QUARTERLY ECONOMIC REVIEW OUTLOOK

INVESTMENT NEWSLETTER / FIRST QUARTER 2013

Executive Summary

A New Year's Day congressional deal to side-step much of the fiscal cliff led to a relief rally in early January. The upward trajectory was further fueled by reasonable economic reports, easing global tensions, a resurgence in China's economic growth, and favorable corporate earnings releases. By month-end, creative legislation to delay government debt ceiling drama and a resolutely dovish Federal Reserve were sufficient to propel U.S. stocks to within striking distance of all-time highs.

Investment returns in February were generally positive despite a steady stream of challenges during the month. On the home front, retailers expressed caution as consumers faced headwinds from higher payroll taxes and rising gasoline prices. The Congressional Budget Office (CBO) also slashed its estimate for the economy's long-term growth rate from 3.0% to 1.9%. As for policy, Federal Reserve meeting minutes revealed more discussion of backing off the monetary throttle, and Congress failed to either prevent or modify $85 billion in sequestration cuts. These cuts are now working their way through the system and will be increasingly felt in the second and third quarters. Job losses of 750,000 by year-end and a 0.6% hit to 2013 GDP are expected.

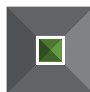
The Dow Jones Industrial Average and S&P 500 index hit new all-time highs in March. Renewed vigor in U.S. manufacturing, continued housing and auto strength, and jobless claims pushing against a five year low were contributing factors.

Despite domestic stock market records, challenges were present during the quarter. Relative calm in Europe gave way to renewed concerns following inconclusive Italian elections and a banking crisis in Cyprus. Subtle undertones of protectionism were also evident during the quarter and not so subtle competitive currency devaluations were unabashedly pursued, particularly by Japan. Geopolitically, the threat from Iran has escalated, territorial disputes between China and Japan were disconcerting, and North Korea made specific threats against the U.S. and its allies.

As a reflection of the diverse set of circumstances outlined, capital market behavior was distinctly different this quarter than in recent years. Since the financial crisis, risky assets, globally, have tended to move up and down in lockstep fashion. Knowledge of domestic equity returns, for example, would serve to identify whether it was a "risk on" or "risk off" macro environment. From a return perspective, the overall risk posture of a portfolio was more critical than where the risk came from. In contrast, specific exposures mattered this past quarter. As domestic equity markets rose by low double digits to hit new highs, other geographic regions and asset classes were challenged. International stocks were up only low single digits and emerging markets posted losses. Fixed income performed poorly. Domestic bonds were flat to down and international bonds lost ground. Commodities had negative returns as well. Although broad global diversification detracted from domestic centric returns in the quarter, unsynchronized markets pose far better opportunities to leverage the benefits of diversification in future periods.

Looking forward, unresolved risks remain on the horizon:

- Republicans seem to be gearing up for a fight when U.S. debt ceiling debates resume this summer. Shortly thereafter, Congress will debate the budget for the next fiscal year. The two sides are far apart.
- The Fed's approach to monetary policy is fraught with uncertainty. The timing and magnitude of adjustments to unconventional programs are a



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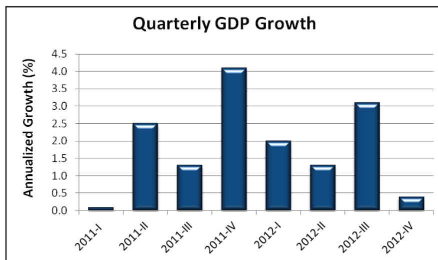
challenge to businesses and investment markets.

- Compared to past years, the crisis in Europe has diminished sufficiently that leadership is losing their sense of urgency. The social unrest of an austerity stricken region is also slowing needed reforms.
- Finally, the Bank for International Settlements (BIS) has grown concerned that buoyant financial markets are becoming too dependent on monetary and fiscal stimulus. They also believe these supportive measures are an impediment to governments pushing through reforms.

