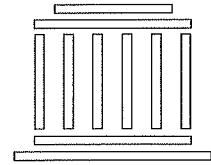
Investment Tally & Perspective



Lincoln Capital Corporation

Volume 22, Issue 3

July 2013

Special points of interest:

- *Economic Data - Page 2*
- *Index Returns - Page 2*
- *Investment Outlook - Page 3*

Ronald E. Albert, CFP
Brittany A. Moran, CFP
Nina Walsh
Karen Jones Ariosta

40 Westminster Street
Suite 202
Providence, RI 02903
Phone #: (401) 454-3040
Fax #: (401) 453-0678
Toll Free #: (855) 768-3040
Email: info@lccorp.com
Web:
www.lincolncapitalcorp.com

This issue of Tally & Perspective reviews recent economic and market activity, and provides an update on the investment outlook in coming months.

Review

The Fed, The Economy and the Markets - Six years ago this month, our central bank, the Fed, began lowering short term interest rates during the initial stages of the credit crisis. They continued to lower short term rates each month until they were near zero in December 2008 (the Fed funds rate, the primary interest rate tool of the Fed, was lowered from 5.26% in June 2007 to 0.16% by December 2008). With continued fears of deflation, or worse, the Fed then took further dramatic actions by purchasing trillions of dollars of bonds (they are currently buying $85 billion of bonds each month) with the explicit objective of lowering longer term interest rates.

These measures were designed to spur economic activity and, while solid arguments may be made for both the pros and cons of their actions, everyone agrees that their unprecedented policy cannot continue indefinitely. For global economies and financial markets to function most effectively, the price of money (interest rates) is best determined by market forces (the supply and demand for money and credit) rather than by government fiat or control.

With this historical background, the financial markets were quite strong in the first half of 2013 until late May, when prices dropped sharply as investors sold securities on concerns that the days of near zero/record low interest rates were nearing an end. Even though the Fed clearly stated they do not expect to begin raising interest rates until 2015, they conveyed expectations that economic growth will, most likely, accelerate in coming months, thereby allowing them to reduce or eliminate further bond purchases in the next year. This caused heavy selling of bonds, stocks, and commodities (gold), particularly by those investors who used borrowed funds. The end result was a 6% decline in the stock market from late May to late June, and a sharp rise in interest rates (the ten year U.S. Treasury bond yield rose from 1.6%% at the end of April to 2.5% at the end of June). Since the recent stock market low on June 24th, significant sums have flowed out of bonds into stocks, pushing share prices within 2% of their record high as of this writing.

(continued on Page 4)

MAJOR INDUSTRIALIZED COUNTRIES

	2013 Est. GDP	Unemployment	Estim. 2013 CPI	Budget Balance	Government Bond Rates
Britain	0.8%	7.8%	2.7%	**-7.6%**	2.64%
Canada	1.8%	7.1%	1.4%	-2.8%	2.50%
France	-0.2%	11.0%	1.2%	**-4.2%**	2.38%
Germany	0.4%	6.9%	1.7%	**-0.3%**	1.77%
Italy	-1.7%	12.0%	1.6%	**-3.2%**	4.70%
Japan	1.6%	4.1%	0.1%	-8.7%	0.87%
Spain	-1.7%	26.8%	1.7%	**-7.0%**	5.00%
Switzerland	1.2%	3.2%	nil	0.3%	1.11%
United States	2.0%	7.6%	1.6%	-4.5%	2.54%

Note: Interest rates in bold are Euro currency rates.

Data from The Economist, June 29th, 2013

EQUITY INDEX RETURNS

Period Ending June 30, 2013	2013			Average Annual Returns			
	1 Q 13	2 Q 13	YTD	1 Year	3 Year	5 Year	10 Year
S&P 500	10.61%	2.91%	13.82%	20.60%	18.45%	7.01%	7.30%
NASDAQ Composite	8.52%	4.52%	13.43%	17.60%	18.64%	9.38%	7.68%
Dow Jones Ind. Average	11.93%	2.92%	15.20%	18.87%	18.23%	8.64%	7.92%
Russell 2000	12.39%	3.08%	15.86%	24.21%	18.67%	8.77%	9.53%
MSCI EAFE (Foreign Index)	5.13%	-0.98%	4.10%	18.62%	10.04%	-0.63%	7.67%

