WT WEALTHMANAGEMENT JULY 2014

MIDYEAR INVESTING OUTLOOK, 2014

THE BULL MARKET ISN'T OVER. BUT EXPECT A CHOPPIER RIDE.

Was it only last year that a charging bull delivered a 32% return to investors in the U.S. stock market? The bull has matured and is now facing some of the setbacks of middle age. So far this year, as of 6/30/2014, the Standard & Poor's 500-stock index has returned nearly 7%. We're convinced that the bull market has got plenty of life left, so don't give up on it yet, just don't be greedy.

In January, we predicted that the S&P 500 would finish the year in the vicinity of 1925-1950 which would have been a 7.5-9% return without dividends which would had approximately another 2.2%. At midyear, it appears very possible that stocks could tack on a little more—with the S&P closing between 1975 and 2000. That would produce gains of an additional 5% for the remainder of the year. Stock returns appear to be able to beat growth in corporate earnings, which analysts estimate at 6% to 7% this year. Dividends will add in access of 2% to the S & P's total return.

But the market has grown more complicated, with a lot going on beneath the surface. The tide is no longer lifting all boats—in order to prosper, you'll have to be choosier about where you invest. Many of yesterday's market leaders are becoming today's laggards, making for choppier waters overall. The TV news pundits branded this a "secular correction" and biotech and high flying internet company's suffered the brunt of the damage.

Much like at the beginning of the year we think the rest of the year will favor larger companies over smaller ones; companies that sell at reasonable values over high-multiples and companies that are more sensitive to improvement in the economy along with those considered traditionally defensive.

In most WT Wealth Management portfolios we continue to overweight Utilities and Consumer Staples as defensive positions to increased valuations in other sectors.

READYING FOR HIGHER RATES

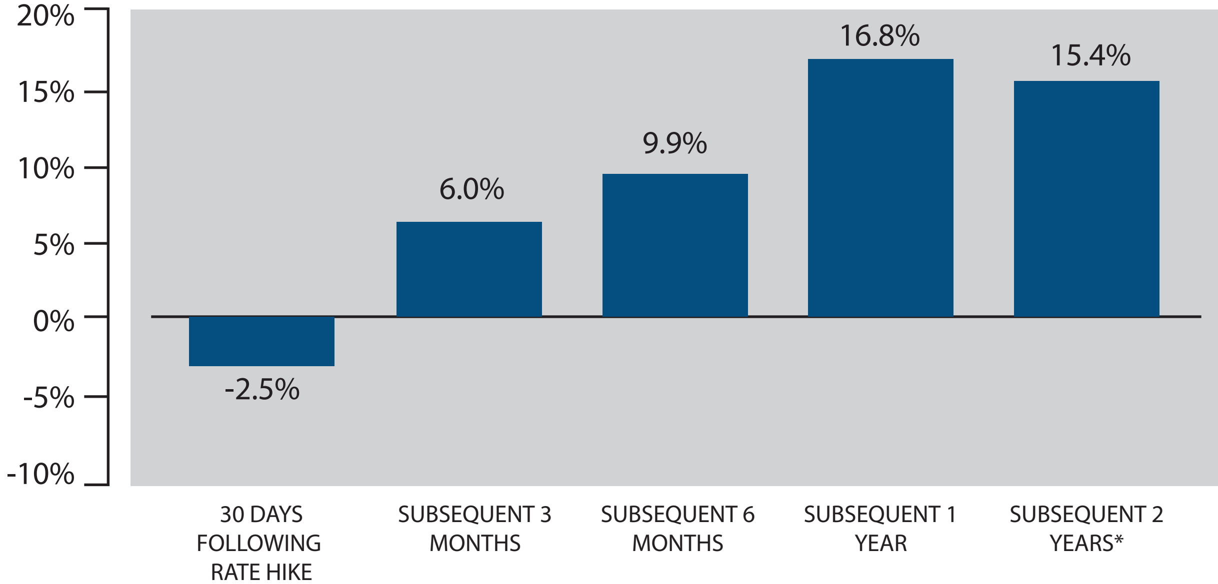
The bull's first challenge will be making the transition from a market driven by super-easy monetary policies and little competition from fixed-income investments to one more focused on corporate profits. The Federal Reserve is unwinding its bond-buying program aimed at keeping long-term rates low and will eventually look toward raising short-term rates, most likely early next year. Rates have been one area that has delivered the largest surprise in 2014. Many experts, including ourselves, are baffled on the lack of upward pressure on rates.

