

QUARTERLY ECONOMIC REVIEW OUTLOOK

INVESTMENT NEWSLETTER / SECOND QUARTER 2014

Executive Summary

In many respects, outcomes for the first half of 2014 proved to be the opposite of consensus expectations. Widely anticipated acceleration of the U.S. economy was greeted by a first quarter GDP decline of 2.9% - the largest post WWII contraction not associated with a recession. Bonds, expected to fall on rising interest rates, rallied to outperform stocks in the first quarter and delivered reasonable results for the first half of the year. The dollar weakened despite forecasted strength, and the opposite was true for the yen. The Japanese stock market cratered, commodities, utilities, and real estate rallied...the list of unexpected outcomes goes on and on. Suffice it to say, to the extent the notion of diversification was challenged by last year's one-dimensional investment market, it has been adamantly reinforced in 2014.

Not only have forecasts been erroneous, but investors have also faced a series of unpredictable geopolitical events in 2014. Putin invaded Crimea and reignited the Cold War, Thailand's military overthrew the government by means of a coup, and a Sunni insurgency in Iraq raised tensions in the region.

The situation has prompted fears of a disruption in oil production from the second largest OPEC producer.

Considering economic miscues and geopolitical curveballs, an investor might be concerned to open second quarter portfolio performance reports. In actuality, all major asset classes delivered gains, and the dispersion of returns across stocks, bonds, domestic, international, etc. was the tightest in recent memory. All in all, it was a good quarter, and a good first half, which generated modest, respectable returns.

Looking forward, the global economy is expected to grow slower than initial expectations, but at a faster pace than 2013. The U.S. should grow about 2.0%, in-line with the previous three years. Housing has weakened, and the outlook is uncertain. Pockets of weakness remain in the labor market yet inflation has moved higher. China's economy looks to be finding a floor, and the government is making adjustments to hit its 7.5% annual growth target. Credit issues and real estate declines are uncertainties. Abenomics continues to be fleshed out in Japan, inflation

is rising, and the nation's April 1 tax hike appears manageable. Despite progress, growth will still be only marginal over the next year and this "export nation" has posted a trade deficit for 23 straight months. As for Europe, the U.K. is likely to be the best performer among G7 nations this year, and its central bank will probably be the first to raise rates. The euro zone shows modest, but broad based improvement. Manufacturing is growing, and unemployment ticked lower. That said, growth is quite slow and the sheer number of unemployed is massive. The euro is stubbornly strong and inflation (disinflation really) is dangerously close to degrading into full-blown deflation. Lastly, central banks, globally, remain tremendously accommodative - despite resulting capital market distortions/ imbalances and elevated investor risk taking.

Economic Review and Outlook

Economic Growth

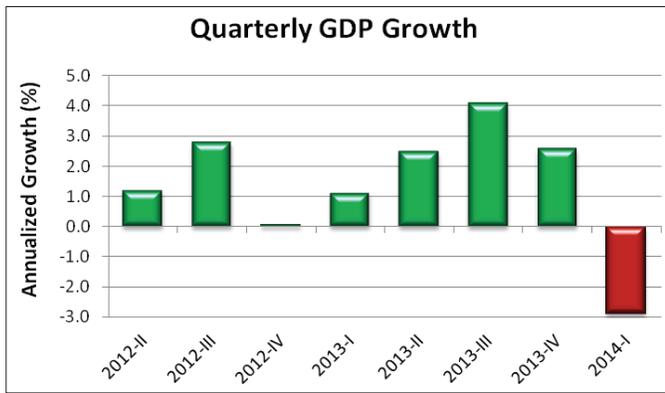
Considering widely held expectations for faster growth this year, results in



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the first quarter were both surprising and disappointing. As shown below, U.S. economic output fell at a seasonally adjusted annualized rate of 2.9% in the period.

