HARBOR VIEWS

HARBOR ADVISORY QUARTERLY NEWSLETTER

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HARBOR ADVISORY
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A LOOK INSIDE HARBOR VIEWS

- *Thoughts on the Economy* – The sequester is a very blunt instrument but it seems to be the best our government can muster in terms of fiscal responsibility.
- *Our View of the Financial Markets* – The U.S. equity market has extended a good year close to 'great year' territory.

LATEST NEWS FROM HARBOR ADVISORY

- You can visit us at: www.harboradvisory.com. Take a look and let us know your feedback.
- Jack De Gan continues to make news with his regular guest appearances on CNBC's top rated financial shows "Squawk Box", "The Call", "Closing Bell" and on Bloomberg TV, Fox Business News and National Public Radio.

THOUGHTS ON THE ECONOMY

Economic growth for the first quarter of 2013, originally reported at 2.5%, has been revised to show a 1.1% gain. Including an "advance" reading of 1.7% for Q2, the first half of 2013 GDP growth was about 1.5%. We believe the true level of economic activity to be closer to 2% which keeps intact our estimate for full year 2013 of 2-2.5% real economic growth. Europe has not been so lucky in 2013. Economic growth continues to contract slowly with stability in sight in the second half of 2013. The emerging market economies continue to see their level of economic activity reflect the developed world's slowdown. We expect the EM complex to show GDP growth for 2013 of 5% real growth. Combined with the developed world, worldwide economic activity should expand by 3% this year.

In light of the fact that central banks in the developed world have been standing on the monetary accelerator for over four years, this is a meager growth rate. The U.S. has averaged only 2.2% growth per year since our recession ended in 2009.

A bright spot in the U.S. has been employment which has accelerated to show over 200,000 non-farm payroll jobs created on average each month in 2013. This would suggest the rate of GDP growth reported is understated at present. Enormous pent up demand for autos and housing in this country continues to be a significant driver of economic activity. Even greater deferred demand is building in the European auto sector as sales there have declined for 5 consecutive years. European vehicles on the road today are 12 years old on average.

One potential concern is a greater contraction in growth rates in China. Reported figures of 7.5% growth currently may overstate activity as some anecdotal information such as electricity consumption fell far short of that figure.

Government spending continues to contract as a contributor to GDP growth. In the U.S. the sequester is a very blunt instrument but it seems to be the best our government can muster in terms of fiscal responsibility.

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Nod to the ubiquitous disclaimer: While we're not infrequently, and always quite accurately, accused of being of strong opinion – we want to let the reader know we've been wrong before, we will be again, but please don't hold it against us. The forward looking parts of the letter are the best efforts of fallible humans working at Harbor Advisory.

OUR VIEW OF THE FINANCIAL MARKETS

The U.S. equity market has extended a good year close to 'great year' territory. Our expectations for 2013 in December were for a 10-15% year in equities. At the writing of our spring newsletter we said the market had already met the upper end of our target and would go higher. With the S&P 500 now showing an over 18% gain year-to-date we have now reached fair value in our estimation. This would suggest to us that growth for the remainder of the year could be commensurate with earnings growth plus dividend yield, or low to mid single digits.

This level of return approximates what we should all expect from stocks over the long term. We should look to earn the dividend yield and receive growth similar to the rate of expansion in net earnings. Historically, the rate of earnings growth of corporate America is 6-7% annually. Dividend levels are currently at 2.3% on the broad market indices so our projection over the intermediate term should look something like 8-9%.

We own a fair amount of emerging market equities for our clients which have outperformed the U.S. markets strongly over a ten-year horizon but have lagged badly over the last five years. Slower developed world growth slows the export markets for the EM economies which are highly commodity and export dependent. We are sure there will be a reversal in this relative performance which has happened historically but we cannot say when that may happen. Consequently we endure the pain, keeping the future opportunity firmly in view.

We continue to worry about the bond bubble created by the Fed's security purchases and zero interest rate policy (ZIRP). Rates on 10 year treasury notes have advanced from 2.1% to 2.7% since our spring letter. We continue to see higher rates ahead which guides our fixed income investment policy: we own very short-term bonds for our clients, many maturing in the next 12 months. We expect very little return from fixed income assets in the short to intermediate term.

BEWARE OF FRAUDSTERS AND SCAM ARTISTS

A friend related a story last week. The grandfather received a jarring call from the 25 year old grandson. A gravelly voice said: "Papa…I am in Panama City…I was on vacation…I got drunk at a bar…I hit someone when driving back to my hotel…I need money for bail to get me out of this horrible jail… please, please don't tell Dad…here is my lawyer...please speak to him." Within the course of the next 3 hours a very hardnosed grandfather had decided to wire $40,000 for the bail. The fraudster had gotten all the convincing personal information about travel dates and nicknames presumably from facebook posts or other easy to find (in this age of cyber communication) places. Protect yourself if you find yourself put in such a situation. Share your decision questions with a trusted advisor if you cannot discuss it with a family member.