TRIVANT
CUSTOM PORTFOLIO GROUP, LLC

October 2013

Quarterly Insights

EXECUTIVE SUMMARY

U.S. Stocks And Bonds Rise In The Third Quarter

In the Third Quarter, the domestic S&P 500 Index rose 5.25% and is up 19.79% year to date. Europe rebounded strongly (+13.66%), while Japan (+6.71%) and Emerging Markets (+5.90%) kept pace. Before jumping on the bandwagon, remember that over the last two years, Europe has lagged the S&P 500 Index by over 20% and Emerging Markets has lagged by over 35%. We raised foreign exposure from 10% to 15% in Q3, which helped benchmark out-performance. The Barclay's Aggregate Bond Index rose 0.78% in the Third Quarter and is down 1.84% year to date. Rates are rising. We await further normalization of bond yields to reposition our bond portfolio.

Fed Tapering Should Catapult Lending

The current lending efficiency of the U.S. banks is an awful 42% as a result of the $3.70 trillion Fed quantitative easing. The push to keep interest rates low has diminished the incentive of banks to lend. Bank excess reserves ($2.13 trillion) far exceed outstanding business loans ($1.57 trillion). Our view is out of the mainstream. We welcome Fed tapering as soon as possible. Higher interest rates will incentivize banks to lend to full capacity. This will be positive for the economy and the stock market.

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Third Quarter 2013

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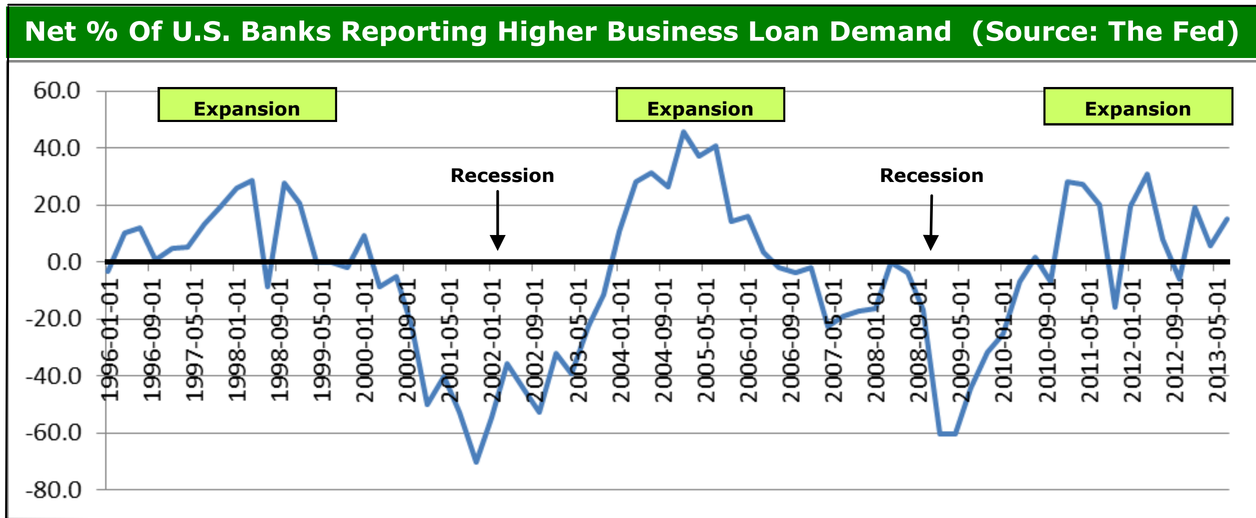
Fed Tapering Should Catapult Lending

