Timmons Wealth Management

Client Newsletter – Second Quarter 2013

Summary

- Markets in the second quarter were largely driven by speculation and an overreaction to news emerging from the Federal Reserve regarding its bond buying program (QE3).
- Rapidly rising interest rates hurt bond investors while a reassessment of risk and political turmoil drove losses across most emerging markets.
- US equity markets once again outperformed despite giving up some gains in the second half of the quarter.
- Increased volatility is likely to remain as investors adjust to a world with reduced Federal Reserve stimulus.

Market Overview for Second Quarter 2013

Despite a strong start to the second quarter, the US stock market gave back much of its gains from late May through the end of June with the S&P 500 posting returns of +2.91% for the full quarter. Bonds experienced their second straight quarter of negative returns declining -2.79% as measured by the Barclays Global Aggregate Bond Index. Mounting concerns related to US monetary policy led to sharp losses across emerging markets while fears of a continued slowdown in China's growth, the ongoing recession in the Eurozone and concerns about central bank actions in Japan weighed on global stocks. For the quarter, global stock markets outside of the US declined -2.94% as measured by the FTSE Global All-Cap Ex-US Index.

The second quarter marked the return of increased price volatility across global stock and bond markets driven by growing speculation that the Federal Reserve would move forward plans to begin tapering its quantitative easing program earlier than originally anticipated. As of the May meeting, the Fed noted that it remained committed to purchasing $85B p/month of agency mortgage-backed securities and longer dated treasuries in a bid to keep longer term interest rates low to boost lending and investment, while keeping the Federal Funds Rate at historical lows of 0%-0.25% with an unemployment rate target of 6.5% and an inflation target of 2%. The Federal Reserve statement released on June 19th left these targets unchanged, but Bernanke's comments in the post-statement news conference did note the potential for the Federal Reserve to begin tapering their bond purchase program (QE3) later this year if the economy continued to improve.

Despite reassurances of continued and prolonged monetary policy support and low short term interest rates for the foreseeable future, bond investors weren't buying it. Rates across all areas of the bond market

Liam Timmons, President
Timmons Wealth Management
35 Carl Jordan Drive
Attleboro, MA 02703
(774) 331-2172
Liam.Timmons@TWealthManagement.com

Timmons Wealth Management is a Registered Investment Advisor offering independent investment management and financial planning services to clients.

Key Market Data for 2Q2013

TWM Client Benchmarks	2Q2013
Aggressive Growth Strategy	1.74%
Capital Appreciation Strategy	0.83%
Balanced Return Strategy	0.07%
Broad Market Benchmarks	**2Q2013**
S&P500	2.91%
FTSE Global All-Cap ex-US	-2.94%
Barclays Global Aggregate Bond Index	-2.79%
Barclays US Treasury Bill 1-3 Months	0.01%

moved higher as investors sold bonds resulting in broad losses across both US and foreign bond markets. From May 1st to June 30th, the yield on the 10 Year US Treasury rose from 1.62% to 2.48%, an increase of 53% in only a two month time period as investors fled bonds for the relatively "safety" of cash. Since 30 year mortgages are typically priced off the 10 Year US Treasury, new homebuyers and those seeking to refinance were faced with higher mortgage rates. Treasury Inflation Protected Securities (TIPS) experienced losses of -7.05% for the quarter, as investors who had previously purchased the bonds as a hedge against inflation headed for the exits on the assumption that an earlier exit from QE3 would likely reduce the risk of significant future inflation. The size and speed of the sell-off in bonds shocked even veteran bond managers including Bill Gross from PIMCO who experienced growing fund redemption requests while forced to simultaneously contend with falling bond prices.

The reach for yield, a topic we have discussed in the past as a major risk to investors, came to the forefront this quarter as the rise in domestic interest rates led to a sharp selloff across emerging market debt. Historically low interest rates over the past several years in the US and foreign developed countries have led many investors to take on more risk by buying lower rated emerging market bonds that pay higher yields. In many cases, these investors purchased bonds in local currencies which further added to gains as emerging market currencies appreciated vs. the dollar. With rates rising sharply in the US and increased volatility across stock and bond markets, investors began selling emerging market debt en-masse with the emerging market debt category experiencing some of the largest investment outflows in recent years. Investors were once again reminded in another painful lesson that higher yields generally exist due to higher risk. For the quarter, emerging market US-denominated debt declined -5.1% as measured by the Barclays Capital Emerging Markets USD Index while emerging market local currency debt declined -6.48% as measured by the Barclays Emerging Market Local Currency Government Index.

