INVESTMENT COMMENTARY

July 2014

First Half Review, Second Half Outlook

As indicated in our previous Investment Commentary, we have been cautious on the broader market given its move higher over the past two years without experiencing a noteworthy correction. Well, in spite of the market's impressive buoyancy in light of recent geopolitical events in the Middle East, we remain cautious near-term. Just as difficult as predicting the timing of a market "pull back" can be, sometimes it is just as difficult predicting the cause of one. We, therefore, are relying primarily on historical averages and statistical norms of market valuations, investor psychology, and seasonal/historical trends to support our cautious stance. For our readers who may need a "refresher" on this information, we encourage you to read our Investment Commentary from the previous quarter. It can be viewed on our website, www.capsecman.com, if you do not have a copy. We realize, of course, that there are always periods of time that defy the historical and statistical norms and we try to anticipate those outcomes while not making it our "base case" forecast. As a result, we currently have increased cash allocations in portfolios while seeking to keep pace with the market advance through careful management of equity holdings. So far this year, that strategy has served us well.

Let's review some detail of the market's performance for the first half of 2014. Through the first six months of this year, the S&P 500 has produced a gain of 7.1 percent. The chart below reveals the market's small dip in January and steady ascent.

S&P 500 YTD

We have essentially enjoyed a stock market backdrop wherein stock prices have steadily ascended higher for five of the past six months with very little volatility. While there has been some skepticism about the economic outlook, there has been little news that has negatively influenced the market lately. Economic growth is moderate and data has been generally positive suggesting a continuation of slow growth. Total nonfarm payroll employment rose by 288,000 for the month of June, indicating a strong spring economic snapback that could continue throughout the year. Interest rates have surprised many by actually declining over the first half of 2014, likely reflecting the tepid first quarter GDP numbers and the Federal Reserve's indication that rate hikes remain a year away.

Perhaps in conjunction with the move lower in interest rates, the top-performing sector year-to-date has been Utilities, producing a return of over 17 percent. This has been somewhat surprising, as typically this sector shines when the broader market is in decline, which has not been the case this year. This move higher in the Utilities sector is symptomatic of what appears to be an across the board "chase" in yield, which has also caused a rally in corporate and municipal bonds.

Energy sector year-to-date returns came in a near second, producing a return of over 14 percent. Oil stocks have benefited from the turmoil that has arisen in the Middle East and the prospects of potential supply disruptions. Additionally, many large exploration and production companies are experiencing continued production growth. In late June, federal oil regulators decided to allow exportation of crude oil condensates (a form of shale oil that's only slightly processed), softening a long-standing ban on crude oil exports that dates back to the oil embargo of the 1970's.

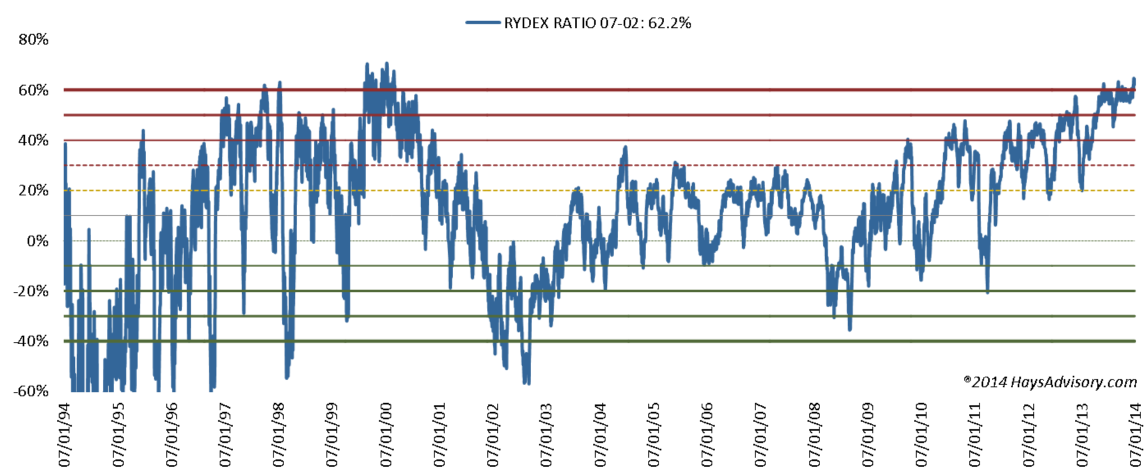
The most notable underperformer this year has been the Consumer Discretionary sector as housing and consumer spending seems to have been the most vulnerable to the first quarter economic slump of -2.9 percent GDP. After producing tremendous returns for investors last year, the Consumer Discretionary stocks were due for a "breather," which was likely triggered by an unusually cold winter that hurt the profits of many retailers. Having said that, the extreme underperformance of the sector so far this year may provide investment opportunities for the back half of 2014.