Economic Review and Outlook

Economic Growth



Data Source: U.S. Department of Commerce

U.S. GDP grew at an annualized rate of 0.4% in the final quarter of 2012.

Two issues weighed heavily on what would have otherwise been reasonable economic growth. Defense spending experienced its fastest quarterly contraction in over a decade, and inventory gains slowed substantially from the third quarter's pace. Absent these factors, double digit annualized rates of expansion in durable goods, housing, and business investment would have resulted in 3.2% growth for the quarter. In short, the quality of economic growth was healthier than the headline number would suggest.

The underlying economic momentum previously discussed helped to compensate for fiscal cliff related headwinds that kicked in with the New Year. In response, economists scrambled during the quarter to raise growth forecasts to account for unexpected strength. Consensus expectations call for 2.3% annualized growth for the first quarter.

As the quarter progressed, a second fiscal constraint kicked in to challenge the economy. Initially delayed by two months, $85 billion in automatic sequestration cuts became effective in March. By their nature, these cuts roll out in such a way that their impact will be felt more intensely as the second quarter gets underway. Accordingly, the pace of economic growth is likely to slow during the period.

Sequestration cuts and fiscal cliff related taxes will trim domestic economic growth by approximately 1.5% in 2013. Netting these detractions against modest gains in momentum is expected to result in full-year growth similar to the 2.2% pace set in 2012.

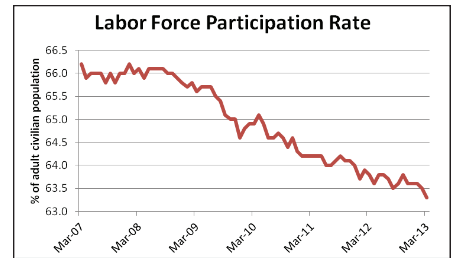
Led by reacceleration in emerging markets, the world economy is expected to grow 3.3% in 2013 following 3.0% growth last year.

Global Growth Rates			
	2011	2012	2013
Euro zone	1.5	-0.5	-0.5
United States	1.8	2.2	2.2
China	9.3	7.8	8.2
Japan	-0.6	2.0	1.2
Brazil	2.7	0.9	3.3
India	7.3	5.1	5.8
Advanced	1.7	1.2	1.3
Emerging	7.5	6.0	6.4
World	3.8	3.0	3.3

Data Source: Goldman Sachs

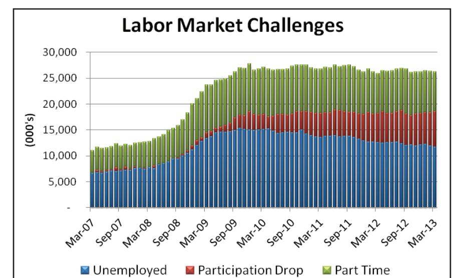
Employment

A declining unemployment rate, currently 7.6%, obfuscates deep labor market weakness. Greater clarity on workforce dynamics can be achieved by incorporating the labor force participation rate as well. The trend is poor.



Data Source: U.S. Department of Labor

In the most basic sense, economic output is a function of the number of workers employed and the productivity of those workers. Simply stated, anything that positively impacts either factor translates into economic growth, and vice versa. Viewed through this lens, the declining blue bars in the following graph, the number of unemployed workers, is far less illustrative than the flat-lined combination of the three colored bars.



Data Source: U.S. Department of Labor

The reality is that zero progress has been made in the labor markets for nearly four years. Each decline in the number of unemployed workers (blue bars) has been greeted with an equal and opposite rise in workers that have decided to leave the labor force (red bars). Here's the point and what is often missed: *A decrease in unemployed workers only improves an*

economy if those workers become employed. Unfortunately, that has clearly not been the case. In 2009, over 26 million people were underutilized by the U.S. economy. That number is no different today.

The labor market remains a significant challenge. Very little true progress has been made since the early days of the financial crisis, and economic growth has paid the price.

