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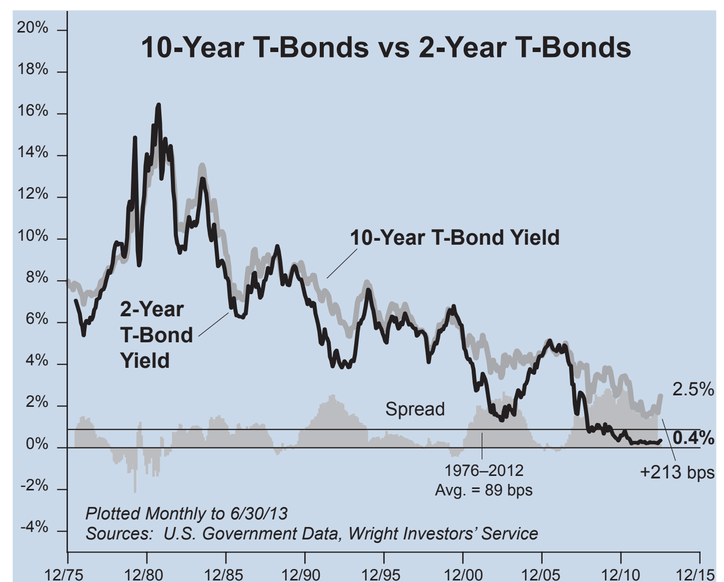
Quarterly Investment Report

July 2013

SUMMARY: ***U.S. stocks had their first losing month in 2013 in June but held onto respectable gains for the second quarter, with both the Dow and S&P returning nearly 3% and NASDAQ gaining 4.5%. U.S. stocks outperformed foreign stocks, particularly those in emerging markets, as China continued to sputter. Bonds did poorly, as concern about the continuance of the Fed's asset-purchase program drove bond yields to their highest levels in two years. While Ben Bernanke indicated that the Fed may soon begin to "moderate" its quantitative easing program and end it by the middle of 2014, that expectation is conditioned on hitting economic growth targets that appear to us ambitious, if not unrealistic. We believe bond investors may have overreacted to Bernanke's comments, but further selling cannot be ruled out.***

U.S. stocks had their first losing month of the year in June but they still managed to record positive returns for the second quarter. For those who believe that the Federal Reserve's quantitative easing program has been the main reason that stocks have performed so well this past year, Fed Chairman Ben Bernanke's warning last month that the Fed may soon "moderate" its bond purchases proved problematic. The Dow Jones Industrial Average and the S&P 500 each fell 1.3% in June but returned 2.9% for the second quarter. NASDAQ lost 1.4% in June but gained 4.5% in the quarter. Gains for the year to date remain strong, with the Dow up more than 15% and the S&P and NASDAQ both up more than 13%. Telecommunications stocks were the best performing sector in the S&P 500 in June, returning nearly 2%; for the second quarter, consumer discretionary and financial stocks had returns of roughly 7%; for the first six months of 2013, health care, discretionary and financials averaged returns of around 20%.



Volatility returned to the markets in the April-June period, with the VIX measure of stock market volatility rising 33% (to 17) and the MOVE index of interest rate volatility shooting up 74% (to 100). June saw the Dow Industrials rise or fall 100 points or more in 16 of 20 trading sessions – eight up, eight down. That is probably the most joint stock/bond volatility since autumn of 2011. The Federal Reserve's tentative schedule for ending quantitative easing came as a jolt to markets that were conditioned for seemingly endless Federal Reserve support. While VIX did stabilize in Q2's final week, interest rate volatility has continued to edge higher in the first week of July.

U.S. stocks outperformed foreign issues, particularly those in emerging markets, during June, the second quarter and so far in 2013. The MSCI Developed World ex U.S. index had losses of 3.7% in June (in U.S. dollars) and 1.6% in Q2. Year to date, the index is up only 3%, compared to the double-digit advances in the U.S. stock market averages. Still, that was better than the MSCI Emerging Markets index, which lost 6.4% in June, 8.1% for Q2, and nearly 10% in 2013's first half. A lot of that loss was due to China, where the Shanghai stock market composite index fell more than 11% in the quarter and Hong Kong's Hang Seng index fell nearly 7%. In addition to a weakening economy, China was rattled in June by a credit crunch brought on by the government in an attempt to cool property speculation.

