

Summary

The new fear dominating the minds of market participants surrounds “normalization,” meaning the process by which the Federal Reserve will scale back Quantitative Easing and eventually raise interest rates to more traditional ranges. To be clear, the Fed has said that any normalization process will be gradual and that, ultimately, the gradual deceleration of the pace of extreme monetary accommodation will occur only when the economic recovery becomes self-sustaining.

Perhaps the normalization challenge whose conditions come closest to rhyming with present circumstances can be found in the early 1960s. At that time, the Fed pursued a normalization policy following a period of deflationary pressures and near zero interest rates. Over the course of the process, the federal funds rate (the overnight lending rate between depository institutions) moved from a low of 0.13% in early 1961 to 4.63% by the end of 1965. During that timeframe, the S&P 500 advanced by more than 50%, excluding dividends.

Market worries of Fed tapering may be premature, and possibly unfounded, in our view. Current conditions remain distant from the Fed’s targets as second quarter GDP is expected to have slowed and inflation eased. Presently, our base case outcome is a mid-cycle slowdown with modest improvements further out. The current environment of low (near-zero) short-term interest rates and continued accommodative monetary policy should provide ongoing support for individuals as well as businesses.

According to an April, 2013 Gallup Poll, despite market gains since 2009, stock ownership among U.S. adults is at its lowest level since 1998, when the survey began. From an historical perspective, market cycles typically do not end with low stock ownership among participants.

Yet Another Worry On The Wall

Economic recoveries often evolve slowly, unevenly, and unexpectedly, and they are rarely evident to the consensus except in hindsight. Stock market recoveries share the same set of skeptics and doubters, even as equities digest and move on from various fears and concerns. This process is commonly referred to as “Climbing the Wall of Worry.”

Since March of 2009, the U.S. economy has improved in fits and starts, and the market has responded, albeit with numerous pauses and corrections. Thus far, at least here at home, modest market pullbacks have proved to be healthy, setting the stage for later advances. Of course these corrective actions always provoke vigorous debate as to the potential depth and duration of the then-current downturn.

Presently, the new fear dominating the minds of market participants surrounds “normalization,” meaning the process by which the Federal Reserve will a) guide interest rates upward to more traditional ranges, and b) scale back or end Quantitative Easing (intervention in the form of bond purchases). When pressed by Congress on May 22nd as to when the Federal Reserve might start “normalizing” monetary policy, Fed Chairman Bernanke said that the pace of bond purchases could be reduced over the next few meetings, if the jobs market showed “*real and sustainable progress.*”

Many investors decided not to wait for that progress, and equity and fixed income markets softened markedly following that May 22nd exchange. As of June 30, the S&P 500 had fallen 3.8% from its top, and the yield on the 10-Year U.S. Treasury stood at 2.49%, a marked increase from 1.85% at the end of first quarter. Despite this negative action heading into quarter-end, the S&P 500 Index posted positive total returns of

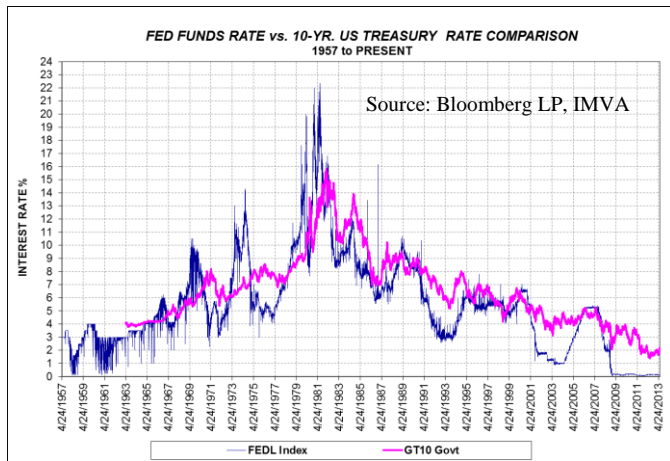
2.9% and 13.8% for the second quarter and year-to-date period, respectively.

Just as corrections are often necessary for maintaining market health, so too is the process of monetary policy normalization. To be clear, the Fed has said that any normalization process will be tapered as opposed to abrupt and that, ultimately, the gradual deceleration of the pace of extreme monetary accommodation will occur only if/as the economic recovery becomes self-sustaining.

Nevertheless, equity markets generally find monetary normalization unnerving. In the past thirty years, following aggressive accommodative actions during recessions, the Federal Open Market Committee has “normalized” monetary policy three times – 1983, 1994, and 2004. In each data series, following a period or periods of high, short-term volatility, the equity markets leveled out and then advanced.