The consensus of most experts at the beginning of the year was a year-end target on the 10-year in the 3-3.25% range as a result of the Fed's bond buying program being discontinued. However, the 10-year has done the exact opposite and has dropped to near 2.5% by the end of June from a high of 2.99 in early January. We fully anticipate the 10-year ending the year in the 2.75-3% range.

As investors begin to anticipate that tightening, the market could suffer a 5% to 10% pullback, perhaps in the fourth quarter. We are in the belief that traders and portfolio managers are looking for any reason to produce a "sell-off/correction". It's a sort of like a beginning of the year diet, everyone does one because they feel it's appropriate. The so-called coming correction has been called for in much the same way.

What most fail to acknowledge is that we have had several mini sell-offs in the past year. From June 18, 2013 to June 24, 2013 we corrected by nearly 5% and then moved higher, then from August 1, 2013 to August 29, 2013 we lost another 4% and moved higher. In 2014, we shaved 5% off from Mid-January too early February and an additional 4% from early April to mid-month. We consider these mini selloffs, healthy consolidation sequences that flushed out jittery equity owners and allowed or tremendous buying opportunities for disciplined long-term investors. If raising interest rates to a more normal level is seen as a vote of confidence in the economy then it won't be the end of the bull market.

Average S&P 500 Performance Following Initial Fed Rate Hike Preceded By a Prolonged Period of Accommodative Policy • All Periods Since 1970



COURTESY OF S&P CAPITAL IQ

As for earnings growth, companies must become less dependent on the plump profit margins engineered by cost-cutting and other maneuvers and more reliant on revenue growth. Since the financial crisis, per-share earnings growth has been strong as companies have cut costs, refinanced high-cost debt, lowered tax bills and bought back shares. A recent spike in mergers and buyouts is aimed at buying revenue growth in our opinion.

Growth will hinge on whether the economy can finally accelerate convincingly. Most economists expect gross domestic product to expand by 2.4% this year, up from 1.9% growth in 2013, with the growth rate picking up to 3% or better in the second half. Many of those who are optimistic about the economy and the stock market are pinning their hopes on another crucial transition—the one in which companies segue from stockpiling cash to spending it. We're five years out from the Great Recession and companies have been hoarding cash. We hope the next five years will be about deploying it.

In the past few years, companies have spent generously on dividends and share buybacks. But a resurgence in corporate spending on physical assets, such as factories, equipment and office space, has been the missing link to more robust economic growth. Such capital expenditures, called "cap-ex" are part of a virtuous cycle as increasing production necessitates spending, in turn creating jobs and income growth, which then increases consumer demand, boosting corporate revenues and profits.

The time is ripe for a capital-spending recovery. With some $1.6 trillion on the books of S&P 500 firms as of year-end, cash stockpiles are enormous. Commercial and industrial lending is also picking up. And companies are nearing the point at which they can't squeeze any more production out of existing plants and equipment. The average U.S. structure, be it a power plant, hospital or restaurant, is 22 years old. That's close to a 50-year high, reports Bank of America Merrill Lynch. The average age of business equipment, including computers and machinery, is more than seven years old, the highest since 1995.

BUYBACKS LOSE FAVOR

Spending on share buybacks, a winning strategy until recently, is now penalizing companies and investors as rising stock prices make programs like this more expensive. The 20% of companies with the largest number of share buybacks in relation to their respective market values outpaced the S&P by nearly nine percentage points in 2013 but lagged the index slightly in the first quarter of 2014, says BMO Capital Markets. Shareholders are voicing their preference for spending on capital equipment over buybacks, dividends and acquisitions.

Many experts see capital spending growing at a rate of 4.7% this year and 5.7% next year, more than double the 2.6% growth rate in 2013. Beneficiaries of a spending boom would include tech, industrial and energy companies, as well as companies that discover and process raw materials. These economy-sensitive sectors together account for more than 40% of revenues generated by S&P 500 companies.

