2013 SPRING INVESTMENT OUTLOOK

The month of March has traditionally been known to “come in like a lion and go out like a lamb” and this year has been no exception given the cold temperatures that have plagued a large part of the U.S. For 2013 this famous idiom could be extended to include a “bull roar” considering the stock market’s vigorous 9% advance to start the year—returns in three months that are comparable to a full year’s worth of gains on average. The S&P 500 is near its previous cycle peaks of 1,527 in March 2000 and 1,565 in October 2007, attempting to break out to a new all-time high. Such action reflects increasing appetite for risk by investors, driven in part by better than expected U.S. economic fundamentals and the easy money policy of global central banks.

Policy uncertainty has eased somewhat in the U.S. compared to the close of 2012 given the passage of the tax bill to start the year, thus avoiding the so-called fiscal cliff. While fiscal tightening measures such as higher taxes and sequestration spending cuts are a headwind to economic growth in 2013, the resurgent housing market and surprisingly resilient consumer have thus far been nice offsets. A resurgence in U.S. energy production has also improved the trade deficit relative to other developed economies, raising the prospects of the dollar (despite current Federal Reserve policies) and laying the foundation for a more efficient economy longer term. Budget fights will continue throughout the year, but the threat of holding the economy hostage in the spirit of political idealism has probably passed for the time being, especially considering the low public approval of such action and the fact that both political parties have extracted some meaningful concessions from the other side over the past year and a half to improve the discretionary budget position of the federal government.

Europe, on the other hand, has diverged from the U.S. in terms of economic progress. Despite the rally in financial assets since last summer following the ECB’s promise of doing “whatever it takes to save the euro,” progress in the real economy continues to falter as the broad region remains mired in recession. Leading indicators point to further deterioration with no credible plan to return it to growth and solve its debt issues. Elections in Germany this fall probably mean the status quo remains intact throughout 2013, increasing the likelihood that volatility could resurface in the troubled peripheral countries like Italy and Spain. The real economy in Europe is getting worse and we see this as the biggest threat to global growth this year. Additionally, emerging market stock indices are off to a difficult start in 2013, down more than 3%. Many of the developing economies rely heavily on export activity and commodity production for growth. Slower global economies, investor concerns regarding an increasingly debt-driven Chinese backdrop, and modestly higher supplies from mining have pushed broad commodity prices back to October 2010 levels.

Year-to-date market returns (excluding income)

	3/25/13 Price	Change from year-end
Dow 30 Industrials	14,448	10.3%
S&P 500	1,552	8.8%
NASDAQ Composite	3,235	7.1%
MSCI All Country World Index ex-USA	256	2.4%

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Current Developments and Outlook

The current economic recovery in the U.S. has been unlike any other in recent generations as the impact of deleveraging following the collapse of Lehman Brothers and the decline in broad government spending once the stimulus was exhausted have flattened the growth trajectory relative to historical norm. The fourth quarter was a case in point as headline GDP advanced a mere 0.1% due to a decline in government spending from budget cuts and fiscal cliff uncertainty, as well as a slowdown in inventory accumulation. However, underlying fundamentals of the private sector were quite strong as consumption and investment grew a combined 3.5% for the quarter. Furthermore, a broad swath of private sector economic data in the first quarter has offered upside surprises relative to most economists' expectations, notwithstanding the higher taxes imposed by the federal government to start the year, potentially laying a better foundation for continued recovery. Data on employment, personal income, capital spending, and housing all accelerated to end 2012 and continue to build momentum in 2013, pointing to headline GDP growth above 2% in the first quarter. Credit conditions and lending standards remain accommodative for the broad business sector, which augurs especially well for near term capital spending and employment trends since financial conditions have historically been a strong nine month lead indicator for both.

One surprise has been the strength of retail sales despite the 2% payroll tax hike. While some discretionary categories like restaurant sales have clearly been impacted, broad spending has held up well thus far. One explanation is that the savings rate declined to just 2.4% in the most recent month, the lowest level since November '07; but the change in the savings rate is generally driven by the wealthiest 20%, who tend to spend more of their disposable income as their net worth rises. Higher stock prices and rising home values are clearly having a short term impact, although we would argue the "wealth effect" from higher stock prices is not a foundation for a sustainable long term recovery despite the Federal Reserve's philosophy.

Perhaps more supportive is the acceleration in payrolls above 200,000 per month since November and the mix of new jobs. Recently there has been a pickup in new construction jobs as the housing recovery firms and a higher level of employment in the professional service category. Such jobs are higher-paying relative to the economy's average income level and have the impact of lifting the aggregate spending capacity of the consumer. This trend bears watching in the coming months. A pickup in new building permits portends further progress as this metric is a leading indicator for construction employment as well as for spending on housing-related durables such as appliances.

Higher incomes and rising home values could also go a long way towards further household deleveraging and balance sheet repair. However, we remain cautious that the current rise in home values is being driven by higher investor demand. According to the Wall Street Journal, cash buyers such as large private equity firms like Blackstone make up 32% of sales nationally. According to some analysts these firms will likely be nearing their capacity for such activity within the next 12-18 months, at which point the baton will need to be handed off to more households. Unfortunately, mortgage credit is as tight as it's been in decades with an average FICO score of 750 for conforming mortgages, according to Freddie Mac.