Looking even further back, perhaps the normalization challenge whose conditions come closest to rhyming with present circumstances can be found in the early 1960s. At that time, the Fed pursued a normalization policy following a period of deflationary pressures and near zero interest rates. Over the course of the process, the federal funds rate (the overnight lending rate between depository institutions) moved from a low of 0.13% in early 1961 to 4.63% by the end of 1965. During that timeframe, the S&P 500 advanced by more than 50%, excluding dividends – overcoming fairly substantial headwinds: the Cuban Missile Crisis, the Kennedy Assassination, and the broad-based unrest associated with the Civil Rights movement and the nation’s escalation into Vietnam. Although we are not calling for a similarly

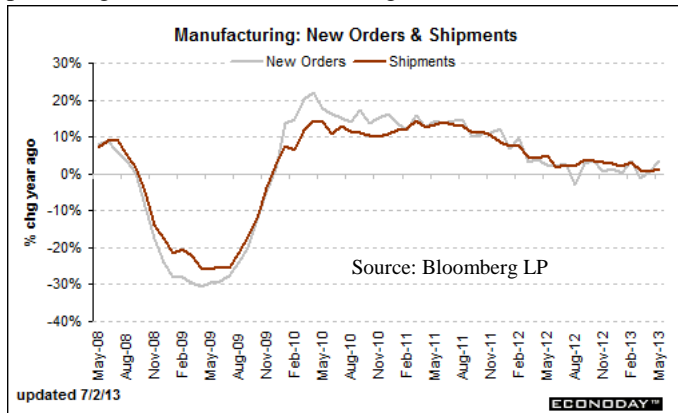
successful digestion of the present concerns, we find this history encouraging.



Current Economic Trends

Second quarter U.S. GDP is expected to have slowed to approximately 1.4%, which follows downwardly revised first quarter growth of 1.8%. Domestic strength continued as the key driver in the second quarter, led by overall strength in autos, home sales, private spending, and average workweek data. Retail, wholesale, and factory trends were soft and reflected a slight unwanted rise in inventories. Manufacturing and exports have been particularly slow, due to general global weakness. Public spending is off as well, given government sequestration and other structural and fiscal policy constraints.

Data from the last week of the quarter, however, gave room for optimism as retail reports and several categories of manufacturing orders bounced somewhat. Additionally, the Architectural Building Index, which had slumped in the preceding month, showed a meaningful advance.

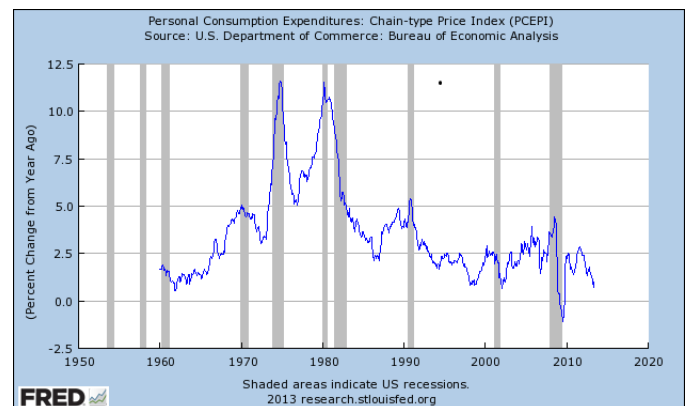
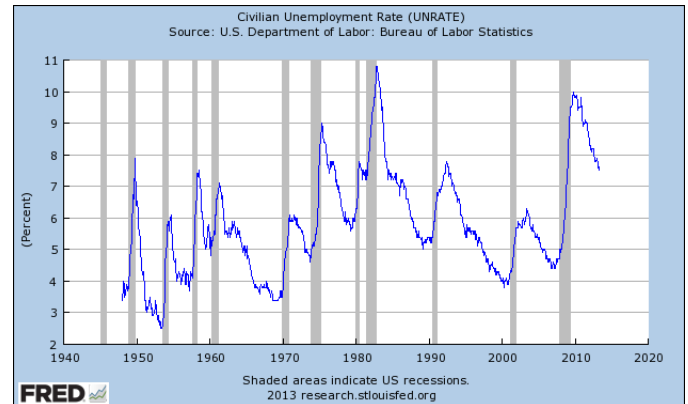


Versus other areas around the globe, modest U.S. economic growth – even if slowing – and private consumption appear to be the bright spots. For now, the likely near-term outcome appears to be a mid-cycle slowdown, with federal fiscal policy and global weakness creating the drag. Ultimately, we need to see Europe stabilize further and the developing economies transition toward greater middle-class domestic consumption and less infrastructure spending. Generally, we will become more optimistic, both at home and abroad, when we see self-sustaining growth (as opposed to government generated) capable of promoting new capital formation.