Global Investment Returns In U.S. Dollars				
	Q2 2013		6 Mos to 6/30/2013	
	Stocks	Agg. Bonds	Stocks	Agg. Bonds
U.S.	**2.6%**	**-2.3%**	**13.3%**	**-2.4%**
Canada	-7.5%	-5.9%	-6.7%	-7.5%
Mexico	-11.2%	-7.5%	-5.8%	-4.2%
Japan	**4.4%**	**-7.0%**	**16.5%**	**-12.4%**
Pacific ex Japan	-10.9%	N/A	-4.7%	N/A
Australia	-13.9%	-8.6%	-6.1%	-8.7%
China	-6.8%	-6.4%	-11.0%	-6.2%
Hong Kong	-4.6%	-3.3%	-1.3%	-2.8%
Europe	**-0.5%**	**0.8%**	**2.2%**	**-1.3%**
France	2.7%	0.0%	3.2%	-2.4%
Germany	2.7%	-0.7%	2.9%	-3.0%
Italy	0.8%	3.0%	-9.0%	0.4%
Netherlands	2.8%	-0.2%	5.3%	-3.5%
Spain	-0.6%	3.0%	-6.2%	3.5%
Switzerland	-0.3%	-1.3%	10.9%	-4.1%
U.K.	-2.2%	-3.3%	0.3%	-8.0%
World	**0.6%**	**-2.8%**	**8.4%**	**-4.8%**
World ex U.S.	-1.6%	-3.1%	3.0%	-6.5%

Sources: MSCI Stock & Barclays Capital Bond Indexes @ 6/30/13.

Economic slowdown in China is one of the main reasons for the sharp drop in commodities prices during the second quarter, particularly in precious metals. Gold prices dropped more than 12% in June and nearly double that for the quarter, closing June 30 at $1234 an ounce, its lowest closing price since August 2010, at one point falling below $1200 an ounce. Silver was even weaker, falling 12.6% in June and 31% in the second quarter; silver has lost more than 35% of its value since the beginning of the year. Oil prices rose 5% in June but were down 1% in Q2.

Bonds did more poorly and experienced increased volatility in the second quarter as yields rose sharply. The Barclays U.S. aggregate total return index fell 1.6% in June and 2.3% in the quarter. Long-term bonds fared worst of all, with maturities of 10 years or more falling 4.4% for the month and 6% for the quarter. The 10-year U.S. Treasury note had a negative return of 4.6% for the quarter, as its yield jumped 63 basis points to 2.48% at the end of June from 1.85% at the beginning of the quarter. (During the first week of July, the yield hit a high of 2.75%, its highest level since August 2011.) The 30-year bond lost 6.5% in Q2, as its yield rose 40 bps in the quarter to 3.50%. Corporate bonds did slightly better, losing 3.3% for the quarter. High-yield bonds fell 2.6% in June and 1.4% for the quarter, although they remain in positive territory for 2013's first half, up 1.4%, in contrast to the Barclays aggregate, which was down 2.4%. The bond market experienced its greatest volatility in almost two years, with the Merrill Lynch MOVE interest rate volatility index ending June at a level two-thirds higher than its December 31 level.

Incoming data on the U.S. economy remains generally on the soft side. The Fed's latest Beige Book, covering late April and most of May, described economic activity as continuing to grow at a "modest to moderate pace," virtually the same description it has used in the past several reports. Following last month's Federal Open Market Committee meeting, the Fed did raise its view of the economy since its previous forecasts. It now sees the unemployment rate falling to between 6.5% and 6.8% next year and to 5.8% to 6.2% by the end of 2015. It also nudged up its GDP projection for next year to 3.0%-3.5% from the 2.9%-3.4% range in its March forecast. But the Fed's forecasts have consistently overshot the economy's actual performance. In July, the International Monetary Fund reduced its estimate of global growth by roughly one-quarter percentage point in 2013 and 2014, citing concerns over the possibility of reduced Federal Reserve policy accommodation as weighing on emerging market economies. Wright Investors believes that, for the time being at least, U.S. economic growth is likely to be closer to 2% than to its 3% long-term trend. In the four years since the end of the worst recession in 75 years, U.S. GDP growth has yet to reach 3% on a year-over-year basis.