Data from Morningstar

INVESTMENT STRATEGY & OUTLOOK

July 11, 2013

The World Economy

- The world economy, now into the fourth year of recovery, is still operating well below its capacity
- U.S. growth will likely strengthen in the fourth quarter with momentum carrying into 2014
- Increased housing and auto activity have changed from drags to growth contributors
- U.S. consumer deleveraging should be a diminishing headwind
- The global backdrop remains challenging for U.S. exports
- Job growth and business investments are restrained by the massive increase in regulations
- Europe is in a recession but the pace of contraction is easing
- There are some risks with China's reform strategy, but odds of a crash landing remain fairly low
- Japan's reflation efforts are having a positive impact on the economy

The Fed and Monetary Policy

- The Fed's been clear that actions will be dictated more by labor market trends than GDP growth rates
- Low rates of inflation have allowed central banks to inject liquidity while repressing interest rates
- Government's spending sequester may remain a modest drag on activity short term
- World economies are still in a low inflationary or even deflationary expansion phase

Bonds and Interest Rates

- Treasury yields are hitting new cyclical highs, as the monetary backdrop begins transitioning
- Forecasts for the 10 year Treasury yield (now 2.6%) are 3% by year end, and 4% by the end of 2014
- A strong dollar will continue to dominate the currency scene
- The macro backdrop for corporate credit in 2013 remains positive

Equities and Commodities

- Equity markets have been in a consolidation phase with potential for near term weakness
- For the cyclical bull market to stay intact, a correction that removes froth and excess is healthy
- Emerging market equities have been hurt by hawkish Fed commentary and China's credit crunch
- Commodity demand should be modestly supported by global growth of 3% this year
- After twelve straight years of rising prices, the price of gold has declined significantly in the past year
- Gold is in the process of making an important bottom, which will likely be followed by a meaningful rally

Summary Outlook

- Higher interest rates will ultimately be positive for investors, though it will produce some transitional pain
- The lack of liquidity in current bond and stock markets is a significant structural change
- Less liquidity means greater price movements in both directions ("melt-ups" and "melt-downs")
- With interest rates rising and stock prices stretched, the near term investment environment is difficult
- Longer term, stocks remain the asset of choice with higher return probabilities compared to bonds

(continued from Page 1)

Structural Financial Market Changes – There is an important matter, which the media has neglected, that we want to bring to the attention of our clients. This issue concerns structural changes in financial systems, which have resulted in reduced liquidity in both the bond and stock markets. Institutions (specialists, block trading desks) that made profits by using their capital to take the other side of trades, are either non-existent or greatly impaired. The result is a significant decline in capital that directly reduces market liquidity. The bottom line is that prices will both rise and fall to a greater degree than in the past. So when demand is strong, markets will have a "melt-up", and when sellers outnumber buyers then markets will have a "melt-down".

With stocks more than doubling since the market low in March 2009, the impact of these structural changes has generally been quite positive. Our main point is that the effect of these changes will be evident in both directions, and clients need to be prepared for sharp market declines that will be exacerbated by these changes.

A Balanced Portfolio with 50% Fixed Income and 50% Equities

Index Components	% of Total Portfolio	Total Return 1st Half 2013
Fixed Income		
US Treasury 1 month T-Bill	5.00%	0.03%
Barclays US Aggregate Bond Index	40.00%	-2.44%
Barclays Global Aggregate Bond Index Ex US	5.00%	-6.48%
Equities		
S&P 500	33.00%	13.82%
MSCI EAFE Index (foreign developed equities)	7.00%	4.10%
MSCI Emerging Markets Index	3.00%	-10.89%
S&P GSCI Precious Metals Spot	2.00%	-28.42%
S&P/TSX Diversified Mining	3.00%	-33.36%
DJ Composite All Real Estate Investment Trust (REITs)	2.00%	4.89%
Total	**100.00%**	
Year to Date Return Through June 2013		**1.62%**

Data from Morningstar