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EXECUTIVE SUMMARY

The U.S. equity markets and the RDM Capital composite portfolio again had solid performances in the second quarter of 2013 even after factoring in the market volatility in June. In the second quarter, the S&P 500 and Dow Jones Industrial Average were up 2.4% and 2.3%, respectively, and the RDM Capital composite portfolio was up 3.4%, outperforming both indices. For the year, the S&P 500 and Dow are up 12.6% and 13.8%, respectively, while the RDM Capital composite portfolio is up 16%.

We were not surprised to see the market pullback at the end of the second quarter, as we expected some profit taking after several months of gains. We already had cashed gains for many of our clients in anticipation of this pullback. The Fed's June policy announcement was the main culprit in the minor June swoon, although continued weak economic data out of China also played a role. The equity markets' reaction to the Fed's announcement that it will slowly taper its bond buying as early as this year was largely overdone. The Fed has for months hinted that tapering was likely if the economy continues to improve as it expects. Further, the Fed confirmed that there are only two options going forward both of which benefit equity investors – either the economy improves to the point that quantitative easing is unnecessary or the economy does not improve in which case the Fed will continue to juice markets.

Indeed, we view the Fed's position as a net positive for long term investors, as it confirms our view that more normal economic conditions may begin to return in 2014 after more than five years of sluggish economic growth. The housing recovery, the domestic energy boom, and the resolution of some of the regulatory and fiscal uncertainties pervasive in our country bode well for the economy in 2014 and beyond. While we are cautiously optimistic about a return to normal economic growth, we continue to have some concern about the effect on the U.S. equity markets of an international economic slowdown, driven in large part by China. We view a slowdown overseas as the most likely explanation should U.S. equity markets falter in the coming quarters.

At the end of the day, the U.S. equity markets present better growth potential than other asset classes, such as international equities, fixed income and gold, and we have allocated our clients' accounts accordingly. For the remainder of 2013, we will attempt to capitalize on any additional temporary corrections. Interest rates may continue to creep up in the second half of 2013, which may negatively affect the higher yielding securities that drove the market in the first half of 2013. Therefore, it is important to maintain positions in more economically sensitive areas, like energy, industrials and financials, which will outperform in an expanding economy, rather than solely yield-producing positions, such as healthcare and consumer defensive stocks.

I. The Market's Tantrum Over The Future End Of Quantitative Easing Spoiled An Otherwise Strong Quarter

A strong start to the second quarter was followed by an increase in volatility and ultimately a small decline in June. The primary reason? The Fed. As many of you know, the Fed in mid-June predicted that it will taper its $85 billion per month bond purchasing program as early as the fall of 2013 and ultimately end the program in 2014, ***assuming its economic projections prove accurate***. The Fed's position should not have been too surprising to the market – ***the Fed cannot juice the economy forever.*** However, the market apparently was surprised that tapering could occur as early as September of this year and Fed asset purchases end by the middle of next year. The Fed has consistently equated 6.5% unemployment and 2% inflation as the threshold for ending its easy money policies, and some may have (incorrectly) assumed that also applied for asset purchases.

While the Fed's statements provided fodder for traders to short the market or cash in on gains, ***we think that the market sell-off was largely an overreaction.*** Even if the Fed tapers its bond purchases in 2013 and ends them in 2014, it still will keep short term interest rates near zero until the unemployment rate falls to at least 6.5% and inflation steadies around 2%. In other words, asset purchases are not the only means for the Fed to keep interest rates low. With the unemployment rate stuck over 7% and inflation running comfortably below 2%, there is little chance that these targets will be met before 2015.

The Fed also can put its foot back on the pedal if it prematurely softens its easy money policies before the economy is ready to grow on its own. The Fed's recent predictions on economic growth have proven too rosy, and its current predictions of a fairly quick return to 3%+ GDP growth and unemployment below 7% are more optimistic than the predictions of most economists. If it is wrong again, the Fed can either reinstitute quantitative easing or not stop it in the first place. Those points were made clear by various Fed members in the days after the Fed announcement.

