ROOF ADVISORY GROUP, INC.®
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

INVESTMENT INSIGHT

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2nd Quarter Review: Recent Bernanke Comments Overshadow Mostly Strong Quarter

The market once again made an all-time high in the second quarter, with the S&P 500 reaching its highest intraday value ever in late May. However, most of the second quarter gains were undone as June progressed due to remarks by the Federal Reserve Chairman Ben Bernanke that triggered the first significant downturn in 2013. Speaking on the Fed's strategy for reducing its planned purchases of Treasury and mortgage-backed debt, Bernanke indicated that the Fed could begin tapering their purchase before year end and discontinue them entirely in 2014. The comments induced a market selloff in the following days, where all major indices fell more than 5% from their highs prior to Bernanke's comments. While the market viewed the Chairman's comments as 'hawkish' in nature, he made it clear this was not a definitive change in the Fed's current policy and that tapering would begin only if economic data deemed it appropriate. In our view, much of June's equity market selloff was an overreaction to the Fed's inevitable move to lessen stimulative policy tactics as the economy continues to improve.

While equity markets reacted to Bernanke's remarks in June, the fixed income markets had begun their valuation slide a month earlier. The benchmark yield on the 10 year US Treasury moved from its low of 1.61% to a high of 2.61% in less than a two month period. This significant increase in yields led to deterioration in bond prices during May and June.

This fixed income selloff is likely also an overreaction because one of the main factors that would increase interest rates is higher inflation expectations. However, there is no indication in recent economic data that rapid inflation is a threat near term. While Roof Advisory Group had lengthened fixed income duration in the middle of 2012, the overall duration of client portfolios has remained well below historical norms. Maintaining a relatively short duration reduces the negative impact on client portfolio valuations in a rising interest rate environment. The lack of inflationary data and continued asset purchases by the Fed lead us to suspect the 10 year US Treasury yield will normalize around 2.50% for the next six to twelve months and halt the current decline in fixed income valuations.

The most notable change for actively managed clients since the last *Investment Insight* was an increase in equity exposure to the maximum equity position for all investment policies earlier in May. Appreciation in portfolio assets and the continued attractiveness of equity yields and valuations relative to the fixed income market prompted the decision to formally progress to maximum equity exposure. Actively managed accounts have also seen an increase in the cash position during June due to a re-characterization of fixed income where the longest duration bond funds were sold in favor of shorter fixed income assets. The sale proceeds will be rolled into two primary fixed income asset classes—a short duration bond fund and a convertible securities fund. Convertible securities have proven beneficial in the current market, as they exhibit the appreciation potential of equities while providing the security and income of a short duration bond fund.

In 2011 and 2012, the summer months had been consistently volatile. The stage is set once again in 2013 for a similar summer of market volatility. The result in the last two summers has been relatively horizontal market movement and this year appears poised for a potential repeat. In the near term, our current bias is to remain at maximum equity exposure and take advantage of the attractive equity yields and valuations relative to those offered in cash and fixed income. Barring a major geopolitical development on the world stage or a sudden shift in policy from the Federal Reserve, equities continue to remain the asset class with the best relative value.