



Client Newsletter
Summer 2013

Dear Valued Client:

June 7, 2013

Welcoming the summer is always special and brings with it warm weather, outside activities, school breaks, and vacation planning. This year we have the added benefit of a recovering domestic economy and supportive markets that keep testing their historic highs!

Throughout the year we have seen the markets continue to be supported by Central Bank liquidity, gradual economic growth, improving economic indicators, a recovering housing market, and continued strong corporate earnings. We have all witnessed equity markets across the board, especially in the US, incurring robust returns since the start of the year. Although we always need to be alert, the return of volatility in the markets is real. This reality has come to fruition in the last week and half where equity markets are experiencing lower volume and short-term profit taking (yes, summer is officially here). That said we are not totally surprised to see some sort of pullback in the equity markets after seeing such strong returns.

On a separate note, we have started to witness what many feel is a definite reversal in Treasury Yields. The 10 year note has recently hit 2.16%, up from 1.88% at the end of March 2013. The key factor in this dramatic change derives from the Fed minutes that were released on May 22nd. The minutes disclosed that some officials were prepared to start pulling back the Quantitative Easing Program as early as the Fed's next meeting in June, though the group as a whole, expressed hesitance. This differs from Mr. Bernanke's comments in May where he stated the Fed could take a first step toward reducing the program at one of its next few meetings, but he cautioned that he was reluctant to move prematurely or aggressively. As a result, the markets, when information is murky, react abruptly and thus we have witnessed a surge in bond yields.

This is a typical market over reaction. We believe that bond yields will eventually rise to normal levels over time but at a much more gradual pace than what we have experienced in the past few weeks (yields dropped to 2.06% as of the close this Thursday). The Fed has indicated time and time again that high interest rates will hurt demand and hence slow down this recovering "slow growth" economy. It is hard for us to imagine the 10 year bond diverging too far from 2 percent in the near term without it affecting the housing recovery, refinancing opportunities, core inflation, and a myriad of other economic factors.

Locust Capital continues to use fixed income instruments in our client's portfolios to generate income. Our typical strategy is to recommend tax-exempt bonds and funds (for taxable accounts) and corporate bonds and funds (for tax-deferred accounts). We also recommend small allocations to high yield and foreign bonds and funds to take advantage of increased interest income from these higher risk investments.

As a reminder, fixed income investing incorporates the following risks:

1. Interest Rate and Market Risk
2. Credit Risk

Let's briefly summarize how Locust Capital presently handles these risks:

Risk #1:

We have, for the past two and a half years, been diligent about keeping the duration (maturity) of the portfolios short. Recently, our fixed income returns have been moderate but our strategy will show its resolve with limited principal depreciation in the rising rate environment. In addition, we will look to lock into higher yielding, strong credit quality instruments as our shorter term bonds mature.

Risk #2:

The credit quality of investment grade Corporations and Municipalities has significantly improved since the recession of 2008 and defaults rates have been extremely low. We look forward to taking further advantage of these investments as rates rise. Credit risk will always be a relevant issue but we mitigate this risk by using best of breed managers and funds.

At Locust Capital, we consistently preach that a solid investment plan entails a well-diversified asset allocation model coupled with tax efficiency as the most effective and prudent way to achieve investment success. Our comments in this letter do not change this opinion but rather, hopefully, provide insight to the present market landscape and our thoughts on today's markets.

As always, we are available to answer any questions or comments.

Enjoy the summer and time with family and friends!

Sincerely,

Locust Capital Management