# HUDSON ADVISOR SERVICES, INC

## OUR VIEW OF THE MARKETS

**By William N. Hudson, Jr. & David D. Burrows Volume 56 July 2013**


Our original market expectations for 2013 were more modest than the gains which occurred. We actually thought the year would be less robust than 2012. Instead, the stock market punched through to new highs in ways that surprised us. But we were skeptical in April and early May. Was this boom too driven by speculators rather than strategic long-term investors?

We got the answer on May 22 when Federal Reserve Chairman Bernanke told a Congressional committee that the Fed would start scaling back its program of bond purchases if the economy continued to strengthen. The comments were benign and obvious. Nonetheless, the market reacted badly and went into a month-long tailspin. Apparently, the boom of previous months was indeed too driven by speculative money not grounded in all the larger realities.

We were not particularly concerned by Mr. Bernanke's comments – or the subsequent market response. In fact, looking longer term, we feel encouraged. The economy needs to stand on its feet without artificial and unsustainable support from the Federal Reserve. This transition is fundamentally necessary – so we have pretty much ignored the negativism shown by some market participants.

At Hudson Advisors, we feel more confident than we have in several years. Despite many uncertainties, the underlying economic and market trends now seem more sustained and predictable. Our investment strategies can grind out return for clients in this environment. We can successfully manage our focus on stocks with higher profit margins and companies with the ability to increase dividends and to reinvest in their own businesses.

## MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the first half of 2013. The equity markets saw their best first-half performance since the technology boom of 1999. Meanwhile, the bond markets took a strongly negative hit from the comments by Mr. Bernanke and the inevitable prospect of higher interest rates.

**Equity Markets:** Stock investors seemed willing to shrug off the fiscal dysfunction in Washington. The outlook for continued albeit slow growth in the U.S. economy spurred investors hungry for return after the starts and stops of recent years. The S&P 500 cruised to an all-time high of 1687 on May 22 prior to the Bernanke comments. Despite the ensuing retreat, the index was still ahead 2.4% for the quarter and 13.82% for the year-to-date. Every sector of the S&P 500 showed gains. The Dow Jones Industrial Average was up 2.3% for the quarter and 15.2% for the half. The Russell 2000 index was ahead 2.9% for the quarter and 13.91% for the half.. The Nasdaq Composite gained 4.9% for the quarter and 9.35% for the half. However, International and emerging markets are flat to negative this year (EEM -13.19% and EFA 2.18% YTD through June 30th).

**Fixed Income Markets:** Our clients know of our stubborn aversion to bonds with longer-term maturities. This viewpoint has often been challenged in recent years as investor fascination with fixed-income investments was contrarian to the viewpoint here at Hudson Advisors. Thus, we take some particular comfort from the events of recent weeks. Following the Bernanke comments, the yield on the 10-year Treasury bond, which moves inversely to prices, quickly spiked from 1.63% to 2.49% at the end of June. It has climbed steadily higher in recent weeks. Investors seem finally to recognize that the inevitability of higher interest rates will hammer bond prices. We believe the trends of recent weeks are not temporary and the long-running bull market for bonds is finally over. As evidence, the Barclays investment-grade corporate-bond index fell 3.3% in the quarter.

## THE OUTLOOK

**The Economy:** The jobs report for June supports our basic optimism. The U.S. economy has now created an average of 200,000 net new jobs for the past six months. Yes, the unemployment rate remains high at 7.7% and the growth of the GDP is still under 2%. But we accept the forecast of the Federal Reserve that the U.S. economy is on a sustained path to stronger conditions. We believe the GDP will surpass 3% growth in 2014 and unemployment might well slip below 7%. These events would trigger the Federal Reserve to ease off its aggressive program of bond purchases – which would be inherently positive and, we believe, not too disruptive to the stock market.

### MAJOR MARKET INDEXES

| | 2 Q Return |
|---|---|
| **Dow Jones Industrials** | 15.20 |
| **S&P 500 Index** | 13.82 |
| **Russell 2000 Index** | 13.91 |
| **NASDAQ Index** | 9.35 |
| **Barclays Aggregate Bond** | -2.44 |

*Total Return Includes Reinvested Dividends.

Our concerns exist more for fiscal policy than for monetary policy. For the moment, the debates over the Federal budget and structural deficit are on pause – making it easier for the market to ignore the fundamental problems. But new issues over the debt ceiling must be addressed in the fall and the noise from Washington will resume. We all will be reminded that that our political leaders have no consensus or plan to confront the excessive levels of federal borrowing. The long-run threat to the economy is deep and profound.

Our other macro concern is the geopolitical instability in the Middle East. Events seem both unpredictable and uncontrollable. The civil war in Syria seems on the verge of becoming a larger regional conflict. The new unrest in Egypt demonstrates the basic social and political volatility in much of the Arab world. The threat to Israeli security is obvious. The correct foreign policy and military response by the U.S. is not so obvious. Widespread turmoil in the Middle East could derail the still fragile recovery of the global economy.

**The Market:** Despite these macro worries, the outlook for the remainder of 2013 is constructive. To use the popular phrase, we believe the Federal Reserve will "taper" its monetary policies at an intelligent and tempered pace. Interest rates will gradually rise, but not enough to stall economic growth and they will remain low by historic standards. Most U.S. corporations will retain their healthy balance sheets and cash positions. As the economy gets back on course, corporate earnings should increase, which means that equity prices are more likely to appreciate than to decline. The S&P currently trades at about 15 times earnings – which is an attractive valuation – and should help to maintain investor interest.

We do not expect the second half of 2013 to be as strong as the first half. But we fully expect that major indexes could grow another 3% to 5% before the end of the year.

## OUR STRATEGIES

**Asset Allocation:** For clients investing new money, we recommend 65% allocation to equities and the remaining portion to cash, bonds with maturities under two years, and alternative investments

**Preferred Equities**: For the equity component, we like the current sectors:

INDUSTRIALS: Driven by demand from business investment, certain areas such as transportation and office supplies should perform well in the years ahead.

TECHNOLOGY: The same trend should benefit technology as companies seek to maintain and upgrade their infrastructure and technology.

FINANCIALS: Financial companies have favorable P/E ratios right now and should benefit from a steeper yield curve as interest rates rise. This trend will especially assist regional banks and insurance companies.

CONSUMER DISCRETIONARY: These stocks have shown solid earnings growth and are predominantly exposed to the U.S. – where conditions are now more favorable than other major economies.

HEALTH CARE: The momentum is this sector is good and pharmaceuticals have particular appeal from an improving pipeline of new drugs.

**Other Investments:** For diversity, we will invest directly in bonds with maturities less than two years. We have also been pleased with our participation in investment programs composed of municipal tax liens. These investments have no credit risk and no interest rate risk. We have seen cash yields in excess of 4% and internal returns over 7%. We will look to continue this form of alternative investment.

**Dow Jones U.S. Sectors**
**(Percent Change for YTD, Ending June 30, 2013)**

| | | | |
|---|---|---|---|
| **Oil & Gas** | **10.36** | **Consumer Services** | **18.76** |
| **Basic Materials** | **-2.01** | **Telecommunications** | **10.49** |
| **Industrials** | **14.09** | **Utilities** | **11.56** |
| **Consumer Goods** | **16.82** | **Financials** | **18.46** |
| **Health Care** | **20.86** | **Technology** | **4.87** |


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