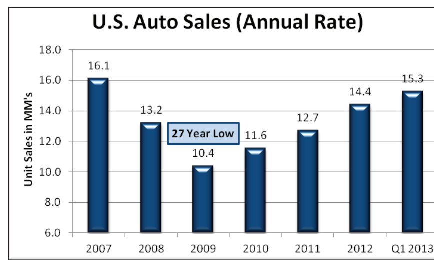
The Consumer

In light of the concurrent loss of the payroll tax holiday and a rise in gasoline prices, close attention has been paid to the response of the consumer. The Conference Board's Consumer Confidence index initially extended a late 2012 downward slide into January. The index then rebounded in February only to lose ground again in March. In short, no clear trend has emerged and, most importantly, the index remains well within the range it has occupied for the past several years.

In terms of actual spending, retailers expressed caution during the quarter based on the aforementioned headwinds. After all, this group would likely be impacted from the removal of $125 billion from consumer paychecks. Despite fears, on a sequential basis, retail sales growth remained positive through the most recent data point in February. That month, itself, posted the second fastest sequential gain in retail sales in the past 17 months.

In similar fashion to retail sales, the housing market, discussed in the next section, has not skipped a beat, and auto sales continue to accelerate.

Transaction prices are up, incentives are stable, leasing is at a healthy level, and new models have been impactful. Expectations are for full year 2013 sales to reach the 15.5 million unit mark, just



Data Source: Bloomberg

below the pre-crisis level shown in the graph.

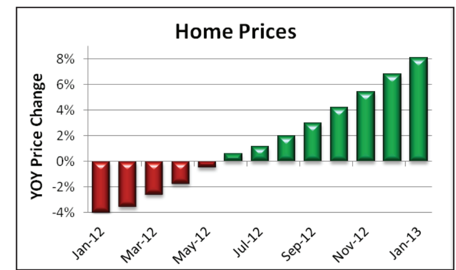
Continued spending trends following a rise in taxes suggest a decline in savings. Indeed, the personal savings rate dropped precipitously in January to 2.2%, a 5.5 year low. The consumer response is understandable in light of other macro-economic variables. First, households have now completely recovered the $16 trillion of wealth lost in the financial downturn. Consumers feel wealthier, *so they are less inclined to save.* Second, household debt service has dropped to record keeping lows of 1980. Consumers have greater financial flexibility and *less need to save.* Third, consumer debt relative to GDP fell in every quarter following the great recession, until an uptick in the final quarter of 2012. Consumers have retrenched enough that they *are less willing to save and more willing to incur debt.*

Of course, the long-term ramifications of low savings rates are not particularly positive. Two-thirds of Americans aged 45 - 60 plan to delay retirement due to lack of savings.

Real Estate

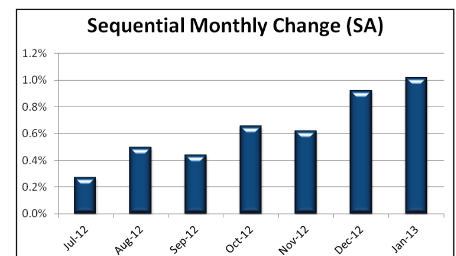
The housing market continues to heal and prices have been rising rapidly. On a year-over-year basis, prices in January rose at the strongest pace since June of 2006.

At least 80% of real estate markets have experienced consecutive monthly price



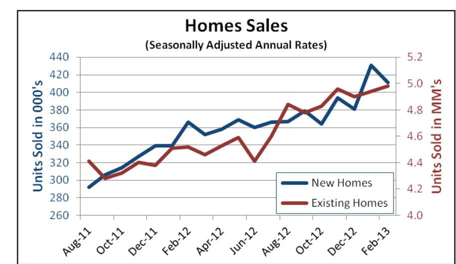
Data Source: S&P/Case-Shiller

gains in each month since last July. In December and January, 100% of markets had month-on-month price increases. Furthermore, the magnitude of price gains is accelerating.



