

## MVCM Quarterly Newsletter

### Second Quarter Ended June 30, 2013

#### **Second Quarter Review: Credits, Currencies and Commodities**

The second quarter of 2013 saw a 5.7% price correction in the S&P 500, but that was a sideshow compared to the main event. A dramatic surge in credit yields started in early May and peaked as the calendar was transitioning to the third quarter. The 10-year Treasury yield spiked up 69% from just above 1.6% to 2.75% over a six week period before pulling back a bit and stabilizing, at least for the moment, in a range on either side of 2.6%.

Meanwhile, as rates turned upwards so did the trajectory of the US dollar against the currencies of trading partners in developed and emerging markets alike. Non-US stocks suffered as a result, which is to be expected. Somewhat less conventional was the trajectory of gold, which led a general downturn in commodities. In past rising rate environments real assets like gold, energy and industrial metals have been preferred investor destinations. Not so this time.

The net effect of all this activity was that, despite the May-June pullback, US equities were once again the best performers on the world asset stage and investors largely did not benefit from exposures in these other mainstays of prudently diversified portfolios. US large caps and small caps alike finished the first half of the year with double digit gains. Interestingly, the pullback came as the market was undergoing a sector rotation out of defensive plays like utilities and consumer staples into more cyclical stocks. As a result the names that normally hold up better in a down market wound up losing more – perhaps an appropriate reflection of a market where traditional signals and patterns wound up on their heads

#### **Third Quarter Outlook: Eye on Rates; US Corporate Earnings**

We expect there to be continued volatility in rates as investors and traders parse the tea leaves of Fed meeting minutes. We also believe that the overall directional trend will likely be biased towards the upside. The policy objectives of quantitative easing have been focused on the borrower – making the cost of capital cheaper to encourage economic growth and job creation. While understandable, this has distorted the normal workings of credit markets, which are supposed to reflect the price of money at which borrowers and savers alike are in equilibrium. Real yields have been negative for much of this time, which history shows is not a sustainable condition for functioning credit markets.

While it is still not clear exactly when the Fed plans to start easing off the money pumps – and recent comments by Bernanke are of a decidedly more dovish bent than they were a couple weeks ago – it is reasonable to expect that as investors price in various “return to normal” scenarios rates will continue to rise. If this happens in a gradual, orderly fashion the damage should be more or less contained. The big concern is that a faster upward glide path may stimulate the pace of net outflows from bond funds, causing fund managers to liquidate more positions and engender a vicious cycle of selling. The fundamentals don’t argue for a rapid return to 4% rates – inflation remains contained and economic capacity is far from overheated. But fund outflows are a metric where we will keep our attention focused.

On the equities side the earnings season currently getting under way is particularly noteworthy. US corporations have steadily delivered on earnings per share and net margin performance, but in recent quarters top line sales growth has started to ebb. The top line faces a couple headwinds: the dollar’s gains make US exports a tougher sell, negative growth in Europe and a slowing of the Asian growth machine reduce companies’ non-US demand forecasts, and in particular economic and financial concerns in China have a potential major impact on many US global leaders.

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With this in mind analysts will be paying close attention to earnings guidance to gauge if the recent strength in the bottom line can hold up if the top line continues to sag. We believe the US equity story remains strong, particularly relative to the less impressive fundamentals in other asset classes. How much more we can expect from the current rally, though, will depend in no small part on what comes out of the announcements and guidance in the coming weeks.

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