Most importantly, the Fed's actions are welcome for both long term investors and retired investors. The Fed is considering reducing its bond purchases because it believes the economy is growing. ***Long term investors*** should gladly trade a stock market that grows due to a strong economy and fundamental earnings growth over one temporarily inflated by the Fed's short-term asset purchases. The main concern for ***retired investors*** is that the Fed's easy money will eventually stoke inflation, which can decimate the value of retirement assets set aside to meet living expenses. That fear has not materialized yet. But, by reducing asset purchases in a measured way, the Fed is reducing the chance of inflation.

Ultimately, ***the market's focus on the Fed in recent years is a red herring.*** As we noted in prior quarterly market commentaries, the Fed's quantitative easing stimulus plans have had less impact on the real economy than many believe. It appears that much of the liquidity supplied by the Fed into the fixed income markets has not been re-invested. Rather, it (1) has come full circle due to reduced money velocity and currently resides in the major banks' reserve balances at the regional Federal Reserve branches, which have skyrocketed to over $2 trillion since the Great Recession or (2) is squirreled away on major non-bank corporate balance sheets, which have similarly skyrocketed to over $2 trillion.

We do not doubt that the Fed's policies have helped to drive up asset/stock prices and boost the housing market by lowering mortgage rates. Quantitative easing also plays a big role in investor psychology through the perception that the Fed will intervene if the market and the economy falter, effectively acting as a guarantor of market performance. But, ***quantitative easing has had a diminishing impact on equity markets.*** With the Fed slowly retreating over the next 12-18 months, economic fundamentals and company earnings will regain their rightful position as the primary market movers. ***We think a renewed market focus on growth and earnings over Fed driven asset price and speculation will be a positive for the market as it reduces the chances for asset bubbles and irrational economic behavior.***

II. There Are Positive Signs That Economic Growth Will Return To Normal In 2014

The U.S. recovery has been maddeningly sluggish. GDP has been growing at about 2% or lower for several quarters, which is well below where a typical expanding economy should be and below the average of about 3.3% growth in recent decades. The government notably reduced its GDP estimate for the First Quarter of 2013 from 2.4% to a meager 1.8%. Despite these unimpressive numbers, the economy has shown enough signs of improvement to have us optimistic for 2014 and beyond.

Housing is a big reason for improved expectations of GDP growth. The housing sector was a major factor in prior economic expansions, but that has not been the case recently due to the aftershock of the housing meltdown. Yet recent economic data appears to indicate that the housing market is beginning to contribute to the economic recovery. Due to a relatively low inventory of homes for re-sale, low mortgage rates, and increasing consumer confidence in the economy, housing sales and prices are beginning to tick up in many regions of the country. For example, sales of pre-existing homes rose in May to the highest level since 2009 and the sale of new homes rose to the highest level in five years. A growing housing market makes consumer feel richer, increases employment, and indirectly benefits other industries tied to housing. While rising mortgage rates due to Fed tapering could threaten this recovery, housing is still at historically affordable rates even as the mortgage rate increases over 4% suggesting that the housing recovery should still have legs.

The booming energy sector also has the possibility to increase economic expansion. We wrote recently on our blog (http://www.rdmcapital.com/wealthmanagementblog/) about the natural gas revolution currently underway in the U.S. thanks to technological developments in drilling for natural gas, such as hydraulic fracturing or "fracking." As we note in more detail in our blog, we believe that the increased production from such techniques, while pushing down natural gas prices in the short term, will provide great long term benefits to the energy industry in the United States and the U.S. economy in general as the country becomes more energy independent and businesses profit from cheaper costs.

We also may see some resolution to the fiscal and regulatory uncertainty that has been a drag on growth since the end of the Great Recession. Since the Great Recession, fiscal and regulatory policy has largely consisted of repeated wrangling over taxes and government spending, expansion of entitlements, and stimulus either in the form of bailouts or government investment. There is little dispute that government dysfunction has led to business manager uncertainty and conservative management of corporate finances, as we have written before. Perhaps the three most notable causes of this uncertainty are questions over the final form of Dodd-Frank (the financial reform law) and Obamacare, as well as the mandatory tax hikes and spending cuts that took effect last year and earlier this year. At very least, Dodd-Frank and Obamacare should be partially implemented in 2014. Regardless of whether one agrees with these legislative initiatives, we believe that some finality to the implementation of this legislation will reduce some of the uncertainty that has stifled growth and allow business leaders to plan accordingly.