The US stock market was not immune to the panic which ripped through the bond market during the quarter. Many investors feared that an early withdrawal of Fed stimulus would hobble what many consider a relatively muted economic recovery in the US, particularly at a time when the housing market is finally beginning to stabilize. These fears were further exacerbated by the belief that too sharp a rise in mortgage rates would make housing less affordable and reduce the level of new and existing home sales. In the face of these worries, the S&P 500 performed well on a relative basis despite relatively low absolute returns. In spite of a roughly -5.76% decline from its peak of 1669.16 on May 21st, the S&P 500 ended the quarter with a positive return of +2.91%. Among the best performing areas of the US market included large capitalization value stocks and small capitalization growth stocks. Financials, healthcare and consumer discretionary stocks were among the best performing sectors while higher yielding sectors of the US market such as utilities, telecom and real estate investment trusts underperformed as the rise in interest rates made these areas of the market less attractive on a risk adjusted basis. Higher yielding areas of the US stock market have been flooded with investment dollars in recent years as investors gravitated away from the bonds in the search for income.

International stock investments experienced another tough quarter. Europe once again struggled as Eurozone sovereign and bank risks remained in an economy mired in a recession. On May 15th, the collective Eurozone posted its sixth straight quarter of economic compression with GDP falling -0.2% for the 1Q2013. Germany remains one of the few Eurozone economies continuing to expand, though growth remains anemic at +0.1%. On a relative basis, Japan's markets produced strong returns of +10.3% despite the Nikkei 225 (Japan's version of the Dow Jones Industrial Average) falling -20%

between May 22nd and June 13th. Japan's central bank remains committed to devaluing the yen in an attempt to fight deflation and boost competitiveness of Japanese companies in the global marketplace. Japan's auto sector has been a direct beneficiary of a weaker yen policy making the country's products more competitive and boosting profits.

However, the biggest story across international equity markets in the quarter was the sharp sell-off in emerging market stocks. For the quarter, emerging market stocks declined -9.1% as measured by the MSCI Emerging Markets Index. Investors witnessed the spread of political unrest and protests across various regions and a mass exodus from emerging market stock investments on the heels of Fed comments in May and June related to tapering of QE3. The virtual coup in Egypt, violent protests in Turkey and civil unrest in Brazil surrounding lavish spending on the upcoming World Cup were just a few unsettling developments. Sharp currency devaluations in markets such as South Africa, Mexico and Brazil added to losses for investors while economic data and news coming out of China left many questioning how much further China's economic growth would slow. To compound issues, the Chinese government curtailed lending to banks in an effort to slow the expansion of credit in the Chinese economy which has inflated real estate prices and led to policies with minimal economic value. This self-induced credit crunch sent short term lending rates spiraling higher, further exacerbating concerns about a potential hard-landing for the Chinese economy.

Outlook

We believe that the market reaction and "taper-tantrum" experienced throughout June in the face of Fed comments regarding changes to their bond buying program were overblown and if anything offered an attractive entry point for long term investors. In recent weeks, the story of bad news being good news has pervaded market dialogue, as investors eagerly await each key economic release with a mindset of weaker economic data correlating to lower probability of earlier than expected Fed tapering. We think this is extremely short sighted and find it surprising stock investors would actually wish for weaker growth when stronger economic growth will lead to improved corporate earnings and profitability driving stock prices higher. We see a relatively low impact of rising rates on stock returns over the next several years as a continued gradual rise in rates would indicate improving economic fundamentals and result in growing earnings and cash flows for companies. Many companies have judiciously locked in financing at low levels for extended time periods as is evidenced by the high level of corporate bond issuances over the past year. Apple, a company which has over $100B+ in cash on its balance sheet, issued $17B in debt for the first time in many years paying a measly 3% on 30 year bonds. These bond issuances and improving company balance sheets will keep interest costs low for companies and add to future profitability.

> ***"If the incoming data are broadly consistent with this forecast, the Committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases later this year; and if the subsequent data remain broadly aligned with our current expectations for the economy, we would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear."***
> *~Ben Bernanke 6/19/13*

Significantly higher interest rates will eventually depress valuations on stocks but we do not believe this will be the case for some time. An interesting study done by JP Morgan demonstrated that when 10 Year

US Treasury rates are rising but below 5%, rising rates are generally associated with rising stock prices. Once rates cross the 5% level, a negative relationship between yield and stock returns appears. Why does this exist? Stock valuations are often calculated based on the discounted value of future cash flows which helps to establish an estimated present value for the company. If the calculated present value is greater than the current stock price this might mean shares are undervalued signaling a good time to buy. Conversely, if the calculated present value is lower than the current stock price this might signal shares are overvalued and that it might be a good time to sell. One important component of the discount rate used to calculate the present value of stocks is interest rates, thus a higher interest rate would result in a larger discount rate and a lower present value calculation making stock prices appear overvalued and less attractive. However, we do not see this as any immediate risk but rather something that investors need to be aware of for future reference. Certain industries will actually benefit from rising interest rates including money center banks involved in lending and payroll processors who earn interest on client funds. Dividend stocks will likely face greater volatility as rates rise and bonds are better able to compete, but dividend paying stocks will likely continue to offer greater total return potential given the ability for companies to grow dividends over time vs. a fixed coupon received from a bond.

