Market Commentary
Q2 2014

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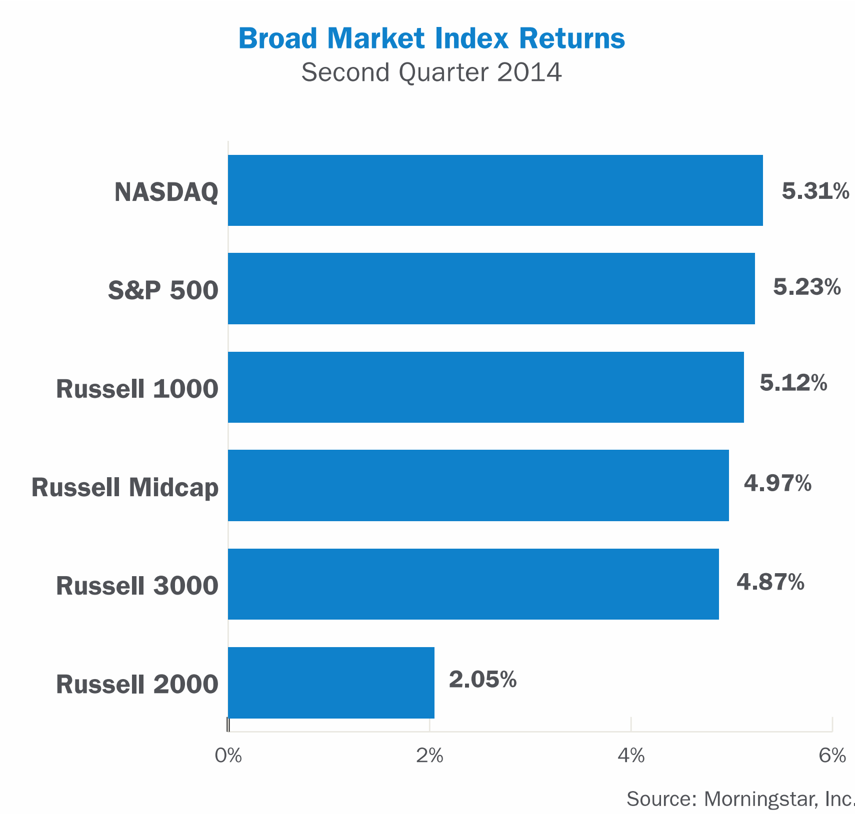
THIS IS A SAMPLE QUARTERLY REPORT LETTER THAT WE SEND TO OUR CLIENTS.

While many market watchers have been anticipating a correction, the market continued its upward trek. The second quarter saw most areas of the domestic and international equity markets solidly in positive territory. For the quarter, the S&P 500 was up over 5%, and year-to-date as of June 30 was up over 7%. Not to be left out, bonds also generated very good quarterly returns, which was nice to see following a challenging 2013 for bonds.

The Economy

The domestic economic landscape in the second quarter remained mixed, after the effects of severe weather in the first quarter lingered. The Bureau of Labor Statistics lowered its third estimate of first-quarter gross domestic product (GDP) to -2.9%, reflecting a broad-based contraction in many areas of the economy, including consumer spending, exports and business investment. It was the largest decline in GDP in five years. The employment situation continued its trend of modest improvement, with an average of about 200,000 jobs added each month during the quarter. In addition, payroll employment finally exceeded the pre-financial crisis peak, having recovered the 8.7 million jobs lost in the recession.



Globally, the themes remained similar to those that prevailed in the first quarter. The eurozone's recovery continued to be tepid, prompting the European Central Bank (ECB) in June to take the aggressive step of lowering its deposit rate to -0.10%, which means

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financial institutions must pay interest on funds held at the central bank and not loaned out. The move was an effort to avoid the prospect of deflation, and marked the first time a central bank instituted a negative lending rate. Real GDP in the eurozone region increased a meager +0.2% on a quarter-over-quarter basis, but the year-over-year growth was a slightly better +0.9%.

In China, policymakers continue to walk the fine line between reining in credit while at the same time avoiding too deep of an economic slowdown. Annualized GDP growth in the first quarter (the latest data available) was +7.4%, the lowest in six quarters. At the same time, tight credit and soft demand resulted in the weakest quarterly property-investment growth since 2009. Premier Li Keqiang stated during the quarter that growth needs to exceed 7.5% in order to sustain employment, and analysts believe the government will institute additional stimulus measures, should growth slow further.