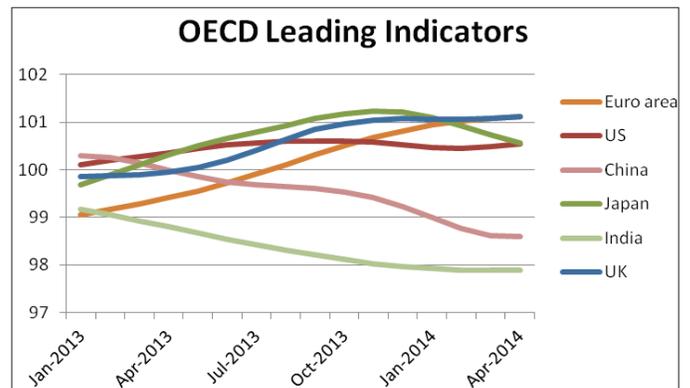
The contraction was the second of the nearly five year old economic recovery and by far the largest in magnitude. As a matter of fact, it was the largest drop since WWII that was not part of a recession! Weakness, generally blamed on harsh winter weather, was widespread. The balance of trade was particularly negative due to both rising imports and falling exports. The combination drove the Net Exports category to its largest drag on economic growth in nearly four years. Government spending, following a rather rapid decline in the final quarter of 2013, continued to be a headwind this year. In contrast to the notion of countercyclical spending, the government has now been a drag to economic growth in 14 out of the past 19 post recession quarters. Consumer expenditures, 69% of GDP, rose at a tepid 1.0% rate and investment spending, both business and residential, was disappointing. Importantly, housing investment declined for the second quarter in a row. This is notable for a number of reasons, not the least of which is the fact that it is a key metric for Federal Reserve Chair Janet Yellen. Lastly, in contrast to widespread accounts and popular belief, inventories did not actually contract in the first quarter, they rose. The pace of inventory gains simply fell shy of the stunning buildup witnessed in the latter half of 2013. In GDP mathematics, a slower pace of inventory growth is a negative.

Admittedly, a summary of the first quarter is not particularly upbeat or pleasant - a 2.9% decline in GDP never is. The silver lining is investors and economists rapidly dismissed the outcome as anomalous, probably

correctly, and relegated results to the history books as if they never happened. Importantly, results from the just completed second quarter are expected to show a bounce in growth to 3.0%. For the full year, U.S. GDP growth is expected to be 2.0%, the same rate as the previous three years.

Turning to the global economy, the International Monetary Fund (IMF) and the World Bank each trimmed their 2014 global growth forecasts, to 3.6% and 2.8%, respectively. Factors cited by these institutions included an unusually cold winter in the U.S., the Ukrainian crisis, poor European and Japanese growth, and struggling emerging markets, many of which are challenged with higher borrowing costs. The Organization for Economic Co-operation and Development (OECD) also cut the growth outlook for its 34 member nations.

The graph below shows leading economic indicators for the world's major economies.



Organization for Econ. Co-operation and Dev.

Through the first quarter, the data shows a mixed bag. The euro zone and the U.K. have shown positive improvement and the U.S. appears fairly stable. Japan rolled over as the year began, and China and India have had negative trends. The following are brief summaries of key economies.

Europe

Following tepid annualized growth of 0.8% in the first quarter, Europe's purchasing manager's report for April showed growth in every country for the first time since late 2007. Also in April, euro zone unemployment fell slightly and industrial production bounced higher. Despite modest improvement, however, European growth is anemic, unemployment is staggering (26

million people), and deflation is knocking on Europe's door. Debt is dangerously high almost everywhere and bank lending has declined for nearly two years. The resulting scarcity of credit is a drag on the economy. As discussed in greater detail later, in June the European Central Bank (ECB) instituted an aggressive set of monetary programs to help lift inflation, weaken the euro, and provide needed credit to the economy.

China

As the year began, industrial output fell to its slowest pace since 2009 and retail sales growth dropped to a two year low. Annual growth through the first quarter came in at 7.4%, and data suggests second quarter activity decelerated from there. For the first quarter, Chinese banks reported the largest jump in bad loans since 2005 and the tenth straight quarter of rising defaults. At present, China is expected to grow 7.3% this year, the slowest pace since 1990 and below the government's target of 7.5%. In response, steps were taken during the second quarter to support growth goals. Increased spending on railways, tax relief for small businesses, and targeted monetary initiatives (i.e. reduced reserve requirements) were all implemented during the period. Fortunately, the economy showed signs of stabilization toward the end of the second quarter. Industrial production edged up in May, the pace of property price declines slowed, retail sales improved, and exports ticked higher.

