Outlook for August, 2013: "New Highs!…"

US Equity markets continue to ***rejoice, hitting all time highs across the capitalization spectrum*** – with small-cap and mid-cap indices outperforming the S&P500. Market participants appear to be rerating valuation mutiples in a context of renewed confidence in the Federal Reserve's largesse as well as better economic outcomes.

Second quarter's Gross Domestic Product (or GDP in econospeak), as measured by the Commerce Department's Bureau of Economic Analysis, posted a ***rise of 1.7%*** (seasonally adjusted annual rate), topping consensus expectations of 1.1%. The BEA also completed an exhaustive recharacterization of expenditures going back to 1929, including those on research and development costs and intellectual property – both of which will now be treated as additions to assets as opposed to expenses.

As a result, first quarter's GDP growth rate was revised down to 1.1% from a previous release of 1.8%, and annual growth rates for the prior three years were adjusted to 2.8% in 2012, 1.8% in 2011, and 2.5% in 2010. The current pace of growth is ***well below the long-term rate*** of just over 3%. GDP is not a leading indicator of markets or the economy and as such, the upward revisions do not alter the business climate nor do they change our recollection of history.

On the ***labor market front***, the U.S. economy added 162,000 nonfarm payrolls in July, slightly below forecasts for 175k. Payroll additions for May and June were revised downwards by an aggregate 26k, further suggesting that the process of healing in the labor market is a slow and arduous one. July's report showed private payrolls increasing by 161k as retail trade (+47k), food services and drinking places (+38k), financial activities (+15k), and wholesale trade (+14k) led the gains. Government payrolls actually increased by 1k, bucking a long declining trend.

The separate household survey reported a drop in the ***unemployment rate from 7.6% to 7.4%,*** the lowest level since December 2008; however, roughly half of the decline came from job seekers dropping out of the workforce. This takes the year-to-date monthly average to 192k, a decent number, but far from what is required to bring the economy back to "full employment". A more realistic representation of unemployment, the so called ***U-6 measure***, that includes these discouraged workers, posted a decline from a seasonally adjusted 14.3% ***to 14.0%.***

The ***ISM manufacturing report*** showed a remarkable gain from 50.9 to 55.4, making this the largest one-month increase since 1996. In the report, new orders, production, and exports were strong. The non-manufacturing (service sector) ISM activity report also gained a similar margin rising from 52.2 in June to 56.0 in July. Taken together these reports imply that businesses might be finally coming out of their funk from the financial crisis as it relates to ***aggregate demand.***

The policy setting meeting of the ***Federal Reserve's FOMC*** ended with very little change in direction. There has not been significant improvement in labor markets or economic activity and inflation is hovering near 1%, far below the Fed's goal of 2.0%. It appears that the current policy of purchasing $85 billion in securities by the Federal Reserve every month will likely continue – despite worries last month about "tapering". The only other notable tidbit is that the Fed used the term ***"modest"*** to describe the most recent confluence of data points, a downgrade in the eyes of some code crackers from the assessment of ***"moderate"*** used in the previous FOMC Statement.

Many commentators from the left side of the political spectrum (including such luminaries as ***Paul Krugman and Joseph Stiglitz***) have come out in support of Ms. Yellen's candidacy for the next Fed Chairman, pointing out that her economic forecasts have been the most accurate among all the Fed Governors: That is not saying much, since history is replete with examples of Fed forecasts that have gone awry! President Obama seems to have also suggested that Donald Kohn – a respected former Fed Governor – might be a good choice.

The debate among talking heads on television about what each person means for the future of the Fed, for Quantitative Easing, and for markets is incessant. Our own opinion is that it matters little in terms of the specific person – since the next Fed Chairman is likely to have a very tough job of figuring out the exit from Quantitative Easing with as little disruption to markets as possible. Regardless of who gets the job, we would put this under the category of ***"be careful what you wish for, as you might get it!"*** Stay tuned on this one.

The ***S&P 500 passed 1,700*** for the first time ever and we reached all-time highs in the Dow, mid-cap and small-cap indices. The question remains, how much higher can we go? While central banks continue playing the music, we must not forget that companies are still producing decent earnings. So far, second quarter earnings show profit growth remains reasonable, but sales appear to be flat. What this tells us is that companies are continuing to produce earnings by cost cutting and restructuring debt at historically low interest rates (thank you, Uncle Ben).

Volatility in U.S. equity markets is low, with the S&P 500 daily volatility (measured as an average of the previous 90-days) currently at 0.71%. For a little perspective, daily volatility ***peaked*** at just over ***4.50%*** during the turbulent days of 2008; that's over 6 times more volatile than today. Surely, central banks' unprecedented easing which is responsible for all the liquidity in the system is one of the reasons for this lower volatility – which does imply that volatility could rear its ugly head once the "ultra-easy" monetary policy period ends.

We also think that investors in general, are ***under-invested*** in the equity market for a variety of reasons: The extent of uncertainty regarding fiscal and monetary policy combined with the perceived lack of earnings visibility are two reasons for this state of affairs. Also, the experiences of 2008/09 are still very fresh in investors' minds – thus leading to many investors not believing in the upward movement in equities. We suspect that this fact alone could prove to be a ***major positive*** for equity markets going forward.

International equity markets have also generally under-performed US equity markets on a year-to-date basis. Specifically, ***emerging markets*** have posted sizable ***negative returns*** for a variety of reasons: A slowdown in China (whether it is planned or unplanned is yet to be determined), increasing social fissures in Brazil, worries about currency declines in India (with the Indian Rupee hitting all time lows against the US Dollar) and ongoing worries about ***risk premia*** are all partially responsible. We still think there is greater downside in emerging markets in the near to medium term, but we are now ***interested watchers*** of this asset class.

News of the City of Detroit filing for bankruptcy protection under Chapter 9 caused everyone to stop and reflect on how all this transpired. What was once the face of American ingenuity and good old capitalism is now in the record books as the nation's largest municipal bankruptcy in history. While few people were surprised that it happened, (Detroit has been in a downward spiral for many years), many called for a federal bailout, as if that would change their ways. Detroit is a poster child for local government run amuck and elected officials making fiscal promises they could hardly keep.

While equity markets continue to rejoice as a result of excess global liquidity, we would characterize valuation mutiples as being "reasonable". Make no mistake, while we would like to continue to ***"make hay while the sun shines",*** we are not implying that we ought to ***"throw caution to the winds"!*** As always, our abiding faith in a ***fully diversified portfolio*** - that has a balanced approach to both risk and return - as the main way to attain ***favorable investment outcomes*** over the long haul remains steadfast.

This report was prepared by

Suresh Raghavan, CFA and Clark Blackman III
MBR Financial, Inc.
2000 West Loop South, Suite 1510
Houston, TX 77027

www.mbrfinancial.com

For further information please contact us at
Voice: 832.667.8787
Fax: 281.974.2108
Email: contactus@mbrfinancial.com

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