During the second quarter the Federal Open Market Committee (FOMC) made few changes other than making further reductions in its asset purchase program. Analysts are now beginning to focus on what the FOMC plans to do with reinvestment proceeds of the securities on its balance sheet. The committee stated that it would continue to reinvest the proceeds, meaning that its balance sheet will not be reduced. Some economists have suggested that implementing a plan of not reinvesting the proceeds would essentially form a bridge to the next phase in the process, which would be an interest rate increase.

Highlights

GDP

The Bureau of Economic Analysis released the third estimate of the first quarter 2014 real GDP, a seasonally adjusted annualized rate of -2.9%, down from the 2.6% annualized growth of the prior quarter, and a significant reduction from the prior estimate for the second quarter of a -1.0% decline. The contraction was primarily a result of slowing consumer spending on healthcare and reduced inventory accumulation. Analysts attribute some of the weakening to the severe winter weather, even though the effect was not quantified in the report. Corporate profits fell by 9.1% (not annualized), after having risen 2.2% in the prior quarter. While the GDP result was discouraging, economists generally believe that the lower inventory accumulation will lead to an acceleration in growth down the road. Inflation remains relatively benign, with the personal consumption expenditures (PCE) index of prices gaining 1.4% during the quarter, up slightly from the 1.1% rate

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of the prior quarter. The consensus among economists is that the economy has strengthened significantly since the first quarter, with the improving employment situation being a solid indicator of the improvement. As a result, analysts expect GDP to accelerate to 3% later this year through 2015.

HOUSING

After somewhat of a pause in the first quarter, the housing segment once again proved to be a bright spot in the economy during the second quarter of 2014. Mortgage rates have come back down slightly after having risen late in 2013 and during the first quarter of 2014. In addition, credit requirements have loosened somewhat, as regulators attempt to increase credit availability through government-sponsored enterprises. Existing-home sales for May (the latest monthly data available) advanced at an annualized rate of 4.9 million units, the highest monthly percentage gain since August 2011. However, the pace of sales remains below the five-million-unit rate established in 2013. The inventory of existing homes is not as tight as it was last year, with 5.6 months of supply. Existing-home prices also continue to rise, but at a slowing rate, with the median price up 5.1% from a year ago. In the new-home segment, the NAHB Housing Market Index—a measure of homebuilding activity—ended the quarter at a level of 49, up modestly from the previous quarter's reading of 46. June was the first month this year in which the index rose. Economists believe a continued rebound in housing is likely, primarily as a result of relatively constrained mortgage rates and the ongoing improvement in the employment situation.

EMPLOYMENT

As many analysts had expected, the employment situation followed up a lackluster-but-resilient first quarter with a solid performance during the second quarter of 2014. Employment growth was strong in April, as 288,000 jobs were added, likely a result of hiring being pushed from the first quarter into the second as a result of the harsh winter. The May payroll report, the latest available, showed a gain of 217,000 jobs, below April's surge but in-line with trendline growth. The trend of approximately 200,000 new jobs each month has enabled payroll employment to exceed the pre-recession peak set in 2008. The unemployment rate in May remained unchanged from April at 6.3% as a result of little change in the labor force participation rate. While total payrolls now exceed the pre-recession peak, the rate of new jobs added will need to accelerate going forward in order to keep pace with the growth in the working-age population. Analysts expect employment to pick up to about 300,000 jobs per month in 2015.