Japan

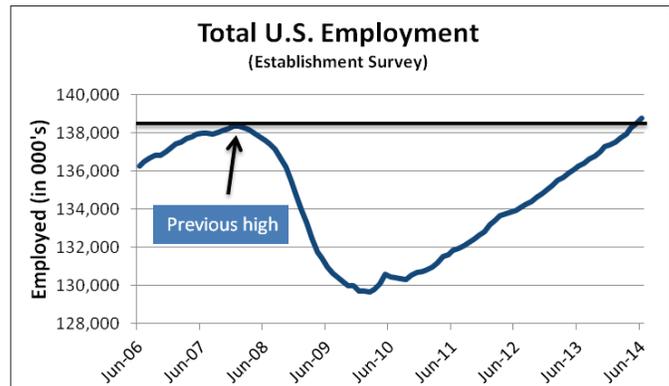
The nation is expected to grow less than 1.0% in the fiscal year that began in April. Considering exports out of Japan are presently challenged, however, this export dependent forecast is somewhat questionable. On the positive side, the country is experiencing success in its goal to push inflation higher. Likewise, the sales tax hike initiated in April does not appear insurmountable as evidenced by a rise in business confidence in May. Furthermore, perhaps by the law of unintended consequences, the tax has helped Japan's trade deficit through diminished spending on imports.

Britain

The U.K. is likely to be the fastest grower of the G7 economies this year and may be the first to institute tighter monetary policy. The (OECD) raised the nation's 2014 growth forecast from 2.4% to 3.2%.

Employment

Following weather related weakness, the labor market bounced back in the second quarter. Payroll growth exceeding 1.2 million over the five month period ending in June was the fastest pace of gains since early 2006. Additionally, all jobs lost in the recession have now been replaced.



U.S. Department of Labor

While the recovery illustrated in the previous graph is a positive, it fails to account for population growth of 15.2 million individuals since the previous peak. The resulting 10.0 million increase in the labor force suggests significant repair is yet needed to fully heal the labor market.

As for other employment metrics, many have shown improvement. Initial jobless claims, weekly hours worked, and job openings relative to job seekers are all back to pre-crisis levels. Even the rate of unemployment, at 6.1%, is not tremendously above the 5.5% rate believed by economists to represent full employment.

Other key metrics do remain out of sync with historical norms. The participation rate has declined dramatically and wage gains have been weak in the post crisis recovery. Both have negative implications for economic growth. Additionally, the number of people working part-time that would prefer full time work is high and workers classified as long-term unemployed (in excess of 27 weeks) remains elevated.

The latter two metrics are critical to Janet Yellen. To her, a plethora of part-time workers and legions of long-term unemployed people represent economic slack well within the Fed's mandate to promote maximum

employment. A close watch on these two metrics will provide a window into Fed policy.

Real Estate

The housing market has shown some signs of improvement from various headwinds over the past year, but conclusive evidence of an uptrend is lacking.

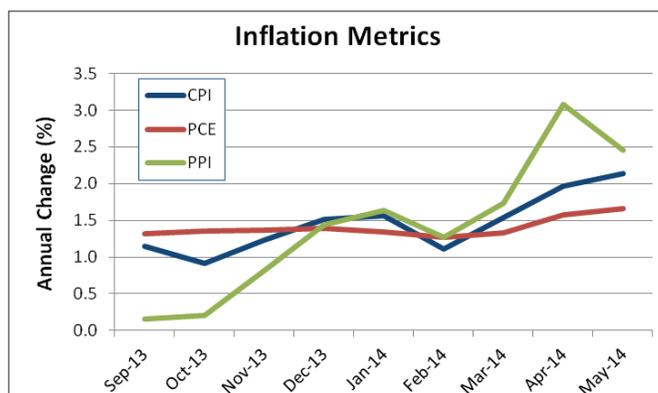
- Mortgage rates are at a seven month low, and housing affordability has improved from a trough last summer.
- New and existing home sales improved recently, including upward spikes for both in May.
- Sequential monthly price gains continue, but in fewer markets and at a much slower pace.
- U.S. homebuilder sentiment rose nicely in June, but remains just shy of what is considered good building conditions.
- Building permits have shown little progress over the past year, and inventory of new homes remains low. Both are impediments to construction activity and future sales.
- Homeowners are in better shape..... Delinquency rates were down 24% in the first quarter from the prior year with all 50 states showing improvement.
- ...but many are not out of the woods yet. Over six million families are still underwater on their mortgages.

