



The Benedict-McLoughlin Report 2013 Mid-Year Update

By Christopher Benedict, CFA

- The beginning of the end of the massive U.S. monetary stimulus appears to be at hand
- Despite the market's sharp reaction, I expect the "unwind" to be a multi-quarter, if not, multi-year transition as the global economy remains relatively fragile
- The "normalization" process will ultimately be a positive as we continue to distance ourselves from the Great Recession

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Global financial markets appear to have begun the "normalization" process over the past few months as the U.S. Federal Reserve (Fed) has signaled the beginning of the end of the massive monetary stimulus that they have been providing since 2008 (see graph on p. 7). The reaction around the world and across asset classes has been volatile. Interest rates on U.S. Treasury securities have increased (bond prices have declined) significantly with the yield on the 10-Year Note, for example, rising from 1.63% on May 2nd to as high as 2.82% on August 15th.¹ This sell-off has taken the rest of the global bond market along for the ride with spreads widening on basically everything including corporate, municipal, international and asset backed bonds. Global equities were hit as well with developed market equities dropping around 9% from their May highs to their June lows while developing market equities dropped 20% in the same time period.² Overall, year-to-date, U.S. and Japanese equities continue to be the only games in town, outperforming other developed markets as well as the emerging markets by a significant margin. Investors appear to be focusing only on the short-term outlooks that have been helped by unprecedented central bank accommodation in both the U.S. and Japan. It is as if investors are saying "fiscal responsibility be damned"

and are embracing the "QE Club" at the expense of essentially everybody else (QE = Quantitative Easing). Now that the end of QE in the U.S. is at least on the table, we shall see if the strong U.S. equity outperformance can continue.

Fundamentally, despite the unprecedented monetary stimulus, the U.S. economy has continued its modest recovery with only sub-par growth. In fact, Q2 gross domestic product (GDP) grew only 1.7% and unemployment remains fairly high at 7.4%.³ Admittedly, there is an economic drag from the fiscal side as "sequestration" has forced some cuts in government spending. In fact, government spending declined by 0.4% in Q2 and although the sequester-mandated cuts are expected to subside into 2014, government spending, I believe, will be relatively subdued in the years ahead.⁴ Indeed, any rise in rates from here would be a headwind in terms of deficit-funded government spending. Furthermore, rising rates increase the cost of our current large debt level and this increased interest expense effectively "crowds out" other potentially productive uses of taxpayer money. On a positive note, increasing energy

independence has already helped the U.S. economy, particularly with the trade deficit as net imports of crude oil and petroleum products have decreased by over 40% since peaking in 2007.⁵ Furthermore, tapping the increased reserves will require a significant amount of both capital and “human capital” investment, thus making the energy sector one of the few bright spots on the employment front.

Globally, the economic picture has been mixed as well. Europe has been the laggard and has remained in a recession for longer than most expected. However, recent economic statistics have been improving and any growth out of Europe would be a welcome boost to global growth. Time will tell but, a case could be made that, since Europe took their austerity medicine early, they may just be starting to reap the benefits as their austerity programs appear not only to have stabilized their budget situation but, also may have set the stage for further growth. However, Europe’s private sector likely has more deleveraging to do (including their banking system) and this may limit this region’s chances of a “rip-roaring” economic recovery. Nonetheless, it should be an improvement as compared to recent years. In fact, it may resemble the subdued recovery that we have been experiencing in the U.S. for the last three years. Importantly, a European recovery should also be beneficial to the emerging market economies considering that Europe is a major export market, particularly for China and other parts of Asia. Overall, while growth in the emerging markets has outpaced the developed markets, the growth has been below potential and spotty. China and other emerging economies are transitioning from being investment and export driven to more internal demand driven (i.e., consumption) and some lumpiness is to be expected. In my opinion, global growth should get a boost over the intermediate and long-term as average income is expected to continue rising in the emerging markets.