The broad disparity in sector performance in conjunction with what we view to be a relatively stable but improving economic environment, suggests that it may continue to be a stock picker's market for the foreseeable future. On the other hand, in light of the market's strong gains over the last few years, it has become more challenging to find new investing ideas with attractive valuations. It is our continued hope that a broad market correction would provide investors an entry point to reinvest at slightly better valuations - when that will happen remains difficult to predict.

The S&P 500 closed the second quarter having gone 51 sessions in a row without closing up or down more than 1%, the longest such stretch since 1995. Meanwhile, the CBOE Volatility Index hit its lowest level since 2007. It could be argued that this reflects a stable backdrop for equities, and seems to suggest growing investor complacency. A five-year chart of the volatility index or VIX can be seen on the following page. Please note the sharp spikes higher during periods of market decline.

RYDEX RATIO

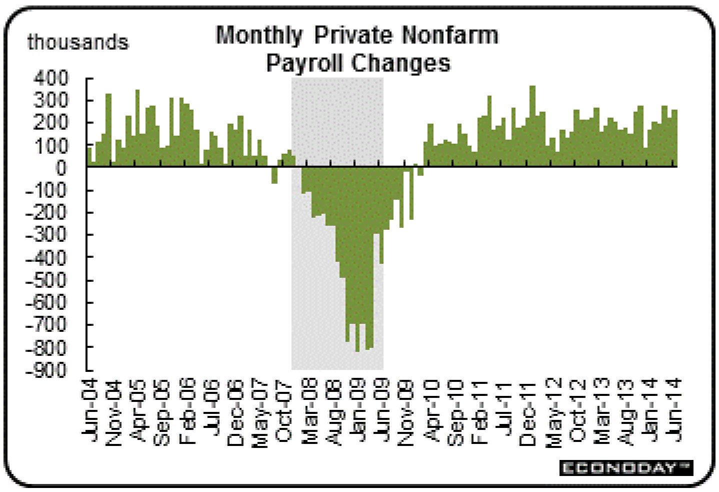
"One interesting note this week comes from our Psychology component. The Rydex Ratio, our most accurate Psychology indicator, is in very negative territory not seen since the euphoria of the Tech Bubble. While it doesn't feel like that period, this group of the trading public is behaving in a similar fashion." *Hays Advisory*



"The Rydex Ratio is a unique measure of market sentiment that is taken from the leveraged Rydex family of funds. This tells us how actual investors are positioning their assets. By dividing the total assets of Rydex bearish funds by the total assets of Rydex bullish funds, we have an excellent contrarian sentiment gauge to help access current levels of fear to greed. The higher the percentage of bullishness by this typically wrong way investor, the more bearish the indicator and vice versa."

Seems that more and more we are seeing market conditions return to those exhibited prior to the recession of 2008. Increased merger and acquisition activity, the valuations and debt terms commanded in recently minted deals, harkens back to 2007. These increased signs of confidence, by both corporations and investors, seem symptomatic to some sort of market high. That said, many of the structural flaws in the economy (i.e. housing bubble and banks levered to the mortgage market) that lead to market melt-down are very much absent, so we do not see a recession looming. In fact, we remain positive on the current economic expansion. Recent improvement in the employment numbers, pending home sales, and manufacturing all point to accelerating economic growth.