As with particular employment metrics discussed earlier, the housing market is a key focus for Janet Yellen. Fundamentals are clearly not as bright as they were earlier in the recovery. Absent improvement, the Fed will be less inclined to moderate accommodative monetary policy.

Inflation

Low inflation has enabled, and to some extent required, the use of aggressive and unconventional monetary policies in the U.S. Recent price gains have moved closer to, if not above, the Fed's target of 2.0%.

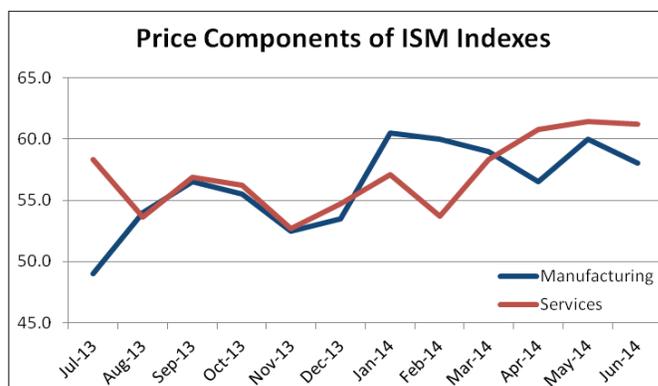
Furthermore, evidence suggests pricing pressures are in the pipeline.



U.S. Department of Labor, U.S. Federal Reserve

- The Producer Price Index (PPI), shown above, is a leading indicator of future consumer prices. Its trajectory speaks for itself.
- The CRB Commodities Index rose 10% in the first half of 2014.
- Research suggests wage pressures are more closely tied to short-term rather than total unemployment. The rate of short-term unemployment is now back to 2007 lows.
- The price components of the ISM indexes portray not only rising prices (over 50 in the graph below), but accelerating price gains for the past year (a rising trend above 50).

Ingredients for more rapid inflation are coming together, and data suggests the economy may be in the early days of such an environment. If so, Fed plans may change and policy rates may move earlier and/or faster than current guidance or market expectations.



Institute for Supply Management

Monetary Policy

The world's central banks are geared up to stay loose or loosen further.

U.S.

Fed Chair Janet Yellen maintained a generally upbeat posture throughout the quarter, but gave assurances - repeatedly - that the Fed intends to keep rates low for a considerable period of time following the wind down of asset purchases. Her focus is on low inflation, a slump in housing, geopolitical tensions, and economic slack. The jobless rate remains elevated in her view. She also highlights those unemployed in excess of six months and others working part-time who would prefer fulltime jobs. Although improved, both metrics remain at historically high levels. Market expectations suggest the end of Fed asset purchases in the fall and the first hike in rates to begin around the middle of 2015. Despite Fed rhetoric, the recent burst in inflation and somewhat rapid drop in unemployment leaves one to wonder if the Fed should/will move the time table forward.

United Kingdom

The nation's recovery is strengthening and unemployment in the first quarter fell to the lowest level in over five years. Despite gains, the Bank of England (BOE) reports inflationary pressures remain subdued. Currency strength has helped in this regard. Subject to continued containment of inflation, monetary policy is on hold waiting for idle capacity to be absorbed. The BOE is likely to be the first major central bank to start to tighten, an event expected to take place in the second quarter of 2015, but may happen sooner.

Euro zone

The primary issue for the region is weak inflation and its close cousin, currency strength. Both have negative implications for global competitiveness, purchasing behavior, and debt management. Pressure mounted during the quarter for the European Central Bank (ECB) to be more aggressive. The International Monetary Fund (IMF) and the Organization for Economic Co-operation and Development (OECD) each pushed for greater action to fight low inflation. Even Germany, heretofore opposed to unconventional monetary policies, declared willingness to back a number of ECB stimulus

measures. The ECB came through in June. Various policy rates were cut, including an unprecedented drop in the deposit rate to -0.1%. A new set of long-term loans, tied to lending, will also be offered starting in September. Lastly, monetary sterilization will cease, and prep-work is being done to buy asset backed securities.