Data Source: S&P/Case-Shiller

Home sales have trended higher as well. As of February, year-over-year sales volumes of new and existing homes had risen 12% and 10%, respectively.

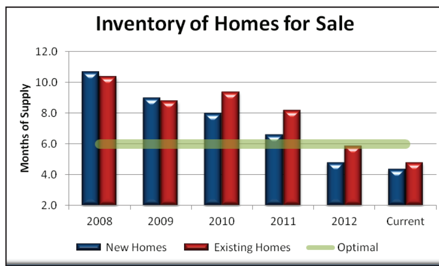


Data Source: Nat'l Association of Realtors / U.S. Census Bureau

An influx of financial buyers has contributed to price and volume gains as well as extremely tight inventory levels.

Housing market stresses have also eased:

- In Q4 '12, 5.2% of homes were facing foreclosure, down from 7.4% the prior year.



Data Source: Nat'l Association of Realtors / U.S. Census Bureau

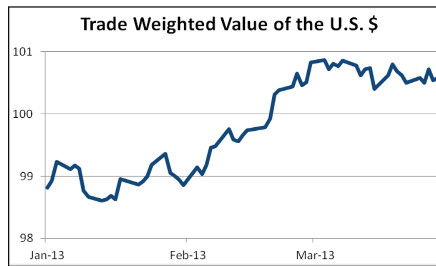
- Distressed sales in January fell 35% from the previous year.
- Households behind on their mortgage payment hit a four year low in January.
- Underwater homes were down to 10.4 million at the end of 2012 versus 12.1 million last year.

The backdrop for housing is attractive. Interest rates are low, financial buyers are active, and household formation rates are on the rise. Tight rental markets have also pushed lease rates high enough that the economics are now in favor of home ownership over rental.

Commodities and Inflation

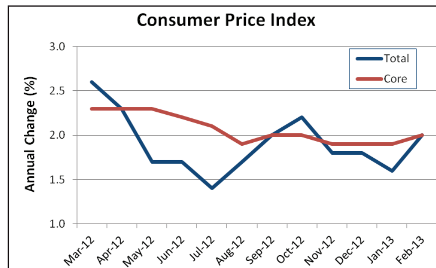
On a longer term basis, commodity prices have been in decline. By the end of the first quarter, the Commodity Research Board (CRB) index was down 19.9% from its post-crisis peak in April 2011 and down 35.8% from an all-time high in June of 2008.

Despite the downward trend, the CRB index changed little during the quarter. Energy products, led by a 20% increase in natural gas, were slightly positive. Metals and agricultural products lost ground. Driving factors behind the relatively benign price movement included modest global growth, slack Chinese demand, and uncertainty as to expected growth in both Europe and the U.S. Demand was also well supplied, and a modestly stronger dollar acted to restrain prices.



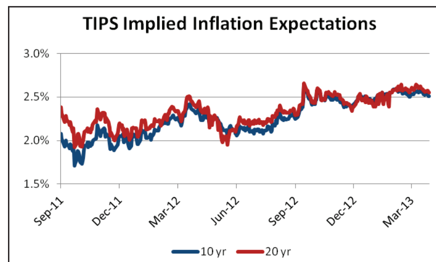
Data Source: U.S. Federal Reserve

As per the Consumer Price Index, inflation has been contained and stable over the past year.



Data Source: U.S. Department of Labor

The same cannot be said of inflation expectations, which have been creeping higher for the past year and a half.



Data Source: U.S. Department of the Treasury

The TIPS market now implies inflation expectations solidly higher than the Federal Reserve's 2% target.

Fiscal Policy

The fiscal cliff deal that passed on New Year's Day avoided broad tax hikes and delayed sequestration spending cuts. No long-term spending cuts were enacted and the agreement did nothing to slow growth of federal spending on healthcare benefits or to shore up social security. The deal will cut the deficit by an expected $650 billion over ten years versus the once hoped for $4 trillion "grand bargain."