U.S. Business Loan Demand Is On The Rise

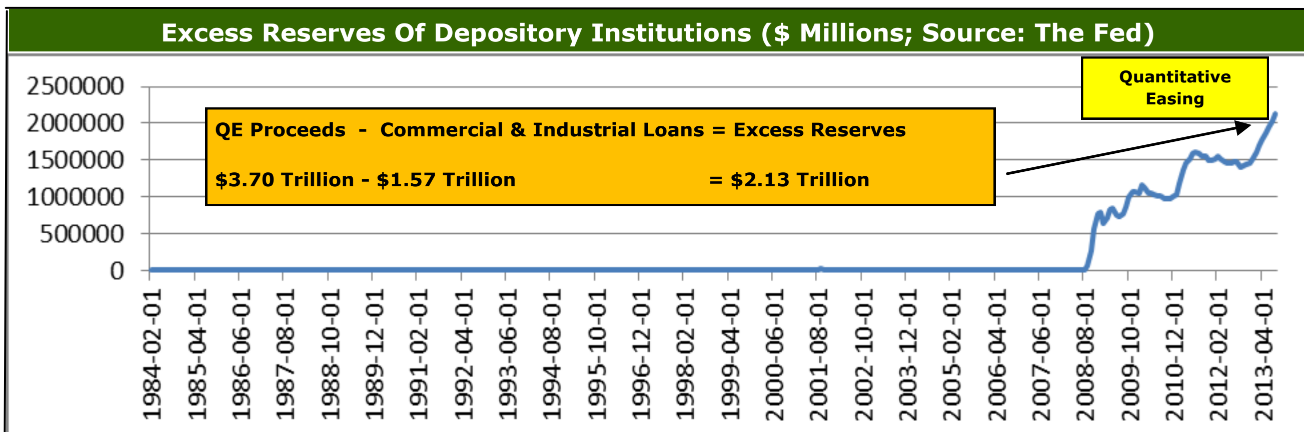
The U.S. economy is recovering, albeit at a moderate pace. Gross domestic product (GDP) expanded at a 2.5% annual rate in the April-June period (source: The Commerce Department). According to the St. Louis Federal Reserve (the Fed), U.S. commercial and industrial loan demand is on the rise. At the end of the Second Quarter, 15% of the banks reported higher demand. This is not surprising. In periods of economic expansion, we expect more businesses to seek financing. In recessions, we expect falling demand.



Banks Are Not Meeting Business Loan Demand Despite Having The Capacity To Do So

For a full economic recovery, businesses must be able to source their financing needs. This is far from the current situation. Many businesses cannot get loans right now. U.S. banks are not meeting lending demand despite having tremendous capacity to do so in terms of their excess reserves. Why is this the case?

The explanation is tied to quantitative easing (QE). The Fed has quadrupled its balance sheet assets (securities held outright) from $869 billion (August 8, 2007) to $3.70 trillion (September 30, 2013) through its QE securities purchases. The QE proceeds are sitting in the U.S. banks with the intention that the banks will lend these funds to businesses, which in turn will foster economic growth. Has this happened? Not really. The banks are stockpiling most of the cash, having lent only $1.57 trillion of the $3.70 trillion to businesses. Since the inception of QE, bank excess reserves have ballooned to $2.13 trillion. Prior to QE, banks held negligible reserves - they always lent to capacity. QE has lowered the banks' incentive to lend.



Banks Have Little Incentive To Lend As A Result Of Quantitative Easing

Quantitative easing (QE) has kept interest rates low. While this has an intended benefit of stimulating economic growth, it has an unintended serious consequence of making bank loans less favorable for banks.

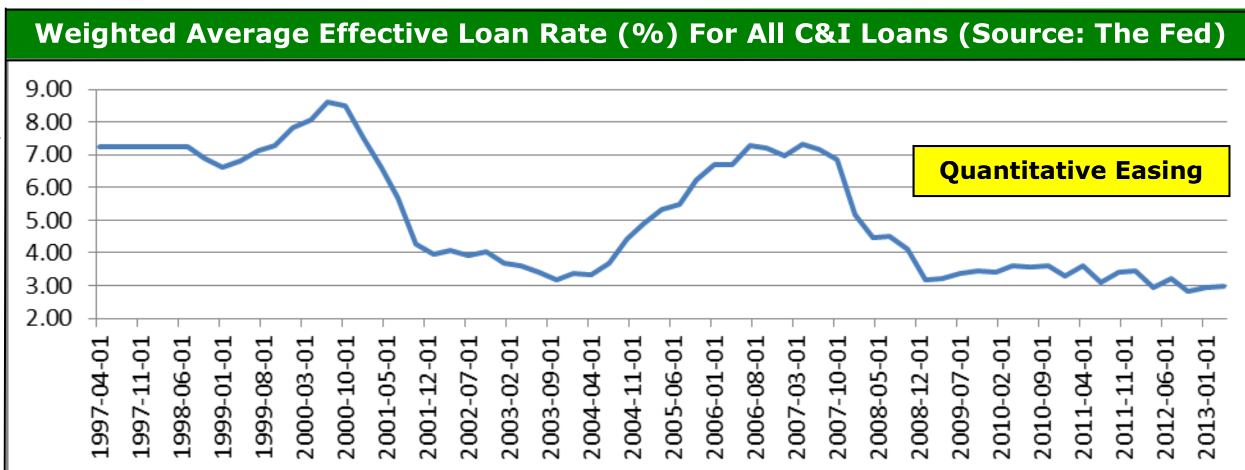
The lending profit for a bank is the spread between what the bank has to pay for funds (its deposits) minus what it charges to lend funds minus bad loans. Banks pay a "short-term" interest rate for its deposits and lend funds for higher interest rates ("longer-term" time frames).

A yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The steeper the yield curve, the larger the spread between short-term interest rates and long-term interest rates, and the better the lending landscape for banks. The spread between the 3 Month Treasury Bill (short term interest paid to depositors) and the 10-Year Treasury Bond (longer term interest paid by borrowers) acts as a gauge regarding the incentive for banks to lend money. As of September 30, the spread between the 3 Month Treasury Bill (0.02%) and the 10-Year Treasury Bond (2.64%) was 2.62%. QE policy hurt the spread starting in 2009. Only recently have interest rates risen to steepen the yield curve.

Yield Curve Slope: 10-Year Treasury Bond (%) vs. 3-Month Treasury Bill (%) - Source: The Fed

	Q3 2013	Q2 2013	Q1 2013	2012	2011	2010	2009	2008	2007
3 Month T-Bill	0.02	0.04	0.07	0.08	0.01	0.14	0.05	0.03	3.00
10 Year Treasury	2.64	2.52	1.87	1.86	1.89	3.30	3.85	2.25	4.04
Yield Curve Slope	**2.62**	**2.48**	**1.80**	**1.78**	**1.88**	**3.16**	**3.80**	**2.22**	**1.04**

The push to keep interest rates low has diminished the incentive of banks to lend. This is evidenced by the very low current weighted average effective loan rate for U.S. bank commercial and industrial loans (2.98%). The QE activities have effectively crushed the average effective loan rate over the last 5 years.



Banks have little incentive to lend under these conditions. It is certainly easier to invest excess reserves versus lend them. There is only a small benefit in lending the excess reserves. As an example, the difference between lending (2.98%) and investing in a 10-Year Treasury (2.64%) is only 0.34%. The risk/reward tradeoff is unfavorable for banks to lend to any customers other than those deemed a "sure thing". Not surprisingly, banks have limited lending to only their best and safest customers. Many worthy customers have been shut out. This "survival of the fittest" loan selection process has seen the delinquency rate on business loans fall from 4.36% in Q2 2009 to a new low of 1.02% in Q2 2013. Getting a business loan right now is tough!

A Tale Of Two Banks: Small Banks Are Lending While Large Banks Remain Zombies

At the height of the financial crisis, the Troubled Asset Relief Program (TARP) was signed into law by President George W. Bush on October 3, 2008. TARP authorized expenditures of $700 billion to fix the financial system, and $245 billion was given to troubled U.S. and foreign banks so that they could recapitalize and survive (these TARP funds have mostly been repaid). The next month, the first of three rounds of quantitative easing (QE) was initiated by the Fed, which has unintentionally ballooned the excess reserves held at the banks. QE1 ran from November 2008 through November 2010, QE2 ran from November 2010 through September 2012, and QE3 has been going from September 2012 to present.

The technical definition of a "zombie bank" is a financial institution that has an economic net worth of less than zero but continues to operate because its ability to repay its debts is shored up by implicit or explicit government credit support. Any bank that received TARP support was deemed a zombie bank. Now that TARP funds have been repaid, these banks may not technically meet the definition of a zombie bank. But by stockpiling QE-manifested excess reserves versus lending them, many banks are still effectively operating as zombie banks. They are "sucking the blood out of QE" to enhance their bottom lines. This isn't what we need.

