QUARTERLY REVIEW AND OUTLOOK

From a historical perspective, 2013 will likely be remembered as a very pivotal period in global economics. While the Federal Reserve implemented new and untested financial stimulus programs ('tools') a few years ago, many of these same programs are now being implemented by other global central banks. The world's financial system is functioning on "monetary theory" with the final consequences yet to be determined. Within this context, there are some very clear themes that we can draw from past experience.

First, in the U.S., it is quite likely that 2013 will mark the end of a 30-year bull market for fixed income securities. Irrespective of the continued stimulus activity from the FED, when the net return (after tax and inflation) of the 10-year treasury is negative, an inflection point has been reached.

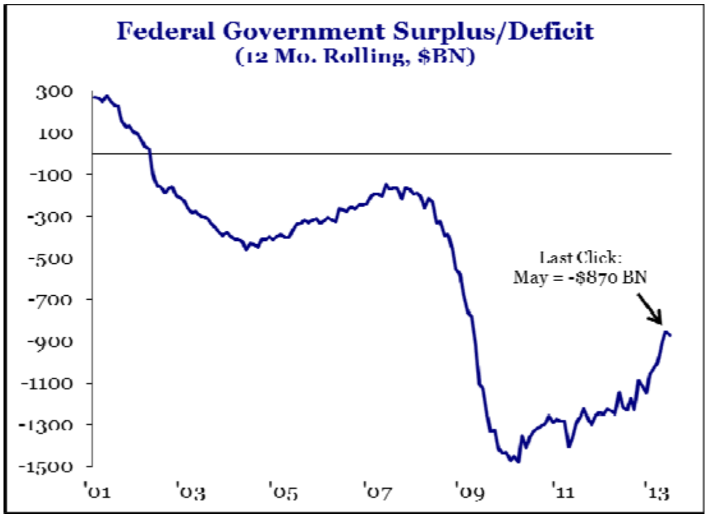
Secondly, given the recent comments by the ECB (European Central Bank) to financially support all countries within the European Union "at all costs", we would expect this economic region to stabilize and show modest signs of recovery through the end of the year. While it may take many years for the EU to return to a vibrant economic powerhouse, a stabilization will carry positive implications for asset prices.

Lastly, economic activity in Japan and China will continue to dominate the Asian markets. After a 20-year malaise, Japan has aggressively adopted a stimulus program ("Abenomics") which has improved consumption and reflated assets prices. Unfortunately, at the same time, China has attempted to transition from an export driven economy to one relying on more internal consumption. While Asian economies continue to offer the best growth prospects, there will likely be many "fits and starts" along the way.

Therefore, with the world awash in liquidity and barring any unforeseen geopolitical event, we would expect the global economies to be moving with an upward bias for the remainder of the year and into 2014.

In looking at the U.S. specifically, the economic picture has clearly improved. Although the unemployment rate remains stubbornly high, it is slowly improving. More importantly, housing and auto sales are now leading our economic recovery and the stock market has reached an all-time high. Adding to this momentum is the improving trends in our federal deficit.

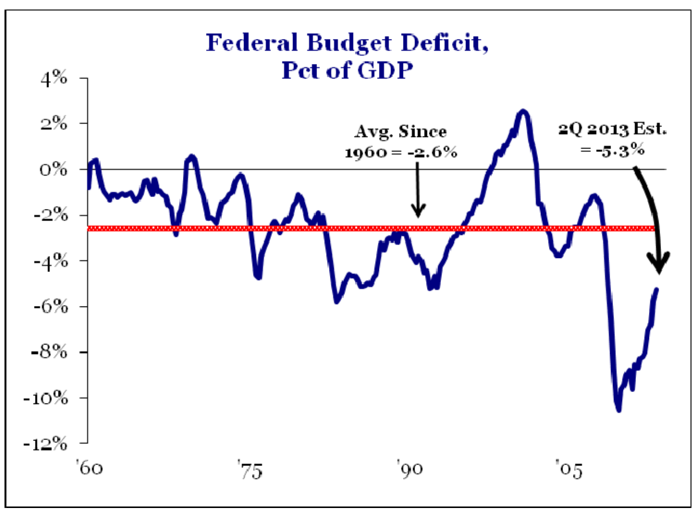
Chart I:



Source: Strategas

As the above chart indicates (Chart I), our budget deficit has almost been cut in half since it hit a trough of $1.5 trillion in 2010. Although growth in GDP has been anemic through the first 6-months of the year, it is widely anticipated to accelerate in the 2nd half and into 2014. Should this occur, in combination with a decline in government spending and increasing tax revenues (Chart II), we would expect the federal deficit to continue to improve.

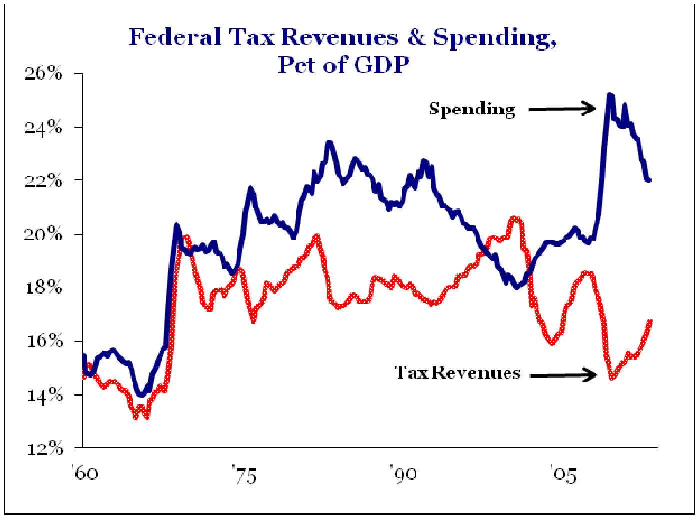
Chart II:



Source: Strategas

As we pointed out in our last quarterly piece, the sequestration program as implemented, while not well thought out, is having an impact on our country's financial picture. The initial negative impact of lower government spending and higher taxes will have run its' course as we enter 2014. Hence, the initial drag to GDP should be alleviated as we move into the new year (Chart III).