Debt limit issues were effectively delayed until the summer, but sequestration cuts became effective in March. Designed to cut $1.2 trillion over ten years, the cuts will trim $85 billion from the federal budget in the current fiscal year. For 2013, the Congressional Budget Office (CBO) expects a 0.6% reduction in GDP and a loss of 750,000 jobs by year-end.

A partial government shutdown at the end of March was avoided through an unusual display of Congressional cooperation. A continuing resolution was passed (with time to spare) to continue funding of various government programs through the end of the fiscal year.

Lastly, on the topic of fiscal issues, the U.S. deficit for fiscal year 2013 is expected to be $845 billion or 5.3% of GDP, the lowest since 2008 and down by almost half from 2009.

Monetary Policy

Federal Reserve meeting minutes in recent months have revealed heightened debate over the risks of unconventional monetary policy. Market instability, the challenge of exit, and excessive investment risk taking are all concerns. Despite discussions, Bernanke has clearly articulated that economic progress to date is unsatisfactory. He is, therefore, resolute in the continuation of unconventional programs despite the potential for market distortions and increased flows into riskier assets.

Another emerging Fed trend is the concept of calibrating bond buying with labor market progress. Under this increasingly likely approach, bond buying would gradually diminish as the unemployment

rate makes progress toward goals. The approach would be transparent to markets and would avoid investor fears of all or nothing quantitative easing.

In the meantime, monitoring Fed statements and actual behavior relative to the following market expectations will be important for investors:

- More than a year of continued bond buying. Purchases slow in 11/13 and end in 5/14.
- More than two years of low interest rates. The policy rate begins to rise in 6/15.
- A bloated Fed balance sheet will remain for over a decade from the start of the financial crisis.

Governments, Politicians & World Events

Japan stressed the need to overcome deflation through public works spending and expansionary monetary policy. The country raised its inflation target to 2% from 1% and is pursuing currency devaluation to gain competitive advantages. The policies being pursued are exceedingly aggressive and carry substantial risk for a country that carries debt nearly 2.5 times the size of its economic output.

In the absence of crisis, Europeans are subtly migrating to a more casual attitude regarding debt levels, deficit targets, and systemic integration. Decreased pressure, including a relatively benign market response to the recent Cypriot banking crisis, has diminished European resolve. Evidence of this includes:

- The ECB agreed to ease terms for repayment of Irish government debt.
- The European banking union may be delayed and/or scaled back.
- France will not meet its 2013 deficit target.
- Ongoing political instability in Italy is rooted in electorate disdain for austerity measures.
- Spain missed its deficit target in 2012 and unilaterally decided it will miss again in 2013.
- Portugal was granted an extra year to comply with its deficit targets.

In Europe, political will is subsiding as social unrest is growing. The two forces are likely to gain momentum following German elections in September.

As the quarter drew to an end, North Korean saber rattling intensified and specific threats were made against the U.S. and its allies. The U.S. responded with a strategic repositioning of military assets and a show of force, but tension remains high and the outcome is uncertain.

Capital Markets Review and Outlook

Overview

The U.S. equity markets fired out of the gate with a 2.5% first day gain, the best since 1928. Performance for the remainder of the quarter was equally impressive as the Dow Jones Industrial Average and the S&P 500 index each climbed to new all-time highs.

Although domestic stock results were admirable, less attractive returns were delivered by other asset classes and from other geographic regions. Bonds were flat to down and developed international equity markets rose by low single digits. Commodities and emerging market stocks lost ground.

Against the "risk on, risk off" behavior of investment markets in recent years, the decoupling of various asset class returns was unusual. Likewise, a globally diversified investor might be disappointed by their portfolio returns when compared only against the S&P 500. However, the bright spot on a go-forward basis is that the rewards of diversification can only be achieved when asset class returns are not synchronized.

