Investment Update

July, 2013

2013 Second Quarter Update

Review: Despite a retreat from its high in May, the U.S. stock market, as measured by the S&P 500, managed a positive quarter, up 2.9%. Bonds fell 2.3% and fixed income yields rose as investors began to anticipate the end of low interest rate policies by the Federal Reserve. Globally, developed markets (EAFE) saw a 1.0% loss. Emerging markets fell 8.1%, as investors worried about slowing growth and potential financial excesses in China.

Period	2Q13	1Q13	4Q12	3Q12
S&P 500	2.9%	10.6%	-0.4%	6.4%
EAFE*	-1.0%	5.1%	6.6%	7.0%
Emerging Markets	-8.1%	-1.6%	5.2%	7.7%
Barclays U.S. Aggregate Bond	-2.3%	-0.1%	0.2%	1.6%

*Europe, Australia, Far East

Domestic Economy: Our economy continues to make steady but moderate progress. Housing and autos continue to bolster growth. Housing starts are running a robust 28% ahead of last year. The auto industry just reported the best monthly sales since December of 2007. The job market showed strength this quarter, adding nearly 200,000 jobs per month, despite continued net losses in government jobs as the sequester and budget cuts force downsizing of government.

Two areas of concern that bear watching are: the shrinkage of government spending, and the effect on our exports due to slower global growth.

The automatic spending cuts mandated by the sequester will have the greatest effect in the last two quarters of the government fiscal year, ending June and September. The amount of the budget authority reduction is $85 billion. However, the cash impact is only $42 billion, since some of the authorization is for contracts that would span several years. The drag on GDP in the June and September quarters is about 0.6%. Factoring this in, we estimate that GDP for the June and September quarters will be about 1.9%, down from our prior estimate of about 2.5%. While weaker than we would like, the growth is reasonable, given that lower government spending is helping reduce the deficit.

600 Atlantic Avenue
18th Floor
Boston, MA 02210-2211

Phone: 617-357-5101
Toll-free: 800-357-5101
Fax: 617-357-7199

info@middletonco.com
www.middletonco.com

Estimates for global growth, excluding the U.S., have declined by about 0.3% since the beginning of the year. Since exports account for only 13% of GDP, we believe the impact will be manageable, unless global growth slows further or the dollar strengthens significantly from here, making our exports more expensive for other countries.

International Economies: The decline in global growth estimates is largely due to Europe and China. While Germany will experience modest growth due to export strength, the rest of Europe is still struggling as austerity measures to correct excessive government spending blunt recovery. There are initiatives to stimulate growth, but we do not expect substantive progress until after the German election in late September. China, under new leadership, is acting aggressively to curb credit excesses in its banking system. As a consequence, growth related to infrastructure spending is slowing. However, consumer spending is expected to remain reasonably strong. With the stimulative fiscal and monetary policies of the new government of Mr. Abe, Japan is the best major economy outside the U.S.

Correspondingly, we have recently cut back on emerging markets and on investments in commodity-dependent economies. We are initiating investments in Japan to benefit from its new vigor.

Strategy: The negative performance of bonds in the quarter continued into July, as a string of stronger economic numbers make it more likely that the Fed will begin to tighten sooner to avoid creating a speculative bubble. Accordingly, we are at the low end of policy ranges in bonds.

The impressive durability of the U.S. economic recovery, despite the headwinds noted above, has kept us focused on economically sensitive domestic stocks. As measured by the S&P 500, stock valuations at 14.3x next twelve-month earnings are still attractive, despite the nearly 14% gain through the first half of the year. Our equity weightings remain near the high end of policy ranges.