Removing the Training Wheels

Complacency, trepidation, fear, scrapes, bruises, crying, wobbling...and eventually utter joy and the sense of accomplishment. These are the basic steps of my daughter’s recent experience when she learned to ride her bike without the help of training wheels. It is an important time in the lives of many people and it may be a fairly decent analogy for what the U.S. economy (and, to an extent, the global economy) will be going through over the next few years. If the sharp rise in interest rates is any indication, the Fed Chairman essentially guided markets out of the complacency stage right into the trepidation and fear stage when he stated in May that the Fed would begin to slowly reduce or taper their bond purchases. The ensuing massive and quick sell-off in the bond market has surprised many investors and, in my opinion, is a bit overdone at this point with the 10-Year Note yield approaching 3%. While the economy and interest rates have always been intertwined, they may never have been as interdependent as they are currently. The Fed has clearly stated that any reduction in bond purchases will be predicated on specific improvements in the economy, most importantly a lower unemployment rate. Indeed, the unemployment rate has been declining, albeit slowly, in recent quarters as a direct result of the Fed’s very aggressive monetary policy. However, while the Fed would like to eventually unwind this policy, I believe they would like to do it very gradually so as not to interrupt the economic recovery. Importantly, the market has effectively tightened policy by over 100 basis points on the 10-Year Note (1.63% to 2.82%) and this may actually slow down the eventual Fed tapering program.

The Federal Reserve’s “grand experiment” of very aggressive monetary policy has generally worked as intended with interest rate sensitive sectors like housing and automobiles being the direct beneficiaries of lower interest rates. Just prior to the

May announcement, mortgage rates were at historical lows which was a welcome tailwind for the recovering housing market. Refinancing activity was at record levels, which not only employed a lot of people in this industry but, also allowed many homeowners/consumers to reduce their monthly housing payment and take those savings and spend it on other things, thus boosting consumption and the overall economy. The same economics have been helping the first-time buyer which, in turn, has helped the housing construction industry. Low interest rates have also helped consumers buy more car than they otherwise could afford as well as many other products where cheap financing has been plentiful (think TVs and dishwashers). All of this activity has made up a significant portion of the economic recovery over the past few years. Higher interest rates, especially if they keep rising anywhere near the recent pace, would likely put this recovery at risk. Indeed, with the recent rise in mortgage rates, the housing sector is already showing signs of a slowdown and the refinancing market has effectively come to a standstill.

Importantly, if we can take the Fed at its word, they have effectively put in a “safety valve” in their proposed plan to reverse course on monetary policy. As mentioned above, the most important metric that they are watching is the unemployment rate. The official unemployment rate has declined to 7.4% but, is still relatively high this far into a recovery. However, if we include people that have accepted part-time jobs but are still looking for full time work as well as people that have given up looking and have not tried to get a job in the past year, the figure, known as U6, is at 14% (see graph on p. 7).⁶ And, this rate is higher than it was in March. Additionally, if the labor market does continue to improve, the official unemployment rate may lag if more people enter (or, re-enter) the workforce. Combine this fact with the recent bond market-induced tightening and this will likely result in a lot of “give and take”

between the Fed, the economy and interest rates over the next several quarters.

Ultimately, the normalization of monetary policy/interest rates is a good thing. It lets market forces work in discovering true equilibrium levels in both the economy and financial markets. From an economic standpoint, artificially low rates (or artificially high) can affect the allocation of capital and, indeed, potentially lead to the misallocation of capital. For example, an artificially low cost of funding for the U.S Government could give a false sense of security and potentially promote spending on projects/programs where the return on investment is sub-par. From an investment standpoint, it should allow correlations between asset classes to decrease which not only allows for more risk reduction from a portfolio construction/diversification standpoint but, should also foster a better environment for alpha generation (i.e., above-market returns). Intuitively, if the return of a stock can be explained by a factor model that may typically have had a 20% weighting on U.S. Federal Reserve policy, for example, that weighting may have effectively been 50% or more over the past few years. In other words, since the financial crisis, in many cases, it has been government policy more than company specific results that have driven equity prices. The expectation is that, as policy becomes less of a factor, investors can rely more on their company specific research to help predict specific stock returns.