Both TARP and QE stabilized and ultimately restored a healthy U.S. banking system. But things can be better than they are right now in terms of business lending. We currently have a tale of two banks: small banks are lending while large banks remain zombies. Why are smaller banks lending more than larger banks? It may have something to do with attitude and a true desire to lend. It may also have something to do with lending incentives. The smaller banks are lending at slightly higher rates as measured by the weighted average effective loan rate. They can monetarily justify their desire to lend by loaning at higher rates. By doing so, the small banks have over three times the incentive to lend to businesses as the large banks in terms of margin.

Small Banks Have Over Three Times The Incentive To Lend As Large Banks (Source: The Fed)

	Wtd. Avg. Effective Loan Rate	10-Year Treasury Rate	Incentive To Lend (Margin)
All US Banks	2.98%	2.64%	0.34%
Small Banks	3.35%	2.64%	**0.71%**
Large Banks	2.84%	2.64%	**0.20%**

CASE STUDY

Let's compare a giant national bank (Bank of America) and a regional bank (PNC, which is in most of our clients'portfolios). Bank of America received $45 billion from TARP and PNC received $7.6 billion. PNC has grown its business lending by over 19% annually since 2010 while Bank of America has expanded lending by less than 10% (half the rate). PNC is recirculating QE money substantially better than the Bank of America. In Q4 2010, PNC took advantage of a 3%+ yield curve slope (see page 3). CEO Bill Demchak recently noted that "the bank added commercial loans when risk-adjusted returns were at a premium and (we) accelerated issuing these loans at a time when you got paid to do so". Large banks like Bank of America should take note.

We Welcome Fed Tapering Because It Should Catapult Lending

The business lending efficiency of the U.S. banks is an awful 42% ($1.57 trillion lent / $3.70 trillion available). Put another way, business lending in terms of dollars could be improved by a factor of 138% right now ($2.13 trillion excess reserves that can be lent / $1.57 trillion already lent). We expect Fed tapering in the near future once we get past the government shut-down and debt ceiling issues. Tapering is something we will embrace rather than fear. We welcome tapering because higher interest rates will incentivize banks to lend to full capacity. This will be positive for the economy and the stock market.

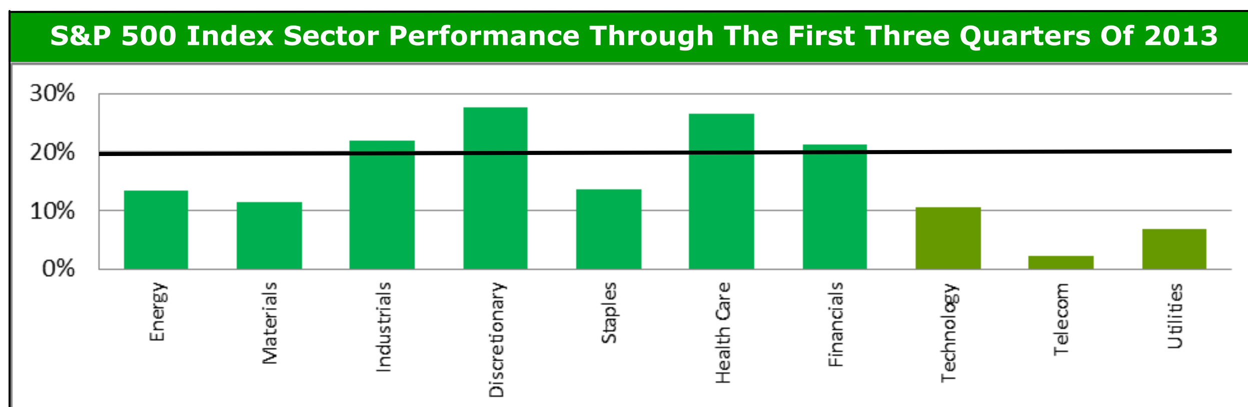
Stock Market Spotlight

The U.S. Market Continued To Rise In The Third Quarter

In the Third Quarter, the domestic S&P 500 Index rose 5.25% and is up 19.79% year to date. Europe had a very strong rebound in the quarter (13.66%), although it still lags the S&P 500 Index for this year and has had an exceptional lag (20%+) over the last two years. Emerging Markets (5.90%) was in line with U.S. performance, although this region is still down 4.05% year-to-date and has phenomenally lagged the U.S. (35%+) over the last two years. Japan (6.71%) was also in line with the U.S.