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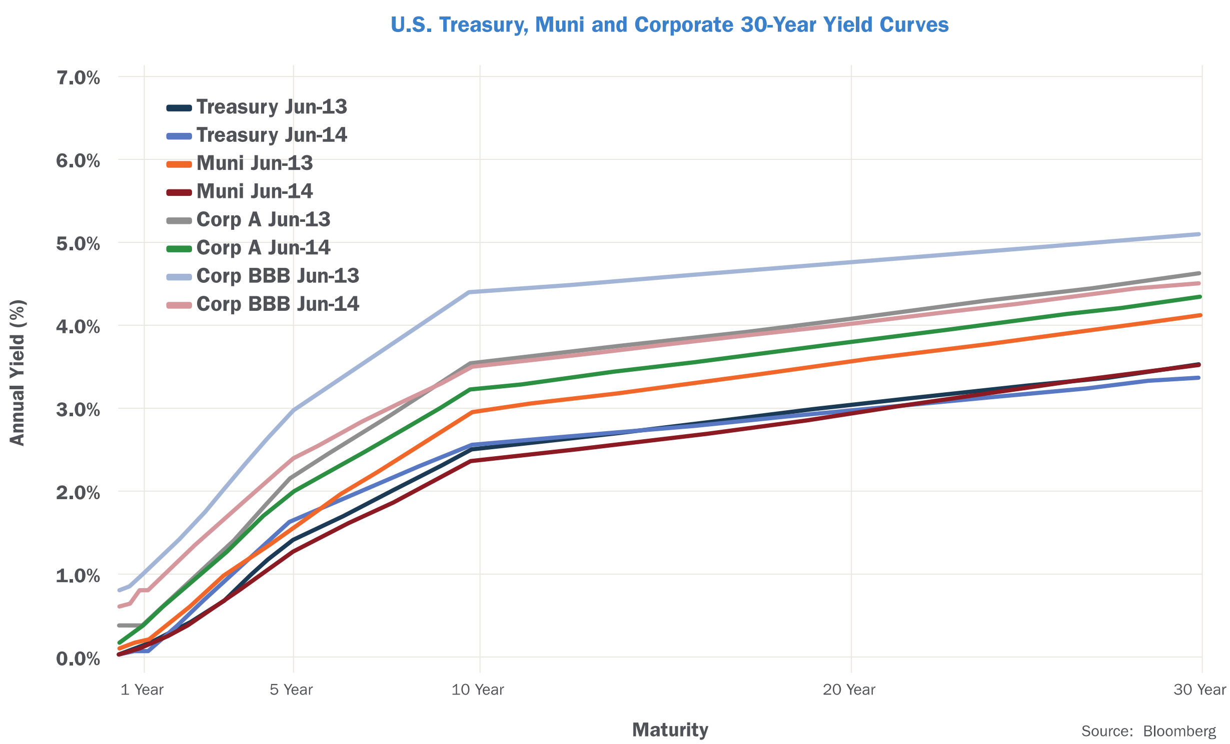
FED POLICY

The Federal Open Market Committee (FOMC), for the fifth consecutive meeting, decided to reduce its monthly asset purchases by $10 billion. The FOMC will now be buying $20 billion of Treasury securities and $15 billion of mortgage-backed securities, down from a total of $85 billion at the peak. In its announcement, the FOMC also lowered its estimate of the long-term Fed funds rate from 4% to 3.75%, likely reflecting the economic contraction of the first quarter. As the FOMC's asset purchase program winds down by the end of this year, attention is being paid to when the committee will refrain from reinvesting the principal payments from the debt it holds so that its balance sheet will be reduced. Fed-watchers believe that not reinvesting these payments will be the next logical step in the process prior to an increase in short-term interest rates.

Interest Rates

Fixed-income securities continued to defy many market analysts during the second quarter, following up the first quarter's rebound with additional solid gains. Once again, the key driver of the generally higher prices was concern about the pace of economic growth. Also, as in the first quarter, geopolitical issues played a role. The flare-up involving Islamic factions in Iraq caused investors to err on the side of safety in the second quarter.



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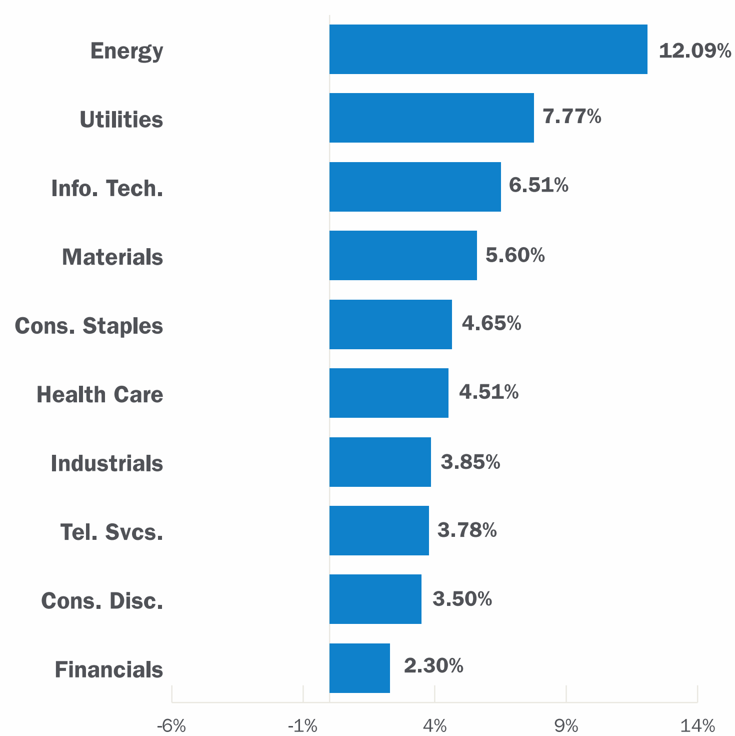
Within this environment, the shape of the yield curve remained relatively stable, as short-, intermediate-, and long-term rates moved modestly lower in concert. Yields trended lower throughout the quarter, confounding a large portion of market analysts, who have been expecting higher interest rates since the Fed announced the winding down of its asset purchase program in 2013. Municipal bonds posted a second consecutive strong quarter, as the fiscal situation of states and local governments continues to improve.