We continue to take a long term perspective on stock investing and realize that even though historical stock returns over the past 100 years have averaged 9.5% (6.5% after inflation), annual returns over shorter time periods often look dramatically different as seen during the period of 2007-2012. Keeping a long term perspective lets investors ride out the inevitable tough times without damaging long term gain potential which occurs by overreacting to short term developments in the market. Overall, the US stock market remains fairly priced given valuations, an improving economy and dividend payouts below historical levels with room to grow. Many investors (including some professionals) have remained on the sidelines in cash, earning a negative real return awaiting the next magical entry point to buy into the market. These market timers masquerading as investors have watched the S&P 500 produce double digit gains in 2012 and YTD highlighting the zero sum game of trying to pick market tops and bottoms. We do not believe anyone can accurately time markets consistently.

Risks still remain in the emerging markets and political unrest has somewhat changed the narrative away from a focus on countries with low debt levels and stronger growth potential to a renewed focus on risk and the impact of rising rates on emerging market economies. This week, the IMF lowered its growth forecast across emerging markets citing “infrastructure bottlenecks, capacity constraints, lower commodity prices, disruptive political transitions and weakening demand for goods.” The Fed’s plans to taper have meant higher yields in emerging markets and a re-pricing of risk with capital outflows raising the price of borrowing which could potentially further stymie growth for countries that are heavily reliant on foreign investment. Though we have been a bit surprised by the volume of investors exiting emerging market investments, the concept of risk in emerging markets is not new to us. Historically, Timmons Wealth Management has capped pure emerging market investments to 2%-4% of client portfolios, far below industry peers who were mandating as recently as the beginning of 2013 allocations in excess of 15% of portfolios. Given the historically high level of volatility and lower risk adjusted returns vs. those garnered in developed markets like the US, we continue to maintain a lower overall exposure to emerging markets. We also recognize that a number of our US-focused mutual fund holdings own large multi-national companies that derive significant revenue from the emerging markets. Our strategy continues to be achieving broad exposure to emerging markets via heavily diversified emerging market funds with proven track records and expertise. We do believe it is a costly mistake for investors to flee this asset class at a time when valuations are quite cheap relative to historical levels.

As noted in previous letters, bonds will likely continue to face an uphill battle as we remain in the early stages of a rising interest rate cycle from historically low interest rate levels. We do not anticipate that we will see interest rates spike significantly from these levels in the short term given that we remain in a period of deleveraging for both consumers and governments. A rapid rise further in interest rate levels would threaten to derail the economic recovery, a risk which the Federal Reserve remains keenly focused on. The recent volatility in the bond markets served as an opportune time for bond investors to reassess existing bond strategies. At the same time, we are presently faced with better yields in areas like high yield bonds than we had as little as two months ago. At Timmons Wealth Management, we have maintained a lower duration (ie. interest rate sensitivity) for some time now and used the recent quarter volatility to further reduce some medium term bond exposure in favor of more unconstrained bond strategies that can roam the globe seeking the best opportunities. In addition, we have shifted more client money into short duration, high yield strategies that reduce interest rate risk while earning a reasonable rate of return. Though these strategies will serve to mitigate some of the risk associated with rising rates, no well-balanced bond strategy is completely immune. We remind our clients with bond allocations that a rise in interest rates will eventually be a good thing for bond investors as it will mean higher income streams. Declines in bond fund prices are never pleasant, but future interest payments will be higher and dividends produced by bond funds will be reinvested at higher rates. Though the inclination for many bond investors has been to flee bonds, we believe a well-balanced portfolio for more risk adverse clients must contain a bond allocation to reduce the volatility and act as a buffer when equity markets decline.

As always, we encourage our clients to maintain a long term perspective as investors and realize the inevitability of bumps along the way. We continue to believe the key to wealth accumulation and preservation is shunning the short term thinking and associated emotional tendencies that might sell newspapers and commercials but rarely lead to sound investment decisions. We encourage clients to reach out to us with any questions or concerns.

Operational & Financial Planning Items

We hope you have received your **Second Quarter 2013 Portfolio Review** package via your secure web portal. If for any reason you have not been able to access the website or reports please contact our office for assistance. We believe your quarterly reporting package provides a critical role in keeping you abreast of what you own and how your investments are performing.

Our new website is coming! Timmons Wealth Management expects to launch its website in July 2013. Clients will have the ability to access the client web portal through our company website. More to come!

Have you had a client review meeting recently? We encourage clients to meet with us at least once per year so we can review your portfolio in greater detail and update your Investment Policy Statement. Please contact our office to set up a date and time that works. We are also always available to speak via phone.

Have you made your IRA Contributions for 2013? Are you maximizing your 401k contributions? Please contact our office to review your current status and options.

Have you put together a retirement plan or updated your plan recently? Timmons Wealth Management offers financial planning services like retirement planning for no additional charge to all clients. We would be happy to provide you with our retirement planning package to get started on a path towards a more secure retirement.

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On behalf of Timmons Wealth Management, we would like to wish you a healthy and prosperous summer and look forward to working with you throughout 2013 and beyond. If there is anything we can do to help you please do not hesitate to contact our office.

Sincerely,

Liam Timmons, President
Timmons Wealth Management

TIMMONS
WEALTH MANAGEMENT
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