Beacon Trust Quarterly

October 17, 2013

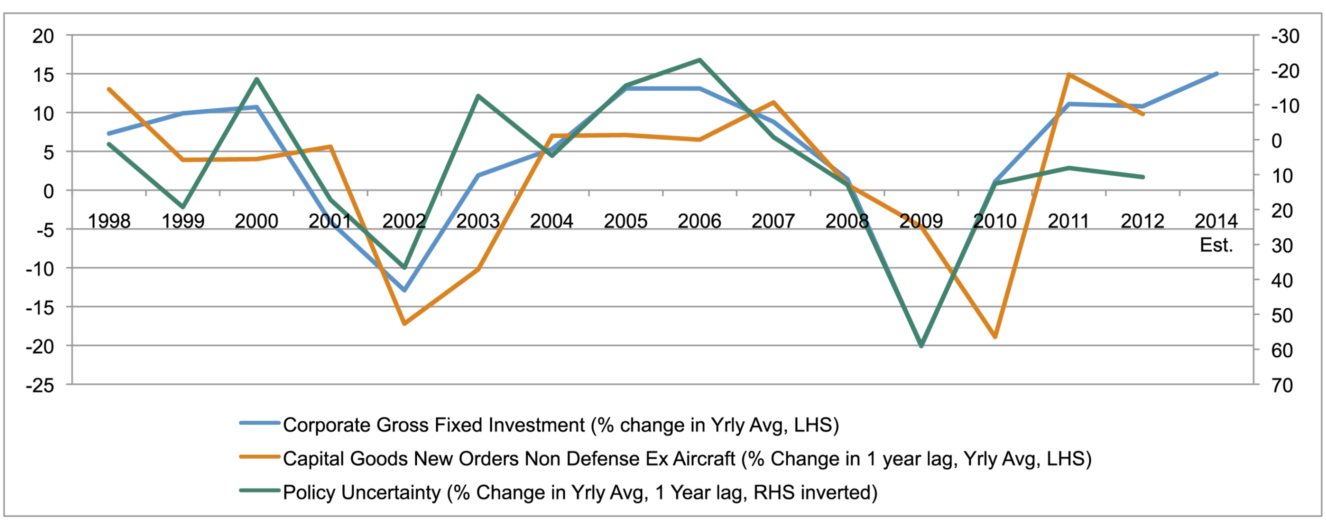
What's Working, What's Not

Even after the short-term agreement on the budget and debt ceiling, it would be a bit of a stretch to say that the government is functional. Undoubtedly, political risk is one of the toughest things to evaluate when assessing the outlook for capital markets. Financial Times columnist, John Authers, put political risk in perspective in his October 12th-13th weekend column: "For now, there remains a risk that stupidity will prevail. While that risk remains, managing money is hard. Investors who complain about politicians are fully entitled to do so." We thank Mr. Authers for that "pass," but it is still incumbent upon investment managers to anticipate political, economic, and capital market outcomes. So what is our prognosis?

It didn't take screaming Social Security recipients or a stock market implosion to end the government shutdown and raise the debt ceiling by $1 trillion. Sanity has returned to D.C., at least temporarily. US willingness to honor debt commitments will again be tested February 7. Other deadlines include budget deficit negotiations by December 13th and a continuing budget resolution by January 15th. So one eye must be kept on D.C. during the winter. In the meantime, investors can turn to more mundane topics such as the economy, the Fed and the capital markets. In addition to analyzing routine labor market, GDP and supply management survey data, it will be important to determine how business and consumer confidence and Policy Uncertainty will affect consumer spending and business fixed investment.

In the short run, monetary policy will continue to be supportive of risky assets (i.e. equities). The Fed should be legitimately concerned about the effect of D.C. paralysis on economic growth, business and consumer confidence, and investor sentiment. As such, the much-feared tapering of securities purchases will likely be on hold until early 2014. In addition, the dearth of economic data, coupled with the government interventionist leanings of new Fed Chairwoman, Janet Yellen, will give the Fed pause in changing QE policy abruptly. As politicians have come to their senses, we expect the stock market to follow suit and respond to monetary stimulus and modest economic expansion.

Against this backdrop, we expect rising dividend yields and compressed credit spreads will cause the S&P 500 to reach our upside target of 1,745 by year-end. For 2014, high single- to low double-digit stock market gains seem plausible. Fixed-income returns should pale in comparison as intermediate and long-term interest rates work gradually higher.



* R^2= 81%

Source: Federal Reserve; U.S. Census Bureau; Economic Policy Uncertainty

Tilts 'N Themes (TNT)

A growing number of stocks in our equity models (CORE and Income & Appreciation) are tied to specific sector/ industry tilts or investment themes. There are currently two industry tilts at work, biotechnology and housing, and one theme, defense.

The biotech tilt stems from our expectation that business investment will rebound significantly in 2014 and beyond. Biotech is an example of an industry that will benefit from profitable investment, in this instance R&D spending. Biotech stocks currently represent 6% of the CORE model.

The chart on the previous page depicts the impact of decreasing Policy Uncertainty and rising Capital Goods New Orders on Corporate Fixed Investment, which is projected to rise nearly 20% in 2014. Recent political dysfunction has been accompanied by what should be a temporary reversal in the downward trend in Policy Uncertainty.

Asset Allocation Strategy

During the third quarter, Asset Allocation models benefited from exposure to the Biotechnology ETF and an underweight position in Fixed-Income. The key detractor was an overweight position in the REIT ETF. As we start the fourth quarter, the models are positively disposed toward Domestic Equities (Biotechnology, Revenue-Weight S&P 500, Equal-Weight S&P 500, and Home Construction), International Equities, MLPs, and REITs. We continue to be underweight Domestic Fixed-Income with the exception of High Yield Bonds.

Fixed-Income Outlook

For the past year, we have clung to the notion that equities would outperform bonds from a total return perspective. Indeed, year-to-date as of 9/30, the bond market (Barclays Aggregate Index) is down 2%, while the S&P 500 Index is up 20%. We believe bond returns will continue to lag stocks in 2014. We would hasten to add, however, that bond yields are not expected to spike abruptly nor rise too far. Although Federal Reserve tapering of securities purchases is likely to begin in early 2014, the negative impact on rates will be tempered by other influences, in our opinion. The declining Federal budget deficit brings with it a shrinking supply of Treasury debt. Other higher rate triggers, such as rising inflation and increased credit demands, will likely remain muted. The Fed's Zero Interest Rate Policy (ZIRP) should remain in effect a few more years, providing somewhat of an anchor to yield levels. Following the Fed's taper head fake of last spring/ summer, 10-year Treasury bond yields rose 100 basis points to 3%. While yields have since retreated to 2.70%, tapering may be partially discounted. Overall, bond market returns will likely be flat to down slightly next year.

From a strategy standpoint, we prefer short-intermediate maturities (1-5 years) and credit product such as high yield bonds. Credit spreads are expected to remain compressed, and default rates should stay at historic lows given a modestly expanding economy. Finally, municipal bond yield levels are more attractive than investment grade corporate bonds for investors who can benefit from their tax-exempt status.

Alan D. Segars, CFA
Chief Investment Officer

Beacon Trust
Guiding you forward.
163 Madison Avenue, Suite 600 | Morristown, NJ 07960 | 866.377.8090 BeaconTrust.com