In terms of total returns, fixed-income securities generated relatively robust results in the quarter, with government securities-related, credit, and municipal indices all posting gains. The Barclays Capital US 5–7 Year Treasury Bond Index advanced +1.8%, and the Barclays US Treasury Corporate 5–10 Year Treasury Bond Index gained +3.0% during the quarter. High-yield securities also posted a solid return, booking a +2.4% advance. Municipals continued their recent good performance, as the Barclays Municipal Bond Index rose +2.6% for the quarter. International fixed income was also a strong performer during the past three months, with the Barclays Capital Global Aggregate ex-U.S. Index advancing +2.7%.

Equity Markets

The second quarter was marked by extremely low equity-market volatility, despite the uneven economic performance, tensions between Ukraine and Russia, flare-ups of violence in Iraq and other parts of the Middle East, and the ongoing reduction in asset purchases by the Fed. The Chicago Board Options Exchange SPX Volatility Index—better known as VIX—finished the quarter at 11.6%, its lowest quarterly close since December 2006. When volatility is low, equities tend to trend higher, and that was the case in the second quarter. The S&P 500

U.S. Equity Market Returns by Major Sector
(GICS Sectors in S&P 500, Second Quarter 2014)



Source: Morningstar, Inc.

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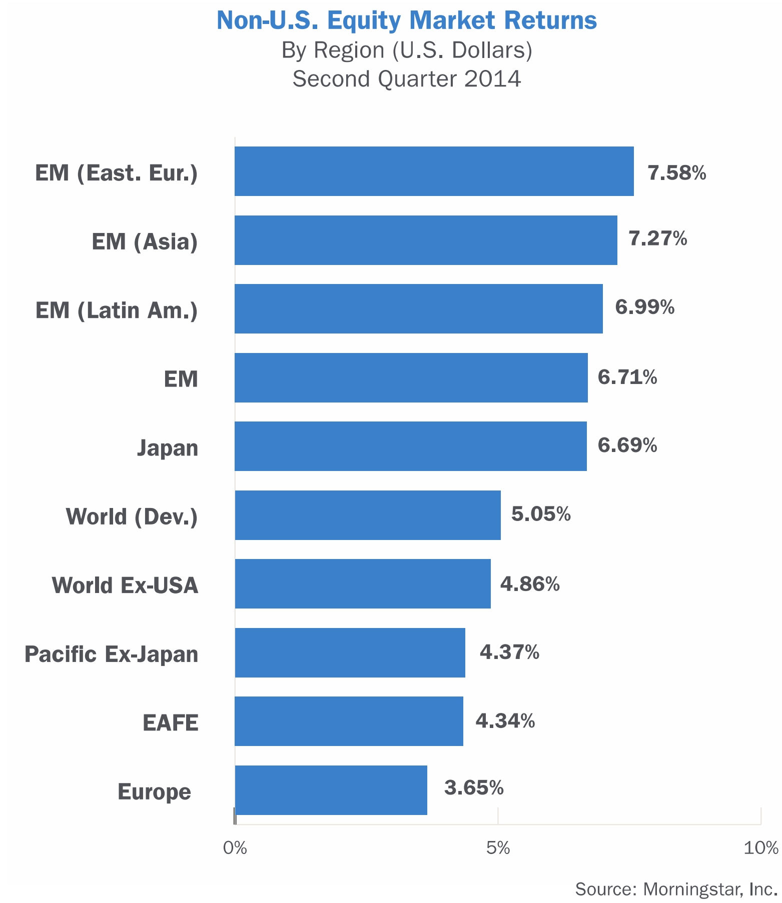
delivered positive returns for each of the three months during the quarter, and has advanced in each of the past five months. For the quarter overall, the S&P 500 gained +5.2%, its sixth consecutive quarter of gains, the longest streak since 1998. The index has advanced +7.1% for the first six months of the year.