The Chicago Fed's national activity index was slightly improved in the latest month, but remained in contraction territory for a third straight month. The Conference Board's index of leading indicators rose 0.1% in May, slightly below the 0.2% Street forecast and more significantly below the 0.4% average monthly increase since the bottom. The leading indicators continue to point to 2% GDP ahead. The Institute for Supply Management's manufacturing index rose to 50.9 in June from 49 in May, just slightly within expansion territory, while the ISM index for non-manufacturing dipped to 52.2 from 53.7. Construction spending rose 0.5% in May, slightly below expectations, while April's 0.4% increase was revised down to a slim 0.1% rise. Overall industrial production was unchanged in May after falling 0.4% in April.

But consumers, who account for 70% of the U.S. economy, continue to do their part to keep the economy expanding. Following April's 0.1% increase, retail sales rose 0.6% in May, the biggest increase in three months. Personal income and consumer spending both came in strong in May. Incomes rose 0.5%, well above the Street forecast of a 0.2% rise, while consumer spending rose 0.3%, essentially reversing the prior month's 0.3% decline, which was the biggest monthly drop since September 2009. The Conference Board's consumer confidence index rose to 81.4 in June, its best level in five years. June auto sales reached a five-year high of 15.9 million.

Market indicators from the critical housing sector, both in terms of business activity and home prices, continued to rise, but that momentum may become more difficult to maintain going forward as interest rates rise, which is certainly a weak point in the Fed's new strategy. At the end of June,

Comparative Bond Returns
Total Investment Return for a Ten-Year Treasury Bond*

If Bond Yields at End of Period Are:	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%	4.0%
Next 12 Months – Annual Rate of Total Return:	15.4%	10.9%	6.6%	2.5%	-1.4%	-5.2%	-8.7%
Next 2 Years – Annual Rate of Total Return:	8.0%	6.1%	4.3%	2.5%	0.8%	-0.9%	-2.6%
Next 3 Years – Annual Rate of Total Return:	5.6%	4.6%	3.5%	2.5%	1.5%	0.5%	-0.5%

*: Estimated returns for a hypothetical 10-year 2.5% Treasury bond due March 2023 under various interest rate scenarios at 6/30/13. Source: *WIS*

Freddie Mac said that the average 30-year fixed-rate mortgage jumped 53 basis points in just one week to 4.46%, its highest level in nearly two years and the largest weekly increase in 25 years. While mortgage rates remain far below the norms of the past 20 years and are probably not yet high enough to scare off potential home buyers, they are bound to reduce home sales some and will certainly discourage refinances, which have accounted for the vast majority of mortgage loan volume the past few years. The National Association of Realtors' pending home sales index jumped 6.7% in May and 12.1% versus a year earlier to 112.3, its highest level since the pre-bubble days of 2006. The NAR said some of the gain may have been due to buyers trying to beat the rise in mortgage rates. New home sales hit an almost five-year high, rising 2.1%, while sales of existing homes jumped more than 4% to an annualized rate of 5.2 million units, the highest figure since November 2009, when a first-time homebuyer tax credit expired. The median price of a home jumped 8.4% during May and more than 15% versus a year ago to $208,000, the highest figure in nearly five years. The widely watched S&P/Case-Shiller 20-city home price composite rose 1.7% in April, bringing its 12-month increase to 12%, the biggest rise since 2006. The National Association of Home Builders' housing market index jumped eight points in June to 52, its biggest monthly increase since 2002 and the first time the index has been above 50, indicating more optimism than pessimism, since before the housing bubble started to deflate in 2006.

Inflation remains low – indeed, well below the Fed's target. PCE inflation, which is the measure the Fed most closely looks at, was 0.1% in May and 1% over the past 12 months, half the Fed's target of 2% and the lowest rate in at least 50 years. If the Fed needs a reason to keep on with its $85 billion a month in bond purchases, today's lower-than-target inflation rate would appear to provide it.