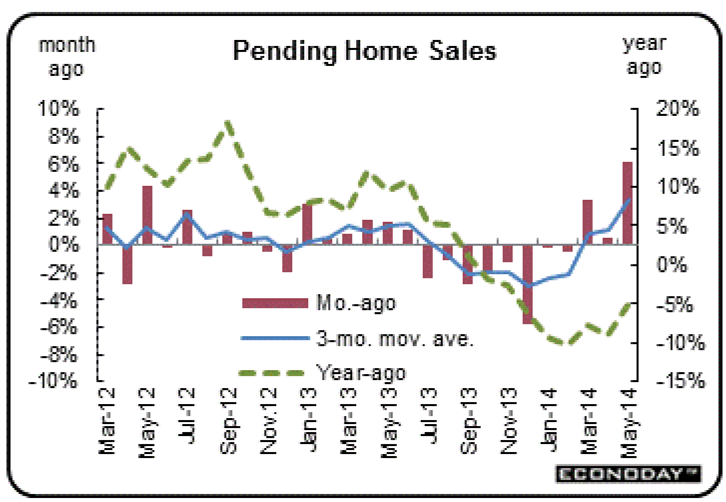
Jobs Show Unexpected Strength in June



“The labor market appears to be gaining momentum. Total nonfarm payroll jobs increased 288,000 in June after a 224,000 gain in May and a 304,000 rise in April. The net revision for the prior two months was up 29,000. The consensus forecast for June was for 211,000. April's gain was the first plus 300,000 figure since January 2012.

The unemployment rate surprisingly fell to 6.1 percent from 6.3 percent in May. Expectations were for 6.3 percent. The U6 underemployment rate edged down to 12.1 percent from 12.2 percent in May.”

Pending Home Sales Jump

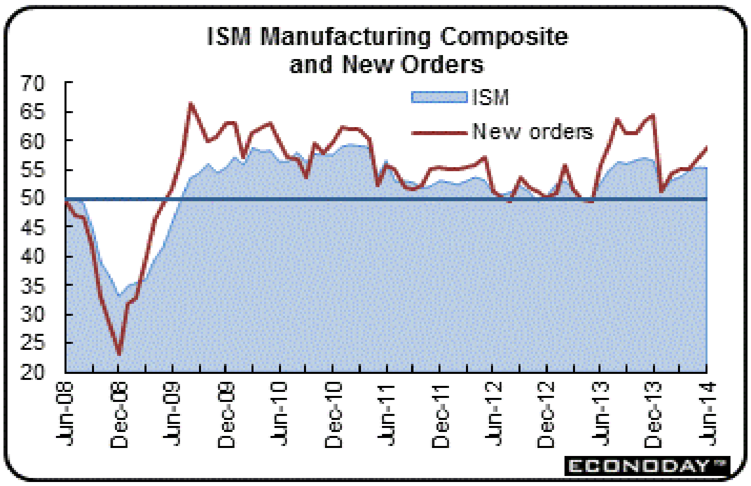


“Housing may be showing a spring thaw boost. Existing home sales, which showed life in April and especially May, may be showing more life in June and July based on pending home sales, which were up a very strong 6.1 percent in May. This gain, coming off a low base, was the largest since the housing stimulus efforts of April 2010.”

“All regions showed solid gains led by the Northeast, which has proven to be the strongest region for existing home sales, and followed by the West where sales have been the weakest. June data suggest a third straight gain for final sales of existing homes which would be the strongest run since this time last year, just before the Fed began to wind down stimulus.”

ISM Manufacturing Shows Improved Momentum

“The ISM manufacturing reports, new orders also were the key highlight of the ISM report for June, overshadowing the headline composite index, which held steady at 55.3. New orders rose 2.0 points to a very strong 58.9 that point to acceleration for general activity in the months ahead. Production, at 60.0 is already very strong as are imports, at 57.0 for a 2.5 point gain.”



Conversely, we do believe the stock market is becoming increasingly vulnerable to a notable market correction. As we have said many times before, we would view such an occurrence as healthy for the bull market's long-term health. Without one, we continue to grow cautious. In essence, we believe the stock market may be getting ahead of the economy.

In the short-term, our “crystal ball” seems a bit “cloudy,” but we endeavor to remain vigilant and proactive in our management of client portfolios, as we prepare for a market dip, while striving to keep pace with the market's advance. May our efforts prove both timely and effective! Only time will tell. In the meantime, have an enjoyable summer!