The performance dispersion among the ten primary economic sectors continues to suggest that correlations across industries and stocks is declining after a long period of increasing. In such an environment stock selection takes on greater importance. The energy sector was the best performer in the second quarter, posting a gain of +12.1%, which was driven, at least in part, by geopolitical tensions in Ukraine and the Middle East. Utilities followed up strong first-quarter performance with another solid gain of +7.8% in the second quarter; the interest-rate-sensitive sector has advanced +18.7% for the first six months of the year. Each of the ten sectors generated positive returns during the quarter, with the poorest performer, on a relative basis, being financials, which advanced +2.3%.

For the quarter, the Russell 1000 Index of large capitalization stocks generated a +5.1% total return. Within the large-cap segment, value stocks again significantly outperformed growth stocks. Small capitalization stocks, as represented by the Russell 2000 Index, continued their weak performance relative to large caps, ending with a total return of +2.1%. However, there are signs that small caps may be regaining a leadership position, as performance in June was very strong. As in the large-cap segment, value outperformed growth within the small-cap universe. The Nasdaq Composite, dominated by information-technology stocks, generated a return of +5.3% during the quarter. The Dow Jones Industrial Average of 30 large industrial companies gained +2.8% during the quarter, and is up a modest +2.7% on a year-to-date basis.

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Real Estate Investment Trusts (REITs) again performed very well during the second quarter, as interest rates continued to defy expectations and trended lower. The DJ US Select REIT Index advanced +7.2% during the quarter, bringing its year-to-date gain to +18.2%. Commodities, on the other hand, experienced a more difficult time in the quarter, largely as a result of lackluster economic growth throughout the world. As a result, commodities were not able to deliver the same type of performance as in the first quarter, with the Bloomberg Commodity Index advancing a mere +0.1% for the quarter ended June 30.

International stocks performed on par with U.S. equities in the second quarter. As the Fed has begun to tap the brakes on liquidity domestically, the European Central Bank has become more aggressive to ensure that the eurozone region's economies continue to recover. In addition, the lower interest rate environment has helped provide support to emerging economies, which swooned early in the year on the prospect of less liquidity and higher interest rates. Performance was generally solid throughout the world in the second quarter, with limited variation across countries and regions. The MSCI ACWI ex-USA Index, which measures performance of world markets outside the United States, gained +5.3% in the second quarter, as both developed and emerging markets fared well.

Looking Forward

The negative first-quarter GDP data notwithstanding, the economy seems poised to accelerate in the coming months, according to many economists. Despite the frustratingly sluggish employment gains, payrolls now exceed the peak reached prior to the financial crisis in 2008, with the economy having replaced all of the 8.7 million jobs lost in the ensuing recession. Payroll gains are likely to accelerate as government employment increases, now that government finances are more stable and fiscal austerity is winding down. Businesses are in a strong financial position to more aggressively hire, and may do so with less political infighting in Washington and greater clarity on the impact of healthcare reform.

Yet, as we mentioned at the beginning of our letter, many market watchers and analysts feel we are due for a market correction. Liz Ann Sonders, Schwab's Chief Investment Strategist, in a recent June 30 commentary titled "Touch of Grey: Sentiment is a Mixed Bag," wrote, "It has been almost 1,000 days since the last decline of 10% or more. The current rally of over 78% represents the fifth longest of all time, just behind the period from 1984 to 1987. But it's well shorter than the longest rally of all time, which was 233% from October 1990 through October 1997."

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It is important to understand that at some point we will see a market correction. The problem is that no one really knows exactly when a correction will occur. Given the strong market advances the past two and a half years, we feel it is prudent to be prepared for a possible correction. This means making sure your portfolio is appropriately diversified and that you have cash set aside for any upcoming cash needs. We want to avoid being in a position of having to sell equities when the market is down.

Please be sure to let us know if you feel your portfolio is no longer appropriate for your situation, or if you feel you have upcoming expenses for which you would need to take money out of your portfolio.

In the spirit of the World Cup we offer you the following quote:

If we want to change things, we must first change ourselves. If we want to play—if we want to change the world—we must first show up on the field to score.
— Paul Rusesabagina

Paul Rusesabagina is the humanitarian Rwandan hotel manager who hid and protected 1,268 Hutu and Tutsi refugees during the Rwandan Genocide. Here's to showing up on the field.