Capital Market Returns	
	1st Qtr 2013
U.S. Treasury Bills	0.0 %
Barclays Aggregate Bond	-0.1 %
Barclays Municipal Bond	0.3 %
Wilshire 5000	11.0 %
S & P 500	10.6 %
MSCI ACWI ex. U.S.	3.6 %
MSCI EAFE (Int'l Equities)	5.1 %
MSCI EM (Emerg. Mkts)	-1.6 %
DJ UBS Commodity Index	-1.1 %

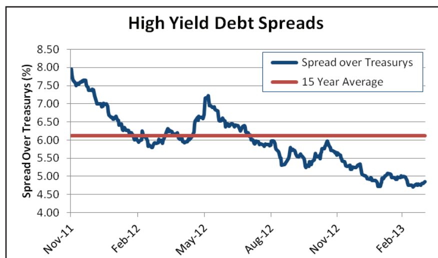
Data Source: Morningstar

Fixed Income Markets

The Barclays Aggregate Bond index lost 0.1% as low yields were insufficient to offset a slight rise in interest rates. International bonds lost 3.5%, largely due to modest strength in the U.S. dollar.

As for credit markets, the Federal Reserve's zero-interest-rate policy and use of unconventional programs have incited an insatiable quest for yield. High yield issuance hit a record of $350 billion in 2012 and spreads over Treasuries continued to compress during the first quarter.

Oddly enough, Federal Reserve officials have grown concerned that [their own] low interest rates are overheating corners of the credit markets, namely junk bonds



Data Source: BofAML High Yield Master II

and mortgage REITs. Imbalances in the junk bond market are indeed becoming pronounced as investors become desensitized to the notion of credit risk. Consider the following:

- In the first quarter of 2013, speculative grade bond yields, on an absolute basis, fell below 6% for first time, ever.
- One-third of dollar-denominated junk bonds now yield below 4.75%. (That's what money markets were yielding in 2007!)
- Forty percent of new issues in the final quarter of 2012 had fewer than normal investor protections. The last time so-called "covenant-lite" issuance was that high was in November of 2007.
- Covenant-lite issuance hit 55% in January, the greatest percentage ever. Nearly one-third of all outstanding high yield bonds now have diminished investor protections. This, another all time record, is 61% higher than the level during the pre-crisis credit bubble.
- Lastly, the 4.8% quarter-end spread shown in the previous graph happens to match the 4.8% average default rate on junk bonds dating back to 1983. There is little room for error.

The challenges in fixed income this quarter are not one-off. Low yields can neither deliver high returns nor provide adequate compensation against even a modest rise in rates. Unfortunately, as previously outlined, junk bonds are not the solution. They offer little, if any, incremental risk adjusted return, and risks have mounted.

Equity Markets

Domestic markets were strong against international counterparts and value generally outperformed growth.

Equity Capitalization and Style Returns		
	Value	Growth
Large	12.3	9.5
Mid	14.2	11.5
Small	11.6	13.2

Data Source: Russell Investments

In terms of fundamentals, corporations are capturing a greater percentage of national income than at any time since 1950 - 40% above the long-term average. At the same time, employees are garnering the smallest portion of national income since 1966. The resulting distortion has not been this pronounced in 50 years. Corporate profit margins are at a high of 9% and stock prices relative to cyclically adjusted earnings are 36% above the long-term average. While these factors have little bearing on stock market returns over shorter periods of time, high multiples on high earnings do not portend strong investment returns over a multiple year outlook. On that note, a joint report by the London School of Business and Credit Suisse recently concludes that investment returns worldwide are likely to be lower for the next 20 to 30 years. Their research suggests real returns of 3 – 4% on stocks and less than 1% for bonds.

Hedge Funds and Alternatives

The HFRI Fund of Funds Composite index gained 3.5% for the quarter. Publicly traded REITs rose 8.4%, and Commodities lost 1.1%.

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