New Albany
Investment Management

July 4, 2013

Market Insight: Volatility is Back!
2nd Quarter Summary and a Look Ahead

2nd Quarter Review: It was a tough quarter for the markets, especially for Asian Equities, Global Bonds, and Precious Metals. Less accommodating monetary policies announced by the Chinese and US Central Banks sent shockwaves across all markets, causing investors to pause and consider what the world will be like without easy money.

The Asian Equity market sell off was led by fears of slowing growth in China which has become dependent on 'phantom' infrastructure projects and increasing personal debt. At the same time inflation is rising, prompting their Central bank to impose tighter lending standards. Fears of a potential credit bubble are causing investors to leave in droves. China's downdraft, spilled over to all its trading partners across Asia (excluding Japan). For the quarter, Asian Indices fell: China Shanghai: -12%, Hong Kong: -7.2%, Southeast Asia: -7%, Australia: -3%.

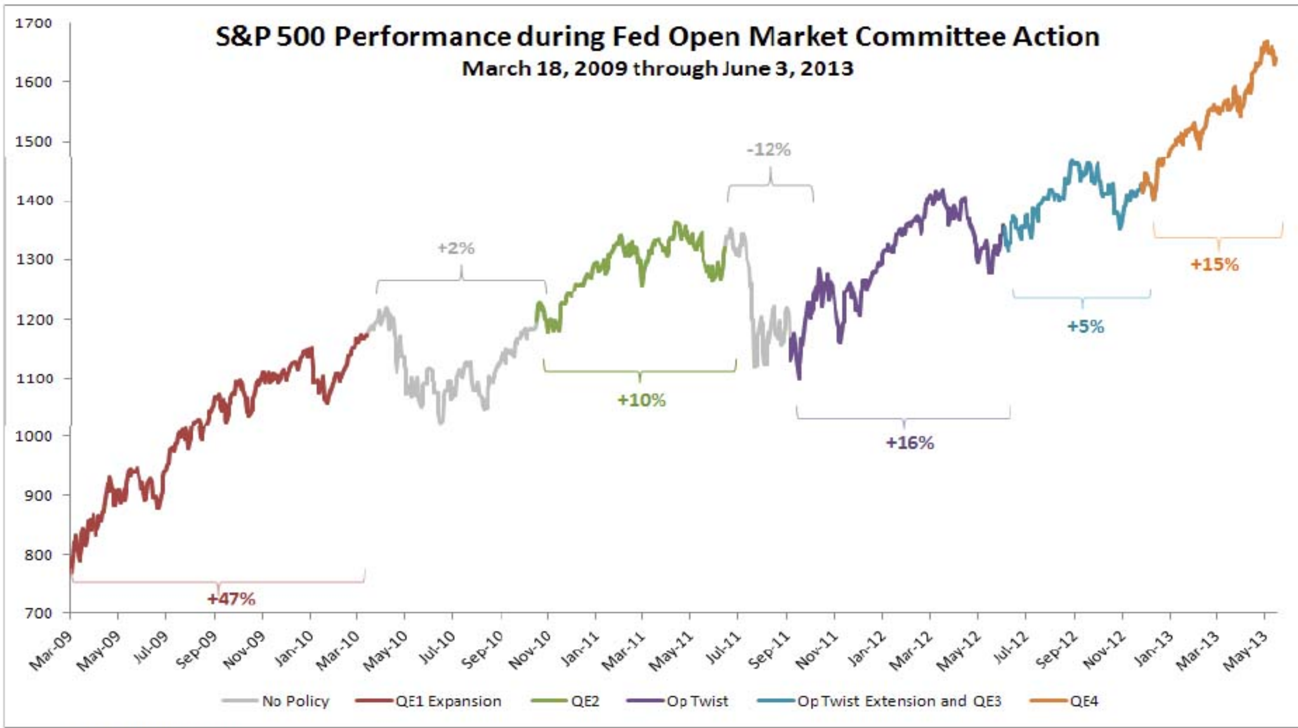
Global interest rates were already rising in the longer maturities even before the surprise announcement by the Federal Reserve to end quantitative easing. But now that the Fed's time table for tapering and raising rates is known, rates across the yield curve rose dramatically, pushing all bond prices down. US 5yr Treasury rates more than doubled from 0.65% to 1.4%, and the longer term, US 10yr rate climbed over 90bpts to 2.6% in one month. This rise in rates affected Global bond prices for the quarter, where prices fell between -1% to -6.5% depending on the sector and maturity. **Now, for the first time in over a decade, year-to-date investment returns are negative in all bond sectors** (except High Yield) **and all maturities.**

Precious Metals prices, particularly Gold, fell hard as the argument for holding precious metals as an inflationary hedge is, at least for now, no longer supported by Central Banks. Gold hit a 3yr low, at just under 1200, down 35% from all time high. For the quarter: Gold: -25%, Silver: -33% , Platinum: -17%, Copper: -25% .