Despite the gridlock in Washington, Congress and the Administration have effectively improved the ten-year outlook of the federal budget by more than $2.7 trillion since August 2011 through caps on spending, higher taxes, and automatic spending reductions known as sequestration. The latest CBO analysis released on February 5th forecasts the federal deficit to improve over the next three years, averaging about $500 billion per year and 2.8% of GDP before resuming its rise again in fiscal '17. This level is less than half the $1.1 trillion deficit that was run in fiscal '12. Discretionary spending by the federal government is expected to fall to 7.6% of GDP in fiscal '13—on par with fiscal '07 levels and below the long term average of 8.6%.
Unfortunately, no compromise has been reached yet regarding mandatory spending on entitlements like Medicare and Social Security, which is the driver of the nation's unfavorable deficit position longer term. At 13.2% of GDP and rising, mandatory spending is on an unsustainable path and growing much faster than the

underlying economy. In the meantime, the federal government has bought some time (aided and abetted by the Federal Reserve) and investors seem more keenly focused on debt crises in other developed economies which are at more critical junctures, such as the eurozone and to a lesser extent, Japan.

The U.S. is years ahead of Europe in laying the groundwork for an eventual sustainable recovery. A resurgence in U.S. energy production from horizontal drilling and fracking should give the country a substantial cost advantage relative to Europe if sustained. Plentiful supplies of domestic natural gas could mean prices of $4-5 per MCF in the coming decades compared to $10-13 in Europe, according to IHS Global. Admittedly, our economy has also benefitted from a more gradual fiscal consolidation compared to the EU, which was thrust into its debt crisis less than a year after the recession ended. Nonetheless, the structural impediments to growth and competitiveness in Europe such as outsized wage gains, rigid labor markets, and excessive transfer payments were years in the making and have yet to be thoroughly addressed.

Outside of Germany, European fundamentals continue to get worse and point to further declines in GDP. Private sector deleveraging has yet to commence at rates comparable to the U.S. in recent years. European banks account for three quarters of lending in the region but are expected to contract their balance sheets 7% in 2013 due to high debt levels, according to Credit Suisse. Thus, credit is contracting unlike in the U.S., where loans to medium and large businesses have been especially strong. There is also a lack of household deleveraging as European banks chose to restructure bad loans from the recession as opposed to realizing losses. Unfortunately, many of these same banks also hold too much sovereign debt of the troubled peripheral countries. Since policymakers choose not to impose greater private sector participation in the debt restructuring of both banks and troubled countries, austere measures are imposed on the taxpayers to pay the due bills, but austerity is not a recipe for economic growth and the citizenry are beginning to catch on.

Political uncertainty is probably the key theme to follow in the eurozone for 2013. Youth unemployment continues its ascent in Spain (56% rate) and Italy (39% rate). Such persistently high levels could eventually give rise to political parties that oppose the euro and the deep austerity measures imposed by European and German leaders. Italy is having problems forming a government following its recent election as support for the common currency has fallen to just 55% in that country, allowing fringe political interests to make in-roads. The German leadership is expected to be less tolerant and flexible in handling immediate crises ahead of its federal election on September 22nd, as evidenced by the recent banking debacle in Cyprus. Thus, workable details for eurozone banking and fiscal union are unlikely to evolve beyond the current sketchy outline until after the elections.

China completed its leadership transition on March 14th with Xi Jinping filling the largely ceremonial presidential role and Le Keqiang becoming head of government. These men will lead China in the coming 10 years as it attempts to transition towards a more open and consumer-centric economy. The slowdown in Chinese economic growth that commenced in 2010 has stabilized for the time being in response to additional infrastructure spending and continued credit growth at the local government level, but much of the recent surge in debt in China is eerily similar to the rapid evolvement of so-called “shadow banking” activities that emerged in the U.S. prior to the popping of our own credit bubble in 2008. We’re not as confident as some analysts are in the central government’s ability to efficiently allocate capital for the betterment of the economy. Notably, private investment in China remains muted at this point in the cycle due to some excess manufacturing capacity and accelerating wage growth. Broad inflationary pressures are also rising along with a resumption in the climb of housing prices, so some economists expect monetary policy to tighten in China by the middle of the year.

Investment Conclusion

We often remind clients that the macro economy and equity markets don’t necessarily move in tandem. Stock prices tend to reflect more than just backward-looking economic data but comprise aggregate investor views per current levels of risk appetite, credit conditions, sentiment, and expectations of future profit growth. Wall Street analysts are forecasting yet another “better second half” as consensus earnings are expected to progress more than 23% on a combined year-over-year basis in Q3 and Q4 compared to just 6-7% in the first half of 2013, according to Standard & Poor’s. Much of this optimism is embedded in the more cyclical sectors of the market such as energy, materials, financials, and industrials. We are highly skeptical of such enthusiasm considering the current valuation of equities is at a cycle high. There still exists the unknown impact of the federal spending sequester and other fiscal tightening measures on full-year U.S. growth, as well as the deteriorating conditions of the real economy in Europe. Forward earnings revisions of S&P 500 companies continue to be to the downside, which support such distrust of the consensus at the current moment. A normal correction in stocks would be quite healthy at this juncture, shaking out the weak holders and eventually putting incremental equity into the hands of more long term investors. In the meantime, we continue to roll-over maturing bond proceeds into short maturities and are keeping adequate cash reserves available should such a buying opportunity develop.

March 26, 2013

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