There Has Been Sector Performance Disparity Year-To-Date In The S&P 500 Index

So far in 2013, the big sector winners in the S&P 500 Index are Consumer Discretionary and Health Care. The big sector losers are Telecom and Utilities. In our view, the biggest sector disappointment is Technology.



We Adjusted Foreign And Sector Weightings During Q3 - And It Worked Out Well

We made several portfolio adjustments in mid-August that are summarized in the table below and discussed in greater detail on page 7 (Your Portfolio). The net effect of these transactions was positive as they contributed to a strong Q3 stock portfolio out-performance versus our benchmark S&P 500 Index. We got a bump from the European rebound. The Discretionary and Health Care sectors were both Q3 out-performers.

Our Third Quarter 2013 Portfolio Adjustments		
Portfolio Adjustment	**Region / Country**	**Sector**
INCREASE	Europe, Japan	Discretionary, Health Care, Financials
DECREASE	U.S.A.	Technology, Telecom, Industrials

The Market Is Moving More On Political Rhetoric Than Fundamentals

The market keeps getting hit with crisis after crisis, none of which has anything to do with fundamental valuation metrics. Volatility has come from fears over Syria, Fed tapering, the current Federal government shutdown, and a contentious debt ceiling crisis. Yet the market takes a licking and keeps on ticking. It is up strongly year to date despite all the negative headlines. We have remained calm and fully invested.

You've Got To Know When To Hold 'Em And Know When To Fold 'Em - We Are Holding 'Em

It is a bad bet to try and maneuver in and out of the market on issues we expect to be settled in the short-term. We remain bullish, welcome tapering, and anticipate a soon-resolved shutdown and debt ceiling.

Bond Market Spotlight

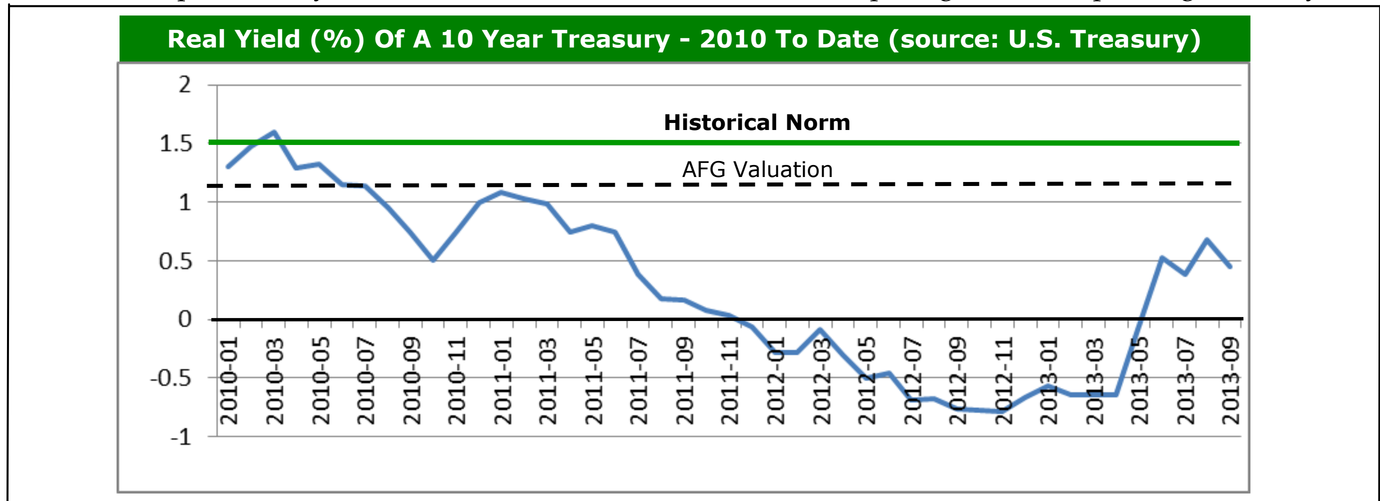
Bond Prices Slightly Rise In The Third Quarter

The Barclay's Aggregate Bond Index, a broad-based representation of fixed income performance, rose 0.78% in the Third Quarter and is down 1.84% year to date. This is the same index level as May 2012. Bonds have been flat over the last 16 months**.** The 10-year Treasury bond yield continued its mid-2013 ascent, ending the Third Quarter at 2.64% after finishing the First Quarter at 1.87%. We welcome the higher yields (see Quarterly Insights, Second Quarter 2013, Good News: Rates Are Rising).