Risks to the Economy: A renewed credit crisis spurred by sovereign debt concerns in Europe (or the U.S. or Japan) may reduce global economic activity and investor confidence; Sustained high oil prices would negatively affect growth; Large, chronic budget deficits (including unfunded entitlement program liabilities) may eventually cause higher interest rates. A sharp depreciation of the U.S. dollar

would likely put upward pressure on inflation and interest rates; Terrorism.

The Stock Market

I continue to frame my view of global equities in the context of three time frames: The short term (3 - 6 months, moderately bullish), the medium term (1 - 3 years, neutral) and the long-term (5 Years+, moderately bullish). Regionally, at a price-to-earnings ratio (P/E) of 15 on expected 2014 earnings of \$115, the overall U.S. market is only slightly above its long-term average, so, at least on the surface, it is hard to argue that it is too expensive.⁷ However, in my opinion, the valuation of the “bond-like” sectors such as utilities, consumer staples and telecom appear stretched on a P/E basis at, 16.1, 16.6 and 16.6, respectively.⁸ Other U.S. sectors like technology and energy which are trading at below average valuations look more attractive, in my opinion. Additionally, while U.S. earnings have been relatively strong, one area of potential concern is the fact that profit margins as a % of GDP are at an all-time high. This notoriously cyclical measure is at a high because companies are very lean as they have kept employment levels low coming out of the Great Recession. Also, borrowing costs were recently at all-time lows and many companies took advantage of this and re-financed at lower borrowing costs. Importantly, we may be at an inflection point where these tailwinds become slight headwinds in the years ahead. Even assuming margins can stay here for a while, domestic profits would only grow at nominal GDP which is running at an approximate 4% clip. If margins were to decrease and/or we get a higher-interest-rate-induced economic slowdown, U.S. earnings could indeed decline. On a positive note, many U.S. companies have shored up their balance sheets and have been returning a significant amount of cash to shareholders via stock buybacks and dividends. Dividends have risen for several years

now and this trend may continue as payout rates are only 36% vs. an historical average of 52%.⁹

Globally, despite the current headwinds, economic growth is expected to be increasingly driven by emerging market economies. Specifically, I believe the rising spending power of the emerging market consumer is one of the better investment themes over the next decade. My model portfolio is exposed to this theme by owning both multi-nationals that have a high percentage of sales to emerging market consumers as well as by owning local consumer focused companies. I believe China is a particularly attractive area for this theme as domestic consumption makes up only 37% of their overall economy compared to the average 50 – 60% globally and 70% in the U.S.¹⁰ Furthermore, China is making a concerted effort to transition their economy from being investment driven to a more consumer driven one and, while this may cause some overall growth volatility, this reality is a major tailwind for this theme. Additionally, even if China’s growth slows from the 8% level down to 7%, certain sectors, such as telecom, will be affected only minimally.

Europe is another interesting part of the world, in my opinion. This region has had some high profile issues (Greece, Spain, etc.) over the past few years but, recent economic performance suggests that they may be finally poised to grow again. Some argue that Europe is about three years behind the U.S. in terms of their recovery and, if that is the case, European equities may be headed for some decent returns in the years ahead. Interestingly, Europe is trading cheaper than the U.S. on both a P/E basis (12.5 vs. 15) as well as on a price-to-book basis (1.31 vs. 2.49).¹¹ Furthermore, Europe is trading at a P/E ratio that is 6.7% less than it did in 2009.¹²

Risks: Geopolitical events may cause highly volatile stock prices; A significant up-tick in inflation which could result from too much economic stimulus would likely compress valuations; Conversely, the U.S. Federal Reserve may feel obligated to raise interest rates sooner than otherwise would be expected to quell inflation which may hurt the economic recovery. The pendulum of government regulation in the U.S. may swing too far the other way (i.e., potentially too restrictive) which could dampen free enterprise and economic growth.