US Equities were the best global performers for the quarter, but not across the board. Performance was spotty, and sector dependent with the best performance from those sectors where earnings are more domestically driven and less dependent on global growth. For the quarter US Indices: Large Cap Growth: +1.3% and Value: 3.5%; Mid Cap Growth: +2% and Value: +4.3%, Small Cap Growth: 3.8% and Value: 0.1%.

A look Ahead: Increase Volatility. Transitioning to a market driven more by traditional fundamentals and less by Central Bank support will be a bumpy and challenging road to navigate. Volatility among the risk asset classes is likely to persist as we move toward Fed tapering of bond purchases. Just the perception of the Fed removing its support has already caused rates to rise, and a 6% correction in equity prices.

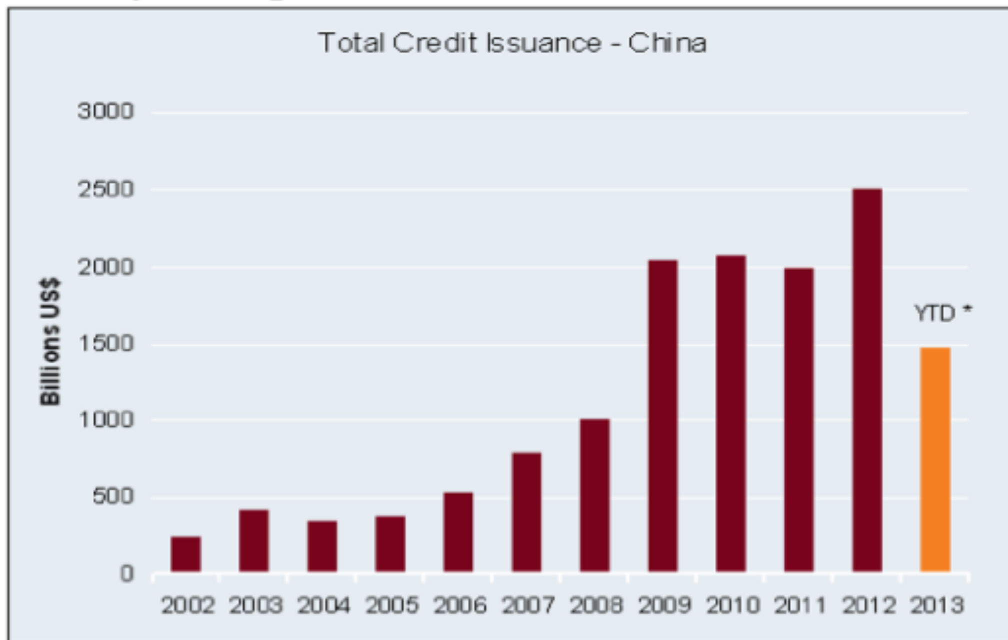
The chart below shows the performance of the S&P500 since 2009 and shows that during periods when Fed increased its stimulus program through QE, the market rose (colored line). In periods where there was no QE, prices fell (gray line).



QE = Quantitative Easing programs.
Source: Bloomberg, DoubleLine Capital
Please see Appendix for S&P 500 definition. You cannot invest directly in an index.

Adding more uncertainty to the global markets is concern over China's private sector credit bubble and how their Central Bank will curtail credit expansion without disrupting the markets. China's debt-to-equity ratio is now at 198% of GDP, and at a level, which in other countries has preceded a major financial crisis. And, with China's economy the second largest in the world, its influence on both global growth and financial market volatility cannot be ignored.

China's rapid credit growth a risk



Source: Bloomberg. * Year-to-date data as of May 31, 2013

Investment Strategy: Given the changing investment landscape where greater volatility is expected, risk positions have been reduced slightly and asset sectors have been re-allocated. Specifically, exposure to global infrastructure was sold and replaced with stocks whose earnings are more domestically generated. At the same time, with the Fed's tapering of bond purchases to begin sometime this fall, the bond market is no longer on sure footing. Thus, exposure to bonds has been reduced and cash has increased.

Please contact me with any questions or concerns.

As we celebrate our Country's birthday, may we all give thanks for God's blessing and the many, many, men and woman who have served to preserve our freedom!

Kind Regards,
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