Bond Yields Continue To Normalize

While investors may be lamenting their portfolio bond component, it is encouraging that bond yields have recently stabilized in terms of offering a positive real rate of return. Over the longer term, we believe this is critically important for investors who require portfolio income. The real yield is calculated by taking the 10 Year Treasury nominal yield and subtracting last year's inflation rate. Much of the last two years have had a negative real yield (inflation has been greater than the 10 Year Treasury yield). This odd time frame is a direct result of Fed quantitative easing (QE) and the unjustified fear of equity markets.

Investors historically receive about a 1.5% real yield for investing in government bonds (source: Burton Malkiel). Right now (September 30), investors are receiving a 0.45% real yield on the 10-Year Treasury (which has a nominal 2.64% yield). Research from Applied Finance Group (AFG) calculates the 10-Year Treasury yield equilibrium at 3.34%, which would increase the real yield by 0.70% (3.34% - 2.64%) to 1.15%. We expect bond yields to continue to normalize with Fed tapering and an improving economy.



Patience Is A Virtue

Our bond strategy has been to stay with short-term maturity bonds with an overall duration of 2.75 years. This is lower than the Barclay's Aggregate Bond Index duration of 5.04 years. Duration is a measurement of interest rate sensitivity. A five-year duration implies that a bond would fall in value by 5% given a 1% rise in interest rates. Since we don't believe we will see a large increase in inflation as a result of QE (Quarterly Insights, July 2013, page 4), we are simply waiting for higher rates (a further normalization of bond yields) before considering a repositioned bond portfolio. In the meantime, we continue to hold 70% short-term corporate bonds and 30% medium-term TIPS (Treasury Inflation Protected Securities).

Your Portfolio

The most significant portfolio adjustment we made in the Third Quarter was to raise our foreign stock weight from roughly 10% to 15%. Europe has been coming out of a recession and we feel that Prime Minister Abe's reforms will invigorate the Japanese economy. The interesting twist is that we intentionally chose to increase foreign exposure with companies that are under U.S. management leadership.

We bought Priceline.com (symbol: PCLN), a premier online travel agency that generates 80% of its revenues in Europe. We also bought AFLAC (symbol: AFL), a supplemental health insurance specialist that has 80% of its business in Japan. Finally, we bought Western Alliance Banc (symbol: WAL) because the small regional banks are best poised for the largest revenue increases from a steepened yield curve. Companies sold were in Technology (Hewlett Packard, Broadcom, F5 Networks), Telecom (China Mobile) and Industrials (Fedex, UPS). Our bond portfolio was unchanged in the Third Quarter, but we anticipate changes as bond yields continue to normalize. The portfolio maintains a short duration to ensure it is less susceptible to rising rates.

The Fourth Quarter is when we assess tax-loss selling in taxable (non-IRA) accounts. This year, we have few losses to harvest. Most portfolios have realized and unrealized gains, some very significant. We will contact you shortly to discuss your account regarding potential measures for tax efficiency (if applicable).

We expect a resolution to both the government shutdown and debt ceiling issues. At that point, we anticipate Fed tapering will again be front and center. We can't wait until it happens! Stay tuned for portfolio updates.

We will continue to closely monitor the market and adjust your portfolio as needed. Please feel free to contact us anytime to discuss questions or comments you may have. We will keep you informed of portfolio progress.

Respectfully submitted,

TRIVANT

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Disclaimer

The information presented herein is intended for informational purposes only. All views are subject to change based on updated indicators. The recommendations made in this publication are made without regard to individual suitability. Investors should consider their own needs and objectives before making any investment decision.

Commentary in this review reflects our portfolio strategy. Many of our clients have different objectives and circumstances which are reflected in unique portfolio considerations. Please note that accounts may not contain all elements of the strategy discussed here. Additionally, individual client customizations and start dates may preclude certain elements of this strategy from being implemented.

Past performance is no guarantee of future results. A risk of loss is involved with investments in stock markets.