The Bond Market

Using the same time frame as above, when considering the U.S. Treasury market, I am neutral, moderately bearish and bearish, respectively. Despite my belief that U.S. interest rates will be higher 2 – 3 years from now, the quick rise in rates in recent months is probably the bulk of the initial move up as the Fed and investors will now monitor the economic performance over the next few quarters. The nominal rate on the 10-Year Treasury now at least provides a positive real return (after inflation) but, probably is not fairly valued (in “normal” times) until the real yield is around 2%, implying a 3.5% nominal rate. However, we are not in “normal” times and I believe it will take a while for the yield to approach this level. As mentioned above, the Fed does not want to derail our recovery and I believe a 3.5% 10-Year yield would do just that at this stage. I believe the recent slowdown in the very important housing sector is important evidence of this.

In light of this outlook, I am still avoiding Treasury and other high quality investment grade bonds and focusing on “spread” areas (i.e., corporate, international, asset backed bonds, etc.) while maintaining a relatively short average maturity in my model portfolio, targeting duration in the 4 – 5 year range. Investing in relatively short, higher yielding

“spread” areas should enable a decent return while protecting against a faster than expected rise in longer term interest rates. As a reminder, all else equal, the longer the maturity of a bond, the longer the duration (i.e., the bond’s price sensitivity to movements in interest rates). For example, assume a 10-year bond (or portfolio) has a duration of 8 and a 5-year bond has a duration of 4. If there was an immediate across the board rise in interest rates of 1% (100 basis points), the price of the 10 year bond would decline by 8% and the 5 year bond would only decline by 4%. So, the lower average maturity/duration portfolio declines less and, if the average yield is more than 4%, an investor can still achieve a positive return over the course of the year even with an adverse move in interest rates.

Risks: The Federal Reserve may be either too conservative *or* too aggressive as it manages monetary policy, which may cause interest rate volatility; Rising budget deficits and/or entitlement obligations may cause a rise in bond supply, which may cause a drop in bond prices (higher yields).

Tactical Allocation Strategy For My Model Portfolios (as of 7/29/13)

Equities	Equal	Fixed Income	-1	Alternative Investments	+1
U.S.	-1	Treasuries	-2		
Int'l	+1	Inv. Grade Corporate	+1		
Growth	Equal	High Yield	+1		
Value	Equal	REITS	-1		
Large Cap	+2	Floating Rate	+1		
Small/Mid Cap	-2				

Legend	
+2	20% Overweight
+1	10% Overweight
Equal	Equal Weight
-1	10% Underweight
-2	20% Underweight

Overweights

Absolute/Total Return Strategies, Large Cap Multinational Equities (U.S. and Europe), Consumer focused China/Emerging Market Equities, Sustainably High Dividend Yield Equities, Corporate/High-Yield Fixed Income, Floating Rate Loans/Bonds.

Changes from the 2013 Investment Outlook: Brazil and Gold stocks are no longer overweight

