HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

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We started off the year saying the stock market had gotten ahead of itself in 2013. That opinion was validated by the flat performance of the market in the first quarter. Ironically – while we enjoy the benefit – the rebound in the second quarter causes us to repeat the concerns expressed in January.

We are fundamentally bullish. The economy continues its slow recovery. The Federal Reserve is measured in its actions. Most important, stocks look attractive because there are not good alternatives. Money market instruments do not pay anything and bond yields are too low.

However, we are not complacent. We sense that many investors are jittery. This bull market is in its sixth year. At some point, there will be a correction. We do not know what particular events may set off that correction. It might be geo-political turbulences – in the Ukraine or the Middle East. It might be unpredictable consequences from the November elections. It might be an unexpected announcement or policy change from the Federal Reserve. It might be worse than forecast corporate earnings. But we do expect the market to correct itself – defined as a 10% decline – sometime in 2014 or early 2015.

That prediction is not cause for panic. The market will correct itself, and then resume its growth trend. There is plenty of sidelined cash waiting for the reinvestment opportunity of lower prices. The challenge for us at Hudson Advisors is to manage through this market cycle. Our strategy is to be both proactive and defensive at the same time. We think our asset allocation and stock picking strategies will serve our clients' long-term interests.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the first half of 2014. The stock market showed new momentum not evident in the first quarter. .Meanwhile, the bond market continued the unexpected gains after its losses in 2013.

Equity Markets: The equity market seemed driven by the craving for investors to have some place to find positive returns. After a slight decline in the first quarter, the Dow Jones Industrial Average gained 3.41% in the second quarter and was ahead 3.33% for the year on June 30. The index rose further in the early days of July and broke past the 17,000 mark. The S&P 500 Index rose 5.23% in the quarter and was ahead 7.14% for the year. The Russell 2000 index gained 2.05% for the quarter and was up 3.19% for the year. The Nasdaq Composite was the best second quarter performer – with a 5.31% gain for the quarter and 6.18% boost for the year.

Fixed Income Market: After its declines in 2013, the bond market benefitted from some of the trepidations about stocks. The yield on the U.S. Treasury 10-year note, which moves inversely to price, fell to 2.51% from 2.76% at the end of the first quarter. Corporate bonds extended their gains with the Barclays U.S. Aggregate Index gaining 1.35% during the quarter.

MAJOR MARKET INDEXES

	2Q Total Return	YTD Total Return
Dow Jones Industrials	3.41	3.33
S&P 500 Index	5.23	7.14
Russell 2000 Index	2.05	3.19
NASDAQ Index	5.31	6.18
EAFE Index	2.95	2.95
Barclays Aggregate Bond Index	1.35	2.71

*Total Return Includes Reinvested Dividends.

THE OUTLOOK

The Economy: The trends in the U.S. economy do provide support for the growth in stock prices. Yes, the economy did surprise with an actual shrinkage of 2.9% in the first quarter. But that decline appears to be an aberration. The most encouraging sign is job growth. In the last six months, employers added a monthly average of 231,000 new jobs. The number was an impressive 288,000 in June – knocking the unemployment rate down to 6.1%.

The consensus forecast is for GDP in the remainder of 2014 to increase at an annualized rate of 2.5%. This increase is spurred by recovery in the housing market and relatively healthy corporate earnings.

But problems linger in the economy. Job growth is occurring in relatively low-paying service jobs. Despite the declining unemployment rate, labor force participation is only 62.8% -- the lowest in 36 years. This underlying weakness in the labor market dampens consumer confidence and the trends in consumer spending are quite uneven. The 2.5% increase in GDP is basically flat to the 2.4% pace averaged since mid-2009. Most economists accept that it is the Federal Reserve policy of keeping interests at virtually zero which is main impetus for economic growth.

The Market: This economic backdrop explains some of the wariness among stock investors. Fortunately, the Federal Reserve seems intent to keep interest rates at their current level until the second half of 2015. Should that policy change – and were the Fed to act sooner on the inevitable actions to tighten money supply --the market would be jolted, setting off the correction we discussed.

There is considerable debate about whether stock prices are too high. The stock market value of companies in the S&P 500 is 16.5 times the 2014 profits that analysts expect for those firms. That ratio is not particularly high by historic standards. But there are few bargains left. The cheap stocks belong to troubled companies. All the other stocks are considered rich or fully valued. The sluggishness in the economy, and the potential for any weakness in corporate earnings, does not allow much room for stocks to move markedly higher.

We expect the market to muddle along for remainder of 2014. There is good prospect for the market to hold its current gains – end even to edge slightly higher. But we retain the caution that some kind of unexpected bad news whether international, political or economic – could trigger a correction in the 64 month run-up in stock prices.

OUR STRATEGIES

Asset Allocation: For clients investing new money, we recommend 55% allocation to equities and the remaining portion to cash, bonds with maturities under two years, and alternative investments. We suggest fully invested clients to trim equities to 55-65% depending upon time horizon and objectives.

Preferred Equities: We remain focused on large cap companies with strong balance sheets, sustainable cash flows, and credible business models. Companies that pay attractive dividends are central to our strategy. Some of the sectors we are like at the moment are:

- FINANCIALS: The stocks of insurance companies and some regional banks have attractive value.
- TECHNOLOGY: The Nasdaq Composite has performed well and some technology companies have room for further growth.
- ENERGY: We like the potential of companies with activity in the domestic production of natural gas and shale oil.
- HEALTH CARE: Some parts of health care such as waste disposal are attractive.
- INTERNATIONAL: Emerging market stocks have been underperformer in recent years – but we anticipate them to rebound in the period ahead.

Fixed Income: At some point, interest rates will rise and inflation will resume. The risk to holders of longer maturities is substantial. Our viewpoint on this issue is well-known to our clients and it is another area where we stick to our story. Instead, for the non-equity portion of client portfolios, we utilize cash, short bond instruments, and alternative investments like municipal tax lien programs.

Dow Jones U.S. Sectors (Percent Change for YTD, Ending June 30, 2014)			
Oil & Gas	**13.67**	**Consumer Services**	**2.11**
Basic Materials	**8.38**	**Telecommunications**	**2.46**
Industrials	**3.33**	**Utilities**	**18.29**
Consumer Goods	**5.01**	**Financials**	**4.65**
Health Care	**10.89**	**Technology**	**10.42**

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