III. U.S. Equities Have Greater Growth Potential Than International Markets, Fixed Income And Gold

Other news making headlines in the second quarter were the state of the Chinese economy, the popping of the gold bubble, and the rise in fixed income yields. While we do not hold Chinese equities or gold and favor equities over fixed income, we address these issues below as they likely will impact U.S. equity performance and/or our portfolio allocation decisions for the rest of the year.

China: Economic indicators out of China in the second quarter continue to suggest that ***the country's economy is weakening*** (although it still is projected to grow at a rate more than 3 times greater than in the U.S.). In particular, China's industrial sector – the driver of its economy – is hampered by overcapacity and softening demand for exports. Many private companies also would be far worse off if not for subsidies provided by the Chinese government. On top of that, the Chinese government is infamous for artificially inflating growth projections, suggesting that the state of the Chinese economy could be worse than publicly known.

Over the long term, a continued downturn in China will impact U.S. companies that rely on Chinese demand, especially those in the commodity and mining sectors. Over the short term, bad news from China can scare the U.S. equity markets. Indeed, ***part of the reason for the sell-off in June was the "credit crunch" in China's financial markets, with interbank interest rates there unexpectedly rising to as high as 30%.*** The Chinese government did not immediately step in to inject liquidity in the market, seeking instead to provide a dose of tough love to slow aggressive lending by Chinese banks. For many investors, this brought back memories of the credit illiquidity in U.S. markets in 2007-2009, which was a major factor in the Great Recession. The Chinese government ultimately softened its stance, indicating a willingness to intervene to bring rates back to reasonable levels, but not before providing a reminder of the significance of the Chinese economy on the U.S. equity markets.

Gold: A recurring theme in our quarterly market letters dating as far back as early 2011 was "caveat emptor" regarding gold. Fast forward to 2013 and gold investors have seen the bursting of the gold bubble that hit its peak of just above $1900 an ounce in September 2011 and has since experienced a drop of more than 33%. Gold bugs drove up prices largely on the argument that gold would increase in value as inflation runs rampant due to international monetary easing. ***This bull argument has proven faulty, as economies around the world have struggled to grow causing inflation to remain low.*** Gold's fall from the hysteria of two years ago is a prime example of the danger of chasing returns, especially in a commodity that is largely a speculative trade or inflation hedge. That being said, there is a price when asset classes become too cheap to ignore. As the price of gold dips down or below its cost of production, gold miners theoretically will cut back on production, reducing supply, and increasing prices. With gold pushing the $1200 level, we may be close to or at that point now.

Fixed income: U.S. equity markets initially revolted against the Fed's policy statement, but fixed income, which is primarily moved by changes in either interest rates or creditworthiness of the borrower, will be most greatly harmed by any increase in interest rates. This is because higher interest rates make new issuances of debt more attractive in the marketplace, and conversely, old issuances with lower interest rates lose value in the marketplace. In fact, investors withdrew roughly $17 billion from bond funds in the first two weeks of June due to fears over rising interest rates, and yields on everything from corporate debt to treasuries have risen over this period. ***Improving economic fundamentals support the equity markets more than fixed income, because an improving economy leads to improving corporate earnings that underpin stock prices.*** Therefore, when compared to fixed income, the equity markets should recover first from any short-term corrections caused by a change in the Fed's interest rate policy as such a change should be accompanied by improved economic fundamentals, as discussed above.

We believe the U.S. remains relatively more attractive than other markets for capital investments and that equities will outperform other assets, including gold and fixed income. Within U.S. equities, we are beginning to look at the more cyclical sectors as opposed to the high yielding, dividend paying stocks that drove the market in the first half of 2013. For one thing, the rise in fixed income yields may make fixed income more attractive to income investors and thus hurt yield-producing equities, such as healthcare and consumer defensive stocks. We of course do not advocate dumping dividend paying stocks, but we are looking to maintain and increase positions in the more cyclical energy, industrials and financial sectors.

As usual, all comments are welcome.

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WEALTH MANAGEMENT