying?) only makes it harder to achieve your financial goals. The probability of making a *(continued on pg. 3)*

THE FED, THE PUNCHBOWL AND OUR CRYSTAL BALL

Federal Reserve (the Fed) Chairman Ben Bernanke is about to enter the most challenging period of his tenure: managing the slow, deliberate removal of extraordinary monetary policy accommodation that has been in place since the Great Recession began in earnest in 2008. The past two weeks have been a preview of several potential outcomes we may experience over the next two years.

The first response of the market to Bernanke's comments in mid June were to panic and sell off—not surprising, but demonstrating a distinct mis-reading of what the Fed has said in the past and what the Chairman reiterated in his post-FOMC (Federal Open Market Committee) press conference. Here are the facts about what HAS been policy, what IS policy and what it all means:

Chairman Bernanke has been clear since June 2011 that the extraordinary measures will continue until several economic data points indicate the economy is able to "stand on its own." Those include the unemployment rate approaching 6.5% (currently 7.6% for the May 2013 reading), inflation not to exceed 2% on a sustained basis and real GDP growth approaching 2.7% or higher. We are nowhere near these economic milestones.

In addition, the FOMC clearly stated that its "exit strategy" would be phased and sequential. It is worth recalling the Fed's statutory objectives are price stability and maximum employment. When it becomes time to *begin* policy normalization, the first actions will be to cease reinvesting bonds the Fed currently holds. The Fed has been purchasing and reinvesting upwards of $85 billion monthly and that will slowly, deliberately and publicly be reduced. Subsequently, it will begin to remove excess reserves from the banking system and announce the *forward* guidance for the Fed Funds Target rate will be towards increasing the rate. Lastly, the Fed will begin to raise the target for the Fed Funds rate.

So, what will it look like and when should we see it? Cue the crystal ball now…

A. Bond buying (Treasuries and Agencies), currently at $85 billion per month will begin to be curtailed in Q4 of 2013. Expect a small, $5 to $10 billion decline per month and the initial pace will be a month of reduced buying followed by a month with no further reduction (to allow for data to come in). This will continue through the end of Q1 2014. If economic data is positive, we will see a subtle shift beginning Q2 2014 to a monthly decrease of $5 billion *every* month until the Fed is no longer adding to its holdings by the end of the year 2014.

B. In the third or fourth quarter of 2014, the language of the Open Market Committee statements will begin to shift away from "highly accommodative stance of monetary policy will remain" (the phrase in June 2013's minutes) towards something in line with "economic conditions are continuing to improve and a gradual return to normalization for the Fed Funds target rate is expected in the mid-term." We do *not* expect the first Fed Funds rate increase from 0.25% will happen before the first meeting of 2015 and all increases will be .25% ending up at 3% by the end of 2016. The model here is Alan Greenspan's 17 consecutive hikes of .25% from June 2004-June 2006.

The Key Point To Remember

The Federal Reserve only initiates these actions as the economy improves. Thus it is *good news* when this happens. The Great Recession was painful, deep and long lasting but it's time for the U.S. economy to stand on its own.

(continued from pg. 2) mistake contrary to your interest is highest when watching others throw themselves off the proverbial cliff.

When a new macroeconomic data point is received, ask yourself if that one fact (which will almost certainly be revised) has changed *your* economic situation? More than likely, the answer is a resounding "no".

We all observed "lemmings" over the past few weeks as jitters about the Fed caused more than one rational soul to leap because others were already jumping. Perhaps our most important job here at Praetorian Guard is to help you stay focused on *your* economy and talk you off the ledge if necessary.

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THE GOOD NEWS FOR THE U.S. ECONOMY

As the punch line to the old joke states, "there must be a pony here somewhere," there is good news about the medium and long-term prospects for the US economy.

First, the energy renaissance we wrote about in our Q3 2012 newsletter is even more significant than we thought. 2012 saw output reach almost 6.5 million barrels per day, a level last seen in 1996. The benefit of this long-term increase (which is accelerating), is greater global price stability for a barrel of oil, reducing the risk of a price shock caused by geopolitical events. Additionally, the USA reduces its imports of oil, improving our balance of trade deficit and benefiting US workers. Finally, along with oil, natural gas output is the highest ever at over 25 trillion cubic feet in 2012—and also accelerating.

Secondly, abundant energy and restrained labor costs are combining to "onshore" US manufacturing jobs. The data shows manufacturing over the period 2010-2012 grew for three consecutive years for the first time since the end of World War II (source: Charles Schwab). When manufacturing is less about labor inputs and more about technology, efficient use of energy and distribution, the US will win vs. many "cheap labor" nations. China's labor costs are rising faster than ours and our workers and firms are very competitive today with the outlook only improving.

Lastly (and this is the start of our next political fight), Representative Dave Camp of Michigan and Senator Max Baucus of Montana are putting tax reform into first gear. The good news is that they are starting from a "blank slate," meaning that ALL tax expenditures will be eliminated and need to be justified to be reinserted. We're not so naive to think that we'll end up at this point, but over $1 trillion in annual tax expenditures (plus disincentives to invest, save and return overseas profits to the US among others) all combine to make our current tax code a disaster. We'll monitor this closely as these opportunities only come along once every 25-30 years.

Don't do something, just stand there

BehaviorGap.com

Closing Thought

I'm the fellow who takes away the punch bowl just when the party is getting good.

—William McChesney Martin Jr.
9th Chairman of the Federal Reserve