

Global markets were expecting the Federal Reserve Bank to signal that it would start to reduce its monthly purchases of treasury bonds in September when the unemployment rate is likely to reach 7% and exit its quantitative easing (QE) in June 2014. The surprisingly clear guidelines and parameters for the economy and the labor market signaled a stronger than expected reversal in the Fed's policy, and thus triggered a sharp un-orderly adjustment in the bond and equity markets. The markets overcorrected which led to unwanted higher interest rates not only in the U.S. but also in global markets and which may make it more challenging for the Fed to achieve their goals of a stronger economy and QE exit next June. The 10-year Treasury corrected from 1.96% on 05/20 to 2.60% on 06/25. From May 22 to June 24, the S&P corrected by 5.8% and investment grade corporate bonds by 5.6%. Global economic outlook has improved but economies are still very fragile. Although financial markets have stabilized Europe remains in an extended recession, the economic outcome of the unprecedented monetary measures by the Bank of Japan is in question, and slower growth in emerging markets, in particular in China and its interbank liquidity crunch, have been fueling market anxiety and volatility in June. Since the financial crises when all countries were on an equal footing and policy responses were largely the same the world has become increasingly interconnected today as different regions are at different points of their business cycle and as such different diverging policies such as extreme monetary measures have the potential to create frictions especially in the currency markets. In the U.S. the economy is increasingly self sustaining. The recovery in the mortgage market and the banking system is well advanced and the low interest rate environment did not primarily lead to an increase in consumption but rather to a strengthening of balance sheets of corporations and private households. However, in an environment of weak commodity prices, slower global growth, continued high unemployment, spare capacity and the likely delayed effects of the government spending cuts (sequestration) on the economy U.S. core inflation is likely to remain at a sustainable 1% -1.5% below the Fed's target level of 2%. Inflation outlook will determine a friendly or unfriendly exit of the Fed's easy monetary policy in our opinion. We expect, however, inflation to remain subdued as the U.S. economy is likely to remain in a modest upward trend of 2.5% this year and gain momentum to 3% to 3.5% in 2014.

#### Dress rehearsal for the end of QE and its effects on the bond market

The Fed has a delicate balancing act over the next few months to guide the market as to the timing of reducing its asset purchase program, as that will lead to higher interest rates and lower risk asset prices, and to convince the market that it will continue its easy money policy (0% short-term rates) until it's targets are reached in order to try to slow the rate of increase in interest rates and reduce the severity of the sell-off in the markets. If interest rates rise too much too quickly, it could impair the nascent housing recovery or trim consumption both of which have helped the economy rebound. Furthermore, the Fed's policy has forced investors to take increasing risks for lower yields and more volatile returns. The risks are that asset prices, the misallocation of capital and a decreasing reward of the risks investors and corporations take, are being distorted. From a technical perspective, the Fed may also be forced to taper its purchases to match the shrinking U.S. budget deficit. It can, therefore, be expected that some tapering will start in fall. Market reactions and worries about higher interest rates are, however, misplaced in our opinion, as the economy can comfortably absorb rates as high as 3.50% which is the historic yield of 10-year Treasuries, 245 basis points over a rolling three-month average of the core inflation rate, which was 1% in June. As leverage remains high we believe the world is moving towards more stability at lower corporate and economic growth rates and thus interest rate increases are likely to be limited.

#### Economy not strong but trending upward

1Q GDP was revised from 2.4% to 1.8% mainly due to consumer weakness as the payroll tax cut, stagnant wage growth and a slow the labor market im-

provement are muting consumption. Investment spending was down almost 8% as corporations react to slower consumer spending, payroll taxes and government spending cuts (sequester). Car and truck sales, however, maintained their strong sales pace in Q2, with Ford Motor Co. posting a 13% increase in vehicles sold and Chrysler Group LLC improving by 8.2% in June. Sales at homebuilding dealers advanced reflecting the improving home construction sector. Nonetheless challenges such as weak wage gains and tax increases remain for the consumer. The auto industry has been a bright spot for the otherwise struggling U.S. manufacturers. The overall sector contracted in May (Institute for Supply Management) and factories have cut jobs for the fourth month in a row.

#### Housing market

Mortgage rates increased from 3.70% to 4.30% in June as a result of the recent market correction. However, the recent increase in mortgage rates will not meaningfully impact the fundamental recovery in demand because affordability remains high relative to history. A 100 basis points increase in mortgage rates would cause affordability to decline approximately 10% which is well above the average between 1971 and 2003. Mortgage refinance origination volume is expected to decrease 22% in 2013 and another 55% in 2014 as rates increase and the industry shifts to a more home purchase-dominated market.

#### Corporate America

2Q earnings are not likely to be encouraging enough to resolve uncertainty. Lack of sales growth from continued weakness in manufacturing, business spending and trade will be compensated by share buybacks and higher margins to drive EPS growth. Although the housing and job market are in an uptrend, China is key to U.S. manufacturing and better EPS growth in the second half of 2013. Export growth also remains very slow. 40% of S&P EPS is earned outside the U.S. 25% in developed markets and 15% in emerging markets. China is 5% of S&P EPS directly, but much more indirectly given its influence on commodity prices and global capital expenditures. U.S. energy, agriculture and capital goods are highly dependent on healthy China growth and increasing consumption oriented commodity prices. In the last decade, China contributed 20% of world GDP growth.

#### Outlook

If gold is an indicator of inflation trend inflation is not likely to be a factor any time soon. Gold returned 12.5% since 2000 five times as much as inflation which was 2.5% on average during this period. With no yield and at the current hefty premium to its fundamental value gold is likely to continue to trade lower. Equities are therefore a much more attractive hedge alternative to higher inflation at some point in the distant future. Equities are fairly valued at this point. Investors have moved from higher credits to lower credits in the bond market before they moved to equities in search of yields which explains why high dividend yielding stocks especially in defensive sectors such as utilities, consumer staples, energy and real estate have outperformed in Q1. As yields in the bond market are becoming more attractive again it is likely that bond investors will return to the bond market. As technical indicators influence the market in short term it is challenging to determine the bottom of the bond market at this point and we, therefore, recommend to keep duration relatively short, remain broadly diversified and dollar-cost-average into high coupon investment grade corporate bonds in industry sectors that are less interest rate sensitive. With regards to equities we continue to favor investments in attractively yielding MLPs, REITs, and sound companies in the healthcare, energy, utilities and industrials sectors.

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