China

Facing weak output, investment, and consumption, more stimulus is expected for the country to hit its 7.5% growth target for 2014.

Japan

Despite IMF encouragement to do more, no changes are presently expected to what is already the most aggressive stance among global central banks. Continued annual expansion of the monetary base by ¥60-70 trillion yen (\$590-690 billion) is expected. Of note, for just over a year the Bank of Japan (BOJ) has bought 70% of all newly issued government bonds and nearly all new 10-year notes. The BOJ is now the largest holder of Japanese sovereign debt, holding just over 20% or \$2 trillion.

Governments, Politicians & World Events

Ukraine

Efforts to regain control in the east were largely stymied for much of the quarter as Russia remained aggressive in the region. Importantly, rather than annexing the southeastern part of Ukraine, as it did with Crimea, it appears Russia's goal is to hinder Ukraine's European ambitions. As the quarter drew to a close a number of factors helped stabilize the Ukrainian situation.

- U.S. and European sanctions, actual and threatened, have been impactful.
- Russia has experienced material capital outflows and currency weakness due to geopolitical fears. The economy is on the verge of recession.
- Ukrainian presidential elections held at the end of May demonstrated an overwhelming desire to remain independent and move directionally in favor of a pro-European platform. Russia accepted the results and indicated a willingness to work with the new government.

- Ukraine's new president became aggressive militarily following the end of a cease fire. Resulting engagements were successful, removing rebels and reclaiming lost territories.

Although some progress has been made, Ukraine's economy will shrink at least 5% this year, even without war. Higher energy prices are coming and social upheaval, even civil war, are real possibilities.

Iraq

Sunni insurgency in the country poses added geopolitical uncertainty. As OPEC's second largest oil producer and the seventh largest in the world, disruption of Iraqi oil production would have a detrimental impact on world oil prices, which rose in response to the turmoil. Global leaders are exploring avenues to control the insurgents. For now, hot spots are not near Iraq's oil producing region.

Thailand

In May, two days after declaring martial law, Thailand's military staged a coup. The elected government was forcefully removed. How the situation plays out is not yet known, but investment markets have taken the news in stride.

Capital Markets Review and Outlook

Overview

Investment markets have not behaved according to plan this year. Rather than dollar strength, the currency has been modestly weak. Bond yields, expected to rise modestly, have actually fallen. Commodities, municipal bonds, utilities, and real estate, left for dead after a poor 2013, have been particularly strong performers in 2014. Lastly, expectations for greater market volatility have been met with the lowest volatility since before the crisis, nearing an all-time record low.

For the quarter, stocks and bonds delivered mid to low single digit returns. Year-to-date, in stark contrast to 2013, the dispersion of asset class returns was amazingly tight. A 2.0% - 8.0% range encompassed the return of nearly every major asset an investor could own.

Equity Markets

The dispersion of equity returns was very tight for the quarter. Domestic and international stocks performed

Capital Market Returns	2nd Qtr 2014	Year-to-Date
Cash and Fixed Income		
U.S. Treasury Bills	0.0 %	0.0 %
Barclays Aggregate Bond	2.0 %	3.9 %
Barclays Municipal Bond	2.6 %	6.0 %
Barclays Gbl Agg. ex. U.S.	2.7 %	5.6 %
Domestic Equities		
Wilshire 5000	4.9 %	7.9 %
S & P 500	5.2 %	7.1 %
Russell 2000	2.0 %	3.2 %
International Equities		
MSCI ACWI ex. U.S.	4.9 %	5.8 %
MSCI EAFE (Developed)	4.1 %	4.8 %
MSCI EM (Emerging)	6.6 %	6.1 %
Hedge Funds and Alts.		
Bloomberg Commodity	0.1 %	7.1 %
DJ US Real Estate	7.1 %	16.4 %
HFRI FOF Composite	1.4 %	2.0 %

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comparably. Modest dollar weakness, particularly against emerging market currencies, enhanced international returns for dollar based investors. Large and mid cap stocks slightly outperformed small, and value stocks edged out growth.

