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ECONOMIC AND INVESTMENT FORECAST
July 2013

The U.S. stock market registered the best first half of a year since 1999, as the S&P 500 tallied a 13.8% return. Conversely, the broad bond index registered a return of -2.4% through the same period. Supportive of stocks, 70% of U.S. corporations beat earnings estimates in the most recent earnings season, which is about the long-term average. In addition, businesses large and small reported cash flow at record levels, helped by historically strong profit margins. Corporations continue to report healthy business conditions, with the majority of executives gaining confidence that the economic recovery can be sustained. From an investor's perspective, the common stock of companies is trading at reasonable valuations: the S&P 500 Index P/E multiple is registering about 15x earnings, below its historical average of approximately 18x earnings. Alternatively, bonds offer less of a bargain, with interest rates still at historic lows.

As the U.S. economy advances at a sluggish rate of expansion, Federal Reserve Chairman Ben Bernanke's actions and words have come under increasing scrutiny. Comments Bernanke made recently, stating that the economy "fundamentally looks a little better to us", spooked investors to hurriedly sell bonds and other income-producing investments. The concern market participants have is that the Federal Reserve's quantitative easing efforts (QE3), currently at $85 billion per month, will be gradually reduced, and then fully terminated by the end of 2014. The reaction to Bernanke's statement was immediate and dramatic. The yield on the 10 year U.S. Treasury rose to 2.5% as $8.6 billion was quickly redeemed from bond funds. The bond market has since stabilized, but investors have had their first glimpse of the impact that rising interest rates can have on bond prices, mortgage rates, and other income-producing investments.

Overseas, economic progress has been elusive. Growth in emerging market countries has been disappointing, while continuing recessionary conditions still linger in major developed markets, particularly in Europe. On a more positive note, some leading economic indicators are improving internationally, which is an encouraging sign going forward for global business. As in the U.S., many central banks around the world have ratcheted up stimulus measures to promote economic growth. In Europe, lower interest rates have led to new orders in manufacturing, and possibly the end to their lengthy recession. China, on the other hand, has been battling double digit inflation, and dealing with an overheated housing market. They recently succeeded in slowing their economic growth rate to 7.5%, and there is concern that China's expansion may be constrained further. To complicate matters, the People's Bank of China is cracking down on their growing "shadow banking" system. This underground financial system in China is an additional source of risk, and a distraction from the major task at hand: China's transition from an export economy to one oriented towards domestic consumption. Economic updates out of China will continue to garner close scrutiny from investors and the markets, given their prominent role in the global economy.

Looking ahead, the U.S. economic recovery is expected to pick up speed, as improvement in housing starts (up 28% year-over-year), the stock market, and the U.S. employment picture, will more than offset the fiscal belt-tightening measures being introduced. However, we expect austerity to become a larger theme in the U.S. going forward, manifesting itself through tighter fiscal and monetary policy. As an example, President Obama's budget released in April calls for $1.8 trillion in deficit reduction over ten years, via higher taxes and major spending cuts across the board. In summary, we continue to be constructive on the outlook for the markets and the economic recovery. Volatility in financial markets will be more of the norm going forward as global investors attempt to navigate the cross currents of financial information, while responding to unexpected monetary policies, geo-political events, and market developments.