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While stocks closed out the first quarter of 2013 on a high note, this second quarter has ended +2.27% for the Dow, +2.36% for the S&P 500, and +4.15% for the NASDAQ after a modest correction over the last few weeks. But what was most remarkable was the sell-off in the Treasury market while the price of gold tumbled 23%. The 10-year Treasury bond yield (which moves inversely to the price of the bond) hit a low of 1.66% on May 2 and quickly rose to a high of 2.58% during the quarter. The sell-off in bonds has been expected, but not at the rapid rate that we have seen. So what has caused this? To state it simply, when Fed Chairman Ben Bernanke spoke in May and then again in mid-June about the Fed beginning its exit strategy--the "tapering"-- from its easy-money policies, it spooked the markets, even though he said it would not begin until the end of the year, or possibly even next year. *But maybe what this talk of "tapering" has done is to rein in asset prices and manage investors' expectations.*

We see the U.S. economy continuing to show signs of improvement, but the data appears mixed. Housing is better, both in starts and home prices. Job growth continues, inflation is tame, domestic energy independence continues to gain traction, consumer confidence is up, and the service-side of the economy, as measured by the ISM Non-Manufacturing Survey, is improving. But on the flip-side, first quarter GDP is disappointing, mortgage rates are rising (although far from historic levels), job growth is slower pace than expected, and manufacturing is showing softness not seen since June of 2009.

What is happening outside of the U.S. is also a mixed picture. Last quarter it was the tiny country of Cyprus that caused concern around the world, this quarter it is China. Signs of China slowing and uncertainty in their banking system will give investors little confidence until they see stabilization of its economy. The emerging markets continue to be weak, but more recently there is weakness in their currencies and bonds. On the positive side, the Eurozone may be improving, or at least bottoming, as the fiscal drag this year seems to be less severe than in 2012. Japan has also had a remarkable recovery, although it has come with extreme volatility.

The Fed's talk of returning to a more normal monetary policy is encouraging; however this will bring continued volatility like we have seen over the last few months. However, it only stresses the importance of sticking to your long-term goals, proper diversification, and buying only the best companies with good balance sheets and good valuations. For portfolios with bond exposure, we focus only on high quality, short to intermediate maturities where we hold the bonds to maturity. We see the market volatility as opportunity to add new stock ideas as well as to add to existing positions.

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