THE BUTTONWOOD

On May 17, 1792, twenty-four merchants gathered under a buttonwood tree at 68 Wall Street. There they signed the Buttonwood Agreement, creating the first investment community, which later evolved into the New York Stock Exchange.

* * * *

SECOND QUARTER 2013

Henry J. Wildhack II
Matthew J. Abbott

110 West Fayette Street
One Lincoln Center
Suite 900
Syracuse, New York 13202

(315) 701-6452
WWW.ARMORYCM.COM

Great First Half - *Some Points of Interest*

Despite posting modest losses for the month of June, the six major US indices that we follow weighed in with positive results for the second quarter of 2013 and the first half of the year. The ***Wall Street Journal*** noted that the Dow Jones Industrials saw its best yearly start since 1999. As we will mention later, June's negative returns were more a result of comments from the Federal Reserve during its June meeting than any meaningful economic data.

Time Period - Index	DJIA	S&P 500	S&P Mid Cap	S&P Small Cap	NASDAQ	Total Stock Mkt
1st Qtr. 2013	11.25%	10.03%	13.06%	11.50%	8.21%	10.52%
June 2013	-1.36%	-1.50%	-1.98%	-0.26%	-1.52%	-1.43%
First 6 Months 2013	13.78%	12.63%	13.76%	15.52%	12.71%	13.05%

While the positive market returns might surprise some, they were not all that unexpected. As we have been saying for quite some time the US stock markets are rising on positive fundamental data that is being tempered somewhat by the interest rate scenario and the Federal Reserve. Obviously the questions are what about the second half of 2013 and what will the Federal Reserve do and when will they do it?

From a fundamental perspective the US economy is ***slowly*** improving. We recently examined four critical components of economic growth and each shows signs of improvement. These include the domestic auto industry, the housing market, the energy sector, and the employment picture. In choosing autos and housing, our very simple logic is that if they improve that doesn't help just each of them. This would also translate into the improvement of all of the ancillary businesses that support auto and home sales. The energy sector, with a goal of energy self-sufficiency, was included for obvious reasons. Finally our simple logic again suggests that if these areas improve a better employment picture should emerge.

An article in the July 2, 2013 edition of the ***Wall Street Journal*** stated that the US auto industry, "in tatters four years ago, is emerging as a powerhouse driven by favorable exchange rates and labor costs in a trend experts say could drive business for years…some experts are also looking at US production as a way to serve booming emerging markets." The US auto industry is once again competitive on an international scale in large part because of the massive restructuring in recent years and a significant lowering of labor costs. The article in Journal stated that "the average cost of a US auto workers pay and benefits was $38 an hour compared with $60 in Germany". The very next day the Journal reported that car sales were at a five year high.

The housing market, which is a critical component of the economy, has also shown signs of slow improvement. While the pace of this improvement might be frustrating to some it should be viewed in the proper context. It must be remembered that the US housing market is recovering from depression type levels. While existing home sales continue to improve, equally as important is the data that states distressed sales, including foreclosures, represented 18% of total sales down from 28% a year ago.

Capital Economics' Paul Diggle wrote "Just 15 months ago, distressed sales accounted for 35% of all existing home sales. The market is starting to take a semblance of normality". This is evidence of the deleveraging process that we have mentioned in earlier Buttonwood newsletters.

ARMORY
CAPITAL MANAGEMENT, LLC

Recently much has been written that the US is well on its way to becoming energy self-sufficient. Evidence to that end suggests that this could occur within the next 10 – 15 years. The Brussels Forum, an annual meeting of influential North American and European political, corporate, and intellectual leaders, recently reported that while "the implications are uncertain, the growing self-sufficiency of the United States will have significant geopolitical implications". In addition, the availability of inexpensive power, free from the international politics of past decades, will potentially breathe new life into the US economy and ensure that the US is becoming a more competitive place in which to do business.

The latest news regarding the job market suggests a slow and somewhat frustrating improvement. The revised May jobs report stated that employer's added 175,000 nonfarm jobs to payrolls and that the unemployment rate ticked up to 7.6% from 7.5%. For the US stock market the report was perfect. While the improving nonfarm jobs number was better than expected the rise in unemployment means that the Federal Reserve may not be in a hurry to raise interest rates.

The Friday July 5th jobs report showed continued improvement as the economy added 195,000 new jobs in June. This beat analysts' expectations by some 40,000 while unemployment remained unchanged at 7.6%. This latest report, which could very well be revised at some point, suggests a trend that is consistent but not spectacular. A key number to watch is an unemployment rate of 7%. Fed Chairman Bernanke has said he expects the unemployment rate to be at 7% when the Fed begins to pull back on its stimulus program.

With all of this good news and recent slow growth we still ask ourselves what might the next 6 months (and beyond) offer investors. We mentioned that the market was off to its best start since 1999 so we went back and reviewed where the economy and markets were in 1999 to see if it offered a glimpse of where we might be headed.

The similarities between 1999 and the last 12 months are as follows: stock prices were going up as were interest rates as measured by the 10 year Treasury note. Beyond those measures things were very much different.

In 1999 stock prices were rising just prior to the dot com bubble bursting. By the late 1990s the US was thought to be in a "New Economy" with no inflation, where recessions were a relic of the past, where earnings and pristine balance sheets were obsolete especially when valuing technology stocks. The NASDAQ was evidence of this speculation as its value rose from 600 in 1996 to a high of 5,048.62 on 3/10/00. It is important to remember also that the 1999 to 2000 time frame ushered in the end of the great secular (long term) bull market that started in 1982. Simply stated – a classic bubble.

Currently while stocks across a broad spectrum have done very well since the benchmark lows of 2009 there is little evidence that we are currently in a bubble phase or approaching one. Talk of the fiscal cliff and sequestration remain a concern for some stock investors. The inevitable pending tick up in interest rates has others concerned. The slow economic recovery is enough to keep others on the sidelines.

From a valuation perspective US stocks are not overvalued. At the height of the dot com bubble the S&P 500 traded at 1,527.46 (March of 2000) with a price earnings ratio of 28.31. At the end of the quarter the S&P closed at 1,606.28 with a P/E of 16.57. If the S&P were to trade at multiples matching those of the dot com era it would be valued at over 2,700.

If the employment picture, auto industry, and real estate sectors are improving and the US is moving towards energy self-sufficiency why were the markets so choppy in June? The interesting answer is interest rates.

It is the consensus of everyone that interest rates will soon begin to creep up – they can't go any lower. This is certainly the most anticipated rate hike since the 1940's when the 10 year treasury hit a secular low of 1.95% in January 1941. As we have said in the 1st quarter Buttonwood a rise in rates is indicative of an improving economy. That is to say, reasonably valued stocks usually do well during a period in which rates are coming off of lows. We also believe that the Federal Reserve will make every effort to increase rates slowly taking every precaution to allow investors and the bond market to adjust to higher rates.

While investors should expect some near term daily volatility we must remember that a correction in stock prices is inevitable; the trend favors those who look for good quality investments over the long term.

As always, please call, email or text us with your questions, comments and concerns. And remember "Get rich slow".

ARMORY
CAPITAL MANAGEMENT, LLC