Financial Conditions/Monetary Trends

“With unemployment still elevated and inflation below the Committee’s (FOMC) longer-run objective, the Committee is continuing its highly accommodative policies.” – Fed Chairman Bernanke, June 19, 2013

The Federal Reserve currently provides accommodation through two methods, one conventional (setting the federal funds rate target) and one unconventional (asset purchases of \$85 billion per month). While most observers agree that a secular interest rate bottom likely has been established, the timing of any formal interest rate increase seems uncertain but distant (see top chart in left column). The majority of FOMC members indicated recently that increases in the federal funds rate target might occur in 2015. As for asset purchases, “tapering” may occur sooner rather than later. However, shifts in either set of policies are data rather than time-dependent. If the economy continues to move toward the conditions the Fed seeks, namely “maximum employment in a context of price stability,” then extreme levels of support would be reduced. Presently, unemployment remains significantly above the Fed’s target of 6.5%, and inflation remains meaningfully below the Fed’s target of 2.0%-2.5%.



As of this commentary, more than \$11.7 trillion of cash is held by individuals and corporations. Generally, higher rates would be a boon to these investors, who are earning next to nothing on this cash. More importantly, “normalized” rates, when they come, should be accompanied by better economic growth than we see today.

Sentiment Indicators/Market Trends

Sentiment and market trends conditions are mid-range and neutral. Market trends are, however, more attractive to us as

equity markets began correcting the short-term over-bought conditions in late June. Sentiment, as measured by the American Association of Individual Investors (AAII), continues to languish. The total put-to-call ratio is beginning to show an escalation in fear, but remains short of any extreme. Together, these measures suggest the likelihood of continued market consolidation, in the near-term, possibly by means of rotation among various sectors. As we noted last quarter, given recent economic strength, particularly on the domestic front, along with highly accommodative financial and monetary trends, we hesitate to take extraordinary defensive actions.

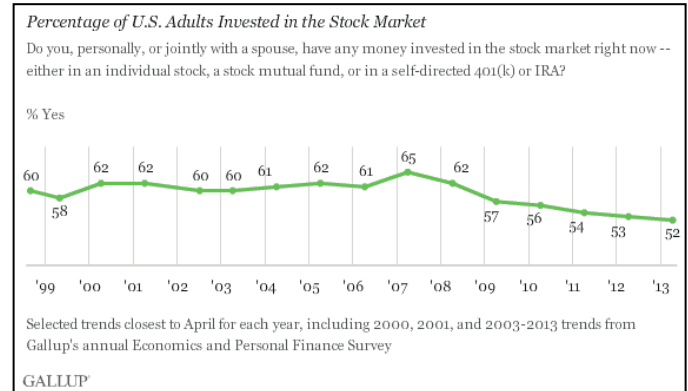
Equity Market Valuations & Earnings

Relative to fixed income and alternative investment opportunities, U.S. equity market valuations continue to screen favorably. The 6.6% earnings yield (earnings per share/stock price) on the S&P 500 still far exceeds the 10-year U.S. Treasury note's yield of 2.49%, even following the recent rise in long-term interest rates. On a dividend basis, while the yield of 2.1% on the S&P 500 no longer exceeds that of the 10-year Treasury, the historical relative comparison remains very favorable. In the context of an extended period of low short-term interest rates and slowly improving economic growth, rising earnings expectations and dividend growth provide a generally favorable backdrop for stocks.

In absolute terms, the S&P 500 Index appears fairly valued with multiples of 15.2x and 14.5x on trailing and forward earnings, respectively. The latter appears particularly attractive, as long as the earnings actually materialize. Both measures fall in the middle of the range bounded by the long-term market median low P/E multiple of 12.4 times earnings and the median high P/E multiple of 16.9 times earnings.

In anticipation of a "great rotation" (the shift of investor interest from bonds to stocks in a rising interest rate environment), a number of experienced and well-respected investors envision the expansion of market multiples toward the high end of the long-term range. One piece of evidence supporting this possibility is the low percentage of household

ownership of stocks. According to an April, 2013, Gallup Poll, despite market gains since 2009, stock ownership among U.S. adults is at its lowest level since 1998, when the survey began. From an historical perspective, market cycles typically do not end with low stock ownership among participants.



Conclusion

Expectations of Fed tapering have created new worries for the markets to discount. These worries may be premature, and possibly unfounded, in our view. For the Fed to institute normalizing (as opposed to tightening) policies, it would likely be in the context of expanding corporate revenues and earnings growth. Current conditions remain distant from the Fed's targets as second quarter GDP is expected to have slowed and inflation eased. Presently, our base case outcome is a mid-cycle slowdown with modest improvements further out. Like the Fed's, our assessments are data as opposed to time-dependent. Equities screen more favorably than bonds on a long-term basis, but stock selection will probably become more important as the market consolidates. The current environment of low (near-zero) short-term interest rates and continued accommodative monetary policy remains constructive for equities, in our opinion.

For an in depth review of our Market Pillars and Charts, visit: <http://www.imva.net/market-pillars/>.

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