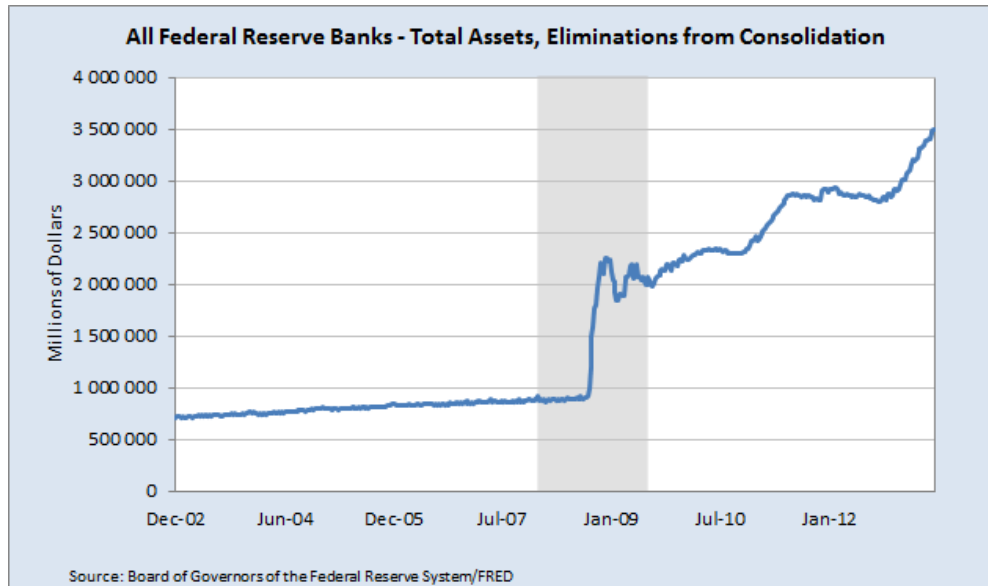
Underweights

Long-term Fixed Income, U.S. Treasury Securities, Small Cap Equities, Developed Market Consumer Equities, REITs.

Changes from the 2013 Investment Outlook: None

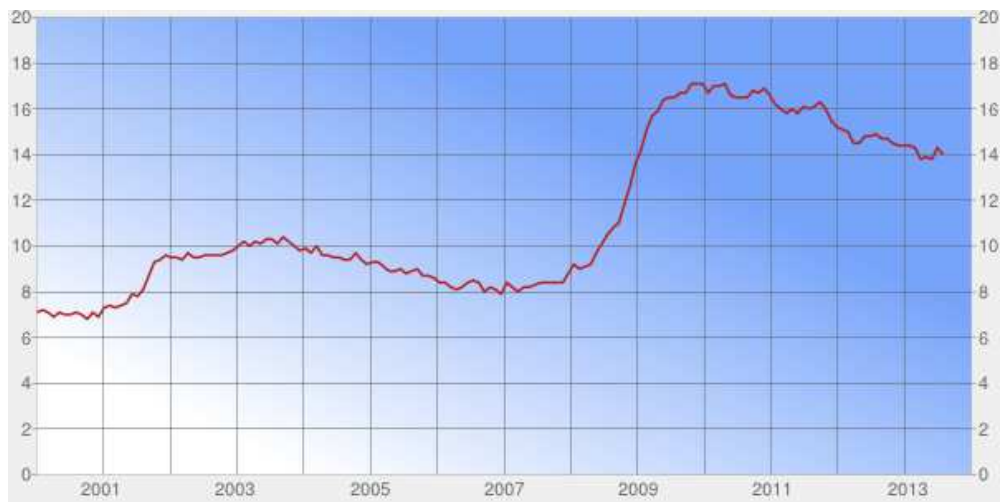
GRAPHS OF INTEREST

U.S. Federal Reserve Balance Sheet (2002 - 2013)



Source: Board of Governors of the Federal Reserve System/FRED, www.ecpofi.com.

U.S. Unemployment Rate – U6 (2000 - 2013)



Source: www.bls.gov

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1. Bloomberg Markets
 2. Bloomberg Markets
 3. Bloomberg News, Lew Says Congress must Avoid Last-Minute Drama on Debt Limit, 7/28/13
 4. Bloomberg News, Economy in U.S. Grows More Than Forecast as Stockpiles Climb, 7/31/13
 5. U.S. Energy Information Administration, www.eia.gov
 6. Bureau of Labor Statistics, www.bls.gov
 7. Bloomberg News, Strategists' Forecasts for S&P 500 Index in 2014, 8/12/13
 8. Adam Parker, U.S. Equity Strategy, Morgan Stanley, 8/5/13
 9. Payouts Head For another Record, Barron's, 7/6/13
 10. Bloomberg News, China Leverage Risks Bypass Super-Saver Households as GDP Slows, 7/11/13
 11. Bloomberg News, Europe Stocks Cheaper Than Last Recovery as Profit Rebound Seen, 8/12/13
 12. Bloomberg News, Europe Stocks Cheaper Than Last Recovery as Profit Rebound Seen, 8/12/13

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