Fixed Income Markets

Interest rates were driven lower in the quarter by slow economic growth, strong demand, subdued supply, low inflation, and geopolitical uncertainty. Covering of short Treasury positions and front running anticipated ECB asset purchases were most surely factors as well. On the latter point, the ensuing rally in euro zone bonds led the IMF to warn that [European bond] markets were priced for perfection, posing an elevated risk of disappointment.

On a quest for yield, investors drove high yield debt spreads lower and absolute yields below 5% for only the second time in history. Even with junk bond defaults running at about 2%, this paltry absolute yield provides little buffer should markets grow concerned about the economic outlook.

Closing Comments

Looking forward, caution is warranted. Based on the Case-Shiller cyclically-adjusted price-earnings ratio, the U.S. stock market has been this expensive on only three other occasions in the past 130 years - 1929, 2000, and 2007. Historians will attest to the unpleasant aftermath of these periods. Several measures of investor sentiment are also at very optimistic levels. Moreover, the central bank driven world of artificially depressed yields and manufactured asset demand has driven many to migrate from a focus on absolute values and expected returns to one of relative opportunities *between* asset classes - i.e. lacking consideration of intrinsic value. This type of mindset can lead to both market imbalances (bubbles) as well as a disregard for risk. Regrettably, despite their validity, these

observations have limited utility in attempting to time markets or reposition portfolios. After all, a review of the monetary policy section of this newsletter suggests continuation, if not acceleration, of the aggressive policies that have brought us to this point in the first place. The best response is to maintain a well diversified portfolio with an appropriate level of risk for your particular situation. Market volatility (i.e. frightening and disappointing markets) will come, but these occasions should be used to harness the value of portfolio rebalancing. Lastly, avoid significant allocation changes from well thought out portfolios. These are almost always emotionally driven and nearly universally damaging to the generation of wealth and the preservation of capital.

Disclaimers

This market commentary was written by Robert W. Lamberti, CFA, a Principal of and Vice President of Investments for Summit Financial Resources, Inc. 4 Campus Drive, Parsippany, NJ 07054. Tel. 973-285-3600, Fax: 973-285-3666. Sources of Performance: Morningstar®. Indices are unmanaged and cannot be invested into directly. The investment and market data contained in this newsletter is not an offer to sell or purchase any security or commodity. Standard & Poor's 500 Index (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. The Wilshire 5000 Index is a market capitalization-weighted index of the market value of all stocks actively traded in the United States. The index is intended to measure the performance of all U.S. traded public companies having readily available price data. The MSCI Emerging Markets Index is an index created by Morgan Stanley Capital International (MSCI) that is designed to measure equity market performance in global emerging markets. Emerging markets are considered risky as they carry additional political, economic, and currency risks. Real Estate Investment Trusts, REITs, are securities that invest in real estate directly, either through properties or mortgages. REITs receive special tax considerations and typically offer investors high yields, however, have liquidity constraints. The Barclays Capital U.S. Aggregate Bond Index is a market capitalization-weighted index comprising Treasury securities, Government agency bond, Mortgage-backed bonds, corporate bonds, and some foreign bonds traded in the U.S. Fund Category Performance is not inclusive of possible fund sales or redemption fees. Investment grade bond analysis included bonds with ratings of AAA, AA, A, and BBB. Municipal and Corporate Bonds are backed by the claims paying abilities of the issuer. TIPS are inflation-indexed securities issued by the U.S. Treasury in an effort to widen the selection of government securities available to investors. Past performance does not guarantee future results. Information throughout this Newsletter, whether stock quotes, charts, articles, or any other statement or statements regarding market of other financial information, is obtained from sources which we, and our suppliers believe to be reliable, but we do not warrant or guarantee the timeliness or accuracy of this information. Neither we nor our information providers shall be liable for any errors or inaccuracies, regardless of cause, or the lack of timeliness of, or for any delay or interruption in the transmission thereof to the reader. Opinions expressed are subject to change without notice and are not intended as investment advice or a guarantee of future performance. Consult your financial professional before making any investment decision.

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