International Outlook

On June 19, Ben Bernanke jolted the stock and bond markets by expressing the view that the Fed may "moderate" and then "continue to reduce" its $85 billion a month quantitative-easing asset-purchase plan. The expectation that the Fed will be finished expanding its balance sheet by the middle of 2014 provoked fears of higher bond yields and contraction in stock price/earnings multiples, but it now looks to us that the financial markets may have overreacted to Bernanke's policy guidance. Senior Fed officials have since tried to assure investors through speeches and public comments to the effect that bond purchases by the Fed – which investors believe have played as important a role as economic fundamentals in boosting stock prices and suppressing bond yields – are likely to continue for some time to come.

Bernanke's expectations about moderation and reduction in Fed bond buying are predicated on the Fed's rather ambitious economic forecasts, which investors should take with the proverbial grain of salt. "If the incoming data are broadly consistent with this forecast, the committee currently anticipates that it would be appropriate to moderate the pace of (bond) purchases later this year," Bernanke said, adding that the Fed will "continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around mid-year." There are a lot of conditions embedded in these estimates, and for the most part the Fed's economic forecasts have overestimated both growth and inflation for some time. William Dudley, president of the New York Federal Reserve Bank, noted that economic growth and employment growth have come in below the Fed's estimates "in recent years"; if that continues to be the case, the Fed's asset purchases "would continue at a higher pace for longer" and that "a rise in short-term rates is very likely to be a long way off." While the Labor Department's report of 195,000 new jobs in June was encouraging, the unemployment rate has remained stuck between 7.5% and 7.7% since February. It is difficult to envision how the jobless rate gets meaningfully below 7% next year at this pace. It is also important to remember that much of the progress in the jobless rate has been the result of a decline in labor force participation, as workers have dropped out of the work force, rather than growth in new jobs. Adding in discouraged workers and persons working part time

Historical and Prospective Returns from Equities and Bonds

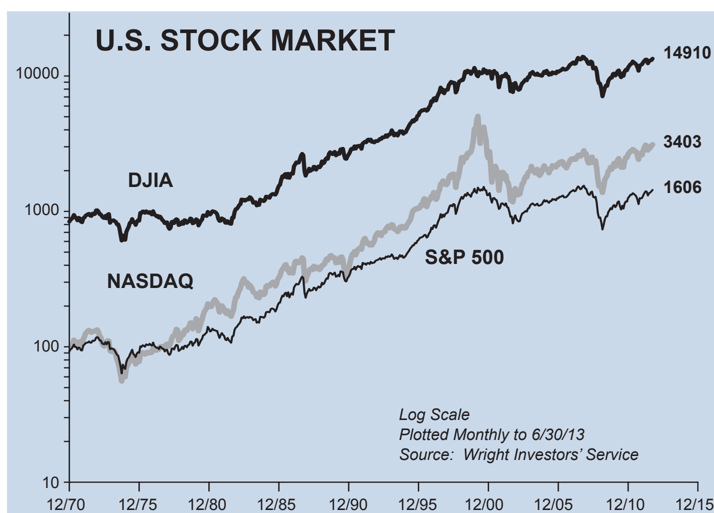
Annual Rates of Return S&P 500 (6/30/13)	1950-2012	1950s	1960s	1970s	1980s	1990s	2000s	2008	2009	2010	2011	2012	2013*	Projection Next 5 Yrs
Dividend Income	3.7%	5.1%	3.3%	4.3%	4.5%	2.5%	1.7%	1.5%	3.0%	2.3%	2.1%	2.2%	1.2%	2.1%
+ Earnings Growth	6.0%	3.9%	5.5%	9.9%	4.4%	7.7%	2.0%	-23.2%	-8.6%	37.7%	14.0%	5.0%	NA	5.5%
+ Change in P/E Ratio	1.0%	10.4%	-1.0%	-8.3%	8.6%	8.0%	-4.7%	-15.3%	32.1%	-24.9%	-14.0%	8.8%	NA	-0.6%
= Total Return	10.7%	19.4%	7.8%	5.9%	17.5%	18.2%	-1.0%	-37.0%	26.5%	15.1%	2.1%	16.0%	13.8%	7.0%
– Agg. Bond Return	6.2%	1.0%	3.0%	6.6%	12.3%	7.7%	6.3%	5.2%	5.9%	6.5%	7.8%	4.2%	-2.4%	3.0%
= Equity Risk Premium	4.5%	18.4%	4.8%	-0.7%	5.2%	10.5%	-7.3%	-42.2%	20.6%	8.6%	-5.7%	11.8%	16.3%	4.0%

Source: Wright Investors' Service; *: Unannualized rates for six months to 6/30/2013.

for economic reasons or otherwise marginally attached to the work force, the true unemployment rate rose to 14.3% in June, its highest rate since February.

