June 2013

2013 HALF-TIME UPDATE

This year has literally defied expectations in several important asset classes – it has become a tale of two outcomes, US equities continue to shine while everything else has significantly underperformed even the more conservative expectations.

OUTLOOK AT THE BEGINNING OF 2013

- **US Equities looked attractive given P/E ratios and massive Fed stimulus**: after the run in 2012, US markets were still slightly undervalued (14 P/E) trading below the last sixty year average (16.4P/E). The Fed was unequivocally backing the economy with the largest asset purchase program in history.
- **Emerging Markets were poised to be the asset class of 2013 given their underperformance**: Emerging Markets were trading with a trailing P/E of 12 and a forward P/E of around 10 which is basically 1.5x book value – that is cheap on both a relative and absolute basis. Compared to developed countries, EM countries' relatively low debt burden and high growth rates reinforce their attractiveness.
- **Municipal bonds would plod along with low yields until the end of the year**. Yields were low but steady and the Fed showed no signs of tapering.
- **The Great Rotation was starting to show signs of life**. After years of cash on the sidelines and bond funds garnering the bulk of the new investment dollars, it looked like investors were finally beginning to rotate into higher return asset classes in search of yield. Preferred shares, MLPs, bank loans, and dividend centric strategies would benefit.
- **Housing was expected to continue its rebound fueled by cheap financing and pent up demand.** The healing of this sector of the economy was critical in sustaining any market gains in the US.

WHAT HAS ACTUALLY HAPPENED (THROUGH JUNE 17TH)

- **US and Emerging Markets diverged by over 25% in less than 6 months**: US Equities: S&P 500 up +15.09% YTD and Emerging Markets down -10.55% YTD.
- **Gold lost its "safe haven" status and tumbled -17.03%** (first negative year since 2000)
- **Commodities continued their slump down -7.05%.** We exited this position in early March (DJP) as there is no imminent threat of inflation- it is down 5% from when we sold.
- **Hedge funds continued to struggle** with the (HFRX) Global Hedge Fund index up 3.48%.
- **Bonds literally cratered after Bernanke's speech illustrating the dangers in fixed income** with the Barclay's Aggregate Bond Index down -1.11% (first negative year since 1999).
- **The Great Rotation got put on hold** – although some opportunistic yielding investments outperformed (MLPs up over 12%), many others suffered double digit losses after Bernanke's comments in May.
- **Housing prices exceeded expectations** - U.S. home prices jumped 10.9 percent in March compared with a year ago (Case-Shiller).

THE BERNANKE EFFECT

Ben Bernanke's statement on May 22nd indicated the Fed's potential to taper its bond buying program before year end. Due to his comments, bond prices tumbled precipitously with the 10 Year Treasury Yield rising from 1.67% to 2.10% in one week, ultimately hitting 2.20%. The average 10 Year Treasury Yield over the last decade is 3.58%. Most analysts, including us, anticipate that rates will rise gradually over the next 24 months, and this sudden spike caught everyone off guard. There was no place to hide and bond managers like PIMCO and Doubleline suffered their worst weekly performance since 2008.

ETF	Ticker	5/22-6/17 Return
iShares S&P CA AMT-Free Municipal Bd	CMF*	-4.57%
iShares Core Total U.S. Bond Market ETF	AGG*	-1.11%
PowerShares Emerging Markets Soverign Debt	PCY*	-5.79%
iShares S&P U.S. Preferred Stock Index	PFF*	-3.13%
PowerShares Senior Loan Port	BKLN*	-1.47%
iShares S&P 500 Value ETF	IVE	-0.40%
Utilities Select Sector SPDR	XLU	-3.54%
Vanguard REIT Index ETF	VNQ	-7.70%
iShares S&P Global Telecommunications	IXP	-2.51%

* dividend payment during this time period not included

As you can see from the table, interest rate sensitive asset classes as well as yield focused sectors traded off significantly in the aftermath of May 22nd. REITs were hardest hit with the sector at one point dropping over 10% in a short span.

OUTLOOK FOR THE REMAINDER OF THE YEAR

- Volatility will continue to pick up as we go into the summer with light volumes.
- US Markets have some additional upside with the Fed's program intact, but we think gains will be more muted in the back half of the year. Earnings and the Fed will be a key determinant of where the S&P 500 goes from here.
- Interest rates will stabilize in the short-term and we might see a bounce back in bond prices and opportunistic yield strategies. Over the longer term rates will continue to head higher, although at a more gradual pace.
- Emerging markets should start to catch up to the US markets. Growth rates are slowing down in the larger countries like China and India, however Emerging Markets are very attractively priced and do not warrant the sell-off.

S&P 500 price targets have been revised upward even after double digit gains

2013 Wall Street Strategist S&P 500 Year-End Target

Firm	2013 Year-End Target at Start of Year	Current 2013 Year-End Target	% From Current S&P 500 Level
Goldman Sachs	1,575	1,750	5.87
Oppenheimer	1,585	1,730	4.66
JPMorgan	1,580	1,715	3.75
Stifel Nicolaus	1,500	1,700	2.84
HSBC	1,560	1,680	1.63
Credit Suisse	1,550	1,640	-0.79
Weeden	1,525	1,620	-2.00
Citigroup	1,615	1,615	-2.30
Bank of America	1,600	1,600	-3.21
Morgan Stanley	1,434	1,600	-3.21
Bank of Montreal	1,575	1,575	-4.72
Barclays	1,525	1,525	-7.74
UBS	1,425	1,425	-13.79
Wells Fargo	1,390	1,390	-15.91
Average	**1,531**	**1,612**	**-2.49**

Increased Target

Source: seekingalpha.com

We are selectively buying equities on pullbacks, at the same time we are continuing to lower our duration on fixed income portfolios. More importantly, we continue to capitalize on asymmetric risk-return opportunities that present themselves in dislocated markets. **Our tactical allocation is up over 12% through June 17th with limited equity exposure**. Securities generally revert to the mean, and this requires taking the emotion out of the investment process and sticking to the analysis.

Recent Changes to the Portfolio:

- Added to our senior floating rate loan position (BKLN) - these loans reset every 30-90 days and if rates rise these pick up the additional interest. Current yield is approximately 4.7% with a low correlation to the S&P 500.
- Sold Emerging Market Debt (PCY) to reduce portfolio duration. PCY has a duration of 9.49 years which added too much downside risk when rates spiked in May.

Overall, we have taken a more defensive posture in the short run in order to dampen the volatility and wait to add to positions on pullbacks. We have done extensive analysis on prior periods in history where rates rose significantly. Historically, Technology (we own TDIV) has been one of the best sectors in a rising rate environment. Bottom line is that we prefer equities in the long term over bonds, and do think that the so called Great Rotation out of bonds hasn't really begun, but will start to accelerate over the next 6-12 months.

MIRACLE MILE ADVISORS

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