Even if all goes according to the bullish scenario, however, investors will soon realize that investing in a bull market approaching senior-citizen status is different than what they've grown used to. Until recently, for instance, a winning strategy for investors was simply to buy and stick with winning stocks. But a momentum-based approach is no longer working. For evidence, look no further than the recent fall of high-flying biotech and social media issues. The Nasdaq Biotechnology index has fallen 16% from its February 25 peak, and shares of social media standouts Twitter (TWTR) and LinkedIn (LNKD) have plunged 48% and 40%, respectively, from their recent peaks.

The good news is that the market's most overpriced sectors are retreating without bringing the broader market down with them. In our opinion "bubble talk" was applied broadly to the market, but really applied to only those high-flying areas, overall we feel equities are still fairly valued, if no longer cheap. Based on estimated year-ahead profits, the S&P 500's price-earnings ratio is 15—a tad below the long-term average and well below the levels of past market peaks. If the market's hot spots can cool down on their own, it's possible we can wring out the excesses without a major calamity. It certainly appears we are on track for an orderly re-evaluation of sectors and asset classes.

THE PERILS OF POLITICS

Midterm election years bring political uncertainty and stock market volatility. In every midterm election year since 1962 the market has corrected, sometimes viciously, with average declines of 19%. But patient investors are rewarded, because 100% of the time, the market has rallied—and significantly, with average gains of 32% for the 12 months following the correction.

Whether or not a major pullback occurs, investors should expect continued shifts in winning styles and sectors. For example, the long winning streak of small-company stocks is likely coming to an end. From the market bottom in March 2009 until March 4 of this year, cumulative price gains for the small caps far outpaced their blue-chip cousins: 228% for the Russell 2000, a small-company index, compared with 178% for the S&P 500, more of a large-company barometer. However, since its recent peak, the Russell 2000 has retreated 6%, while the S&P has been essentially flat.

Historically, small-company stocks have led the market in periods of slower economic growth, but they fall behind when GDP grows by 3% or more, says Russell Investments, the keeper of the index. Small-company stocks recently traded at an average P/E that is nearly 110% of the 20-year average, while the P/E of large-company stocks was 6% below their 20-year average.

Traditionally, when economic growth lags, investors bid up the stocks of companies—of whatever size—that have rapidly growing earnings. Growth stocks have generally led the market since early 2007, an unusually long cycle of dominance. But with confidence in the economy improving, it makes sense to gravitate toward stocks selling at bargain levels relative to earnings and other traditional gauges of value. Rotation is the lifeline of a bull market, as long as the money goes somewhere else, but stays in the market, that's fine.

CONCLUSION

In most WT Wealth Management portfolios we continue to allocate to middle and late expansion sectors like Industrial, Materials, Energy and Healthcare along with defensive sectors like Utilities and Consumer Staples. We have also decreased small and mid-cap exposure in most portfolios and maintain an overweight in domestic large cap.

In the last quarter we initiated additional positions in emerging and frontier markets in anticipation of higher rates in the U.S and potential economic slowdown as the recovery reaches late stages and pauses to digest how to move ahead. This also provides exposure to faster moving economies in light of the drag from China, Japan and most of Europe on most International/EAFE holdings.

We maintain a minimal "un-levered hedge" in most Income portfolios to protect against any organic rise in interest rates as "tapering" continues on schedule with an October 2014 exit date. We anticipate increasing those positions during the 1st quarter of 2015, if not before. In the coming months we anticipate decreasing our bond holdings in most portfolios and increasing our exposure to a variety of income producing alternative investments.

DISCLOSURE

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In addition to the normal risks associated with investing, narrowly focused investments, investments in smaller companies, sector ETF's and investments in single countries typically exhibit higher volatility. International and Emerging Market ETF's investments may involve risk of capital loss from unfavorable fluctuations in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Bonds and bond funds will decrease in value as interest rates rise. A portion of a municipal bond fund's income may be subject to federal or state income taxes or the alternative minimum tax. Capital gains, if any, are subject to capital gains tax.

Diversification and asset allocation may not protect against market risk or a loss in your investment.

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