While the Fed's asset purchases cannot continue forever, some perspective on the likelihood of QE tapering is in order. Any reduction in the size of Fed purchases is likely to be gradual – over an extended period – rather than abrupt. What's more, there doesn't seem to be any serious near-term prospect of the Fed selling bonds or raising interest rates. What's more, some analysts believe that the effect of the Fed's asset purchases on bond yields over the past several years has been relatively modest and that QE could even have had the effect of raising yields a bit due to expectations of increasing inflation in the longer term. In and of itself, a reduction in the Fed's rate of bond buying below the current $85 billion a month rate should not be expected to push rates higher unless U.S. economic activity is about to break out of its 2% growth mode, a doubtful prospect in our view. Moreover, expectations of any QE tapering may have already pushed bond yields as high as they are going to go, or at least a good part of the way there.

As critical an issue is how to kick the U.S. economy into higher gear, something that QE has clearly been unable to do. As the fifth year of economic recovery gets under way, the "economy has yet to achieve escape velocity," in the words of PIMCO's bond guru, Bill Gross. Jeffrey Lacker, president of the Richmond Federal Reserve Bank, said he expects growth to remain "sluggish" for "a couple more years," and therefore the Fed is "not anywhere near decreasing [its] balance sheet yet." In the event the Fed's forecast is correct and the economic outlook is improving, that surely is not bad for stocks, since it portends higher corporate profits.



The U.S. Economy 2011–2014

		% Change In			End of Period Rates	
		Real GDP*	PCE Core Deflator*	Profits from Operations#	90-Day T-Bills	10-Year T-Bonds
2011	Q1	0.1%	1.3%	19%	0.1%	3.5%
	Q2	2.5%	2.3%	12%	0.0%	3.2%
	Q3	1.3%	1.9%	18%	0.0%	1.9%
	Q4	4.1%	1.3%	9%	0.0%	1.9%
2012	Q1	2.0%	2.2%	9%	0.1%	2.2%
	Q2	1.3%	1.7%	7%	0.1%	1.6%
	Q3	3.1%	1.1%	1%	0.1%	1.6%
	Q4	0.4%	1.0%	7%	0.0%	1.8%
2013	Q1	1.8%	1.3%	4%	0.0%	1.9%
	Q2 e	1.2%	-0.6%	3%	0.0%	2.5%
	Q3 e	2.6%	1.7%	5%	0.1%	2.5%
	Q4 e	2.4%	1.6%	6%	0.2%	2.4%
2014	Q1 e	2.5%	1.6%	6%	0.3%	2.5%
	Q2 e	2.5%	1.7%	8%	0.4%	2.7%
	Q3 e	2.7%	1.7%	6%	0.5%	2.9%
	Q4 e	2.7%	1.7%	4%	0.7%	3.0%

e: WIS estimate @ 6/30/13; *: Annual rates; #: Year-over-year chg. in S&P 500 e.p.s. Sources: U.S. Government data, Wright Investors' Service.

Nevertheless, investors should be cautious about expectations for equity returns over the rest of this year. The Dow Jones Industrial Average has already returned half again as much as it did in all of 2012. Stocks have now risen five years in a row. The recent selloff in the wake of Bernanke's comments amounted to less than 5%, in the case of the S&P 500 (which qualifies as only the barest of corrections) after which it quickly gained back most of those losses. A sharper pullback after such a long run-up would certainly not be unusual, and at this point could be setting up the next buying opportunity for long-term equity investors.

Turmoil in Egypt early in the third quarter should serve to remind us that we live in a time of considerable global uncertainty. The coup in Egypt drove up the price of oil past $100 for the first time in over a year, as it raises questions about the security of the Suez Canal, one of the choke points of the international oil market. In addition, the political crisis in Portugal reminds us that Europe's sovereign debt problems, while quiescent since the Cyprus bailout in March, have yet to be resolved. That's why a diversified portfolio of high-quality assets remains the most prudent course for long-term investors.

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