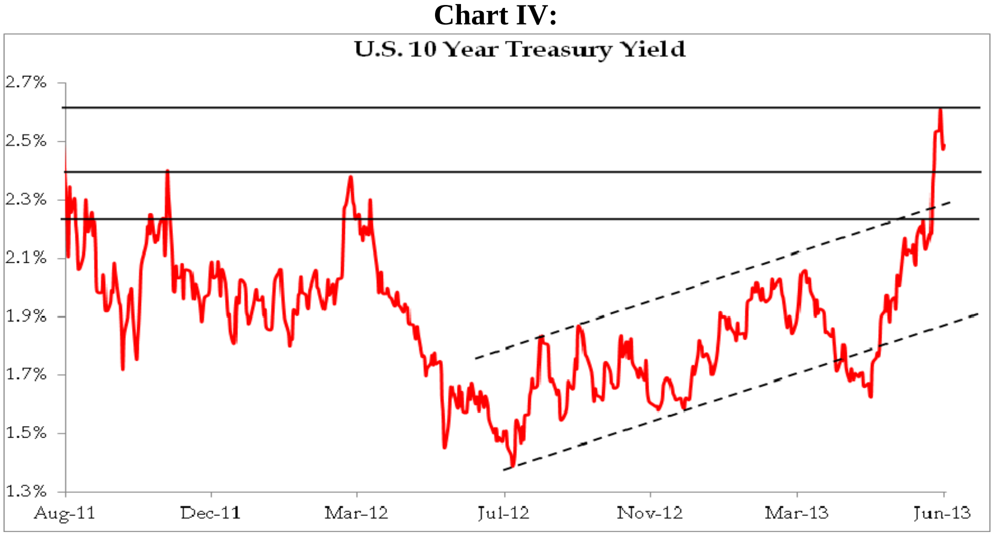
Chart III:



Source: Strategas

We would be reticent not to briefly mention what has transpired in the treasury market over the past month. Given the expectations for better economic growth and comments from the FED relating to a possible tapering of the bond purchase program, the longer-dated treasury maturities sustained a rapid decline in value as yields increased. We highlight the move in the 10-year treasury below (Chart IV).

Chart IV:



Source: Strategas

We've gone from overbought to oversold in less than 60 days. Along the way, we've watched previously firm ceilings taken out at 2.1% and 2.4%, with the new level seemingly now at about 2.7%.

Comments from the FED and sentiment caused a negative shift in the yield on the 10-year from 1.70% to 2.70%; a very unusual and historically large increase in such a short time span. This reflects the fact that interest rates have been held down in part by central bank activity for quite some time. We believe it may take a few years before normal supply/demand factors to finally impact real interest rates. We would also expect this type of move will eventually occur in other countries given the aforementioned implementation of similar policies. In any case, we now expect rates to creep higher over the coming years and may accelerate given any upside to economic activity.

Fixed Income and Equity Market Outlook

The fixed income and by extension, the U.S. equity markets are at a secular inflection point. Federal Reserve quantitative efforts will probably come to a close sometime in 2014; the timing will reflect the overall strength in the economy and the rate of employment growth. However, we believe that the Fed may well lose the ability to control short to intermediate term interest rates as the bottoming process begins to reverse. This should lead to volatile performance in the fixed income and equity markets periodically. Nevertheless, baring a sharp jump in Treasury bond yields above current levels, the equity markets are in a fair value range. As global economic growth begins to improve, valuations should begin to improve from the current level of 15-16 times projected 12 month earnings. We also expect fairly constant downward pressure on bond prices, particularly in maturities in the 10-30 year range.

Our orientation has been to focus on short to intermediate-term fixed income (1-10 years) securities while investing in equities with strong yields. To some degree, our exposure in yield-sensitive equities such as Verizon, Starwood Properties and Philip Morris, among others, is likely to be hurt by investors abandoning yield sensitive stocks and moving to cyclicals in anticipation of any acceleration in economic growth. However, we believe that the recent surge in 10 year Treasury bond yields to 2.7% from 1.7% has run its course. Thus we doubt that interest rates will move substantially higher this year. Our equities that have strong yields all possess strong earnings growth as well. While valuations may be stretched near term on some of these stocks, we remain focused on long term (lower risk) growth in our equity portfolio. We have also begun to raise cash to take advantage of any meaningful pullbacks in the equity market.

As mentioned in the last quarterly review, we have increased our exposure to companies that are excellent managers of real assets (Brookfield Infrastructure Partners) and that will benefit from the global recovery in commercial real estate (C.B. Richard Ellis). Both of these companies should benefit from the global cyclical economic recovery we expect in 2014 forward.

While the markets in both fixed income and equities may be more volatile than in the recent past, we remain constructive on any pullbacks. As always, we remain focused on long term core preservation of capital.

Should you have any questions about our strategy or any portfolio positions, please call us at your convenience.

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