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July 10, 2013

Trend Changing Events in 2013

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Global equity markets were quite divergent during the first half of the year. The U.S. stock market was up a remarkable 13.8%, Europe was virtually unchanged, Japan up 32% and emerging markets down (10.9%). Gold was down (26%) and the U.S. bond index was down (2.5%). This divergence was the result of several trend-changing events that should make the balance of the year quite interesting.

The U.S. Economy is the Global Engine of Growth

The U.S economy is likely to grow at a rate of 2%-2.5% during the second half of the year. Even at this modest growth rate, it is the powerhouse for the world. Benefiting from low oil prices, globally soft commodity prices, improving consumer sentiment, expanding employment and rebounding real estate construction, the positive economic outlook should be on solid footing for at least the next 12-18 months. Housing market improvements, construction and employment have been game changers for 2013.

In anticipation of an improving economy, on June 16th, Fed Chairman Bernanke announced that the U.S. Federal Reserve would likely start a gradual unwinding of quantitative easing, the policy of keeping interest rates artificially low. Most market participants expect the Federal Reserve to start reducing bond purchases in September and continuing through 2014. They are not likely to raise short term interest rates until 2015. Without the Fed's bond purchases, fixed income markets are moving to find a new equilibrium level for interest rate securities. U.S. 10-year treasuries have risen in yield from 1.60% in May to 2.70% in early July.

Higher U.S. interest rates have led to a stronger U.S. dollar. It is once again the global safe haven with capital flows moving in from Asia and Europe. Foreign investors have found a home in the U.S. equity market and may become bond buyers, dampening any significant rise in U.S. interest rates.

Chinese Liquidity Squeeze

The new Chinese government, led by Premier Li Keqiang, has made major changes to its growth model for the next decade. After years of over-investment in capital projects and other reckless lending, China is faced with slowing GDP resulting from slack export demand. China's new leadership is focusing on quality of growth and the need to shift emphasis to domestic demand while at the same time boosting productivity. They are intent on building stronger financial institutions and exchanges to better allocate capital internally…ie., less central control. One of the first steps in this transition is to squeeze the liquidity and speculation out of the old commodity based economy by holding financial institutions accountable. This unpopular strategy for bankers became apparent on June 26th when the Chinese Central Bank reduced internal credit to banks resulting in higher interest rates and a panic in the mid-tier financial and real estate sectors.

China's banking system remains as prone to boom and bust as any Western economy and some say it is the wild west of banking. The big four Chinese banks are in the top ten of the largest banks in the world

and are probably considered "too big to fail." However, there are many mid-tier players in financial markets that might not find a home in the new economic model as they were dependent on easy money and cheap credit. They have provided many risky loans to local governments, property developers, real estate owners and the secondary banking system. With real estate prices up over 120% since 2004, the risk of deleveraging the financial sector is quite high. I cannot think of any country where deleveraging has been a smooth process. Global financial markets are concerned about a Chinese economic slowdown in the near future.

Other Asian stock markets are likely to follow China's lead. The risk of an extended credit squeeze in China has hit emerging stock and bond markets in Asia and Latin America very hard. As the world's largest consumer of raw commodities, metals and oil, the outlook for Chinese growth has global importance. All Asian, Latin American, and Australian stock markets have recently declined as a result of this change in Chinese economic policy.

Mixed Signals from Europe

European policy makers have concluded that the public will no longer buy its austerity model of increasing taxes and reducing spending. Austerity policies were making conditions worse with unemployment reaching 12% in several key countries. Politicians have backtracked on their implementation of austerity and made restoration of growth the new priority. The European Central Bank is likely to continue its expansive monetary policy in support of growth. The Germans are going to have to tolerate larger budget deficits in Spain, France and Italy. Europe is likely to muddle through the recent crisis and European stocks may represent surprising values.

One continuing disappointment in Europe is the lack of a unified approach to European banking supervision. Currently, each country and their depositors are pretty much on their own to defend their national banks. Banks in countries such as Greece and Cyprus are dependent on the handouts of others. The inability to reach a unified approach is primarily a result of German unwillingness to cede control to the EU banking regulators. The current policy works for the stronger northern countries but southern European banks are still stuffed with bad real estate loans and may need greater assistance in the future. Overall, Europe should see economic improvement later this year led by northern European business.

Gold in the Buy Zone

Gold prices have fallen over 36% since July 2011 after peaking near $1,900/oz., it is now at $1,200/oz. The decline is surprising because the fundamental problems that caused the rise in the price of gold are still with us. Central banks in the developed world – the United States, Europe and Japan – are still printing money and demeaning their currencies so you would expect that gold would increase in value. You have to ask yourself the question: Where did all the gold that was sold this year go? The answer is Asia, primarily India and China. The people who bought it are going to hold it, not trade it. Next year, when interest in gold picks up again because of the continued expansive policies of the major central banks, gold will be in short supply and the price will rise, perhaps as sharply as it fell.

The end of an Era for Bonds

The primary theme driving the U.S. Treasury and mortgage markets is that, regardless of timing, the overall direction for monetary policy is headed toward a sustained period of less accommodation and higher interest rates. With the trend favoring higher rates/yields, rallies are selling opportunities. The

majority of economists, fixed income traders and money managers believe the Fed is now worried more about the size of its balance sheet and is willing to start slowing asset purchases this fall as long as the economy does not worsen much from current levels.

In my opinion, most of us have seen the lowest interest rates of our lifetimes. After peaking in 1981 at 15.3%, U.S. Treasury 10-year yields declined to a low of 1.53% in July of 2012 and tested that low in May of 2013 at 1.58%. Since Chairman Bernanke's comments on June 16th that the Fed was planning to start unwinding quantitative easing, the market has sought a new clearing price for bonds. Ten year rates have risen to 2.65% and are likely to reach 3%-3.5% over the next year. Bond prices have adjusted accordingly with long-dated maturities down as much as 12%. The new bear market in bond prices could move fairly rapidly over the next few years and encompass most income based securities including bonds, preferred stocks, utility stocks, REIT's and very high dividend stocks. In all likelihood the era of declining interest rates is over and that of rising rates is just beginning.

Equities Look Good

The rise in interest rates is not necessarily bad for all stocks. After an initial revaluation, companies with real growth prospects will rebound. The business of lending will improve as lenders find it more in their interest to lend money at higher rates. The market is going to have to base its views about equities and currencies on actual economic growth rather than simply the fact that there's cheap money from the Fed.

After a 13% rally in U.S stocks over the last six months and an increase of 115% since March 2009, the stock market is entitled to a rest. Corrections after long rallies are often sharp, unexpected and scary. Because interest rate alternatives are so low, our intent is to stay with the stock market unless material changes to the long-term investment outlook occur.

The most likely scenario is that the current bull market will soon enter a consolidation phase, followed by another rally with fewer sectors and companies participating. I would expect that leading sectors such as consumer, healthcare, real estate and recently, financial services will continue to lead the market. The biggest laggards should continue to be basic materials, utilities, and energy stocks due to slack global demand. Mid-cap and small-cap equities, with a growth bias, have been the leading stock market styles and should be carefully watched for signs of weakness. I am hopeful that foreign stock markets rebound from a disappointing first half and catch up to U.S. markets. Stock and sector selection should be quite important in the later stages of a bull market.

I remain cautious on bonds and optimistic about equities in 2013. However, a 5% to 10% correction in the stock market is very possible and well within normal volatility. As the markets move from denial to acceptance of an improving economy, business investment should improve on a global basis. Outside of a major war or significant shock, I maintain a positive outlook for 2013.

Please call me if you have any questions at 973-267-8120.

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