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Quarterly Update
First Quarter 2013

Introduction

In the spirit of the newly started baseball season…the hits just keep on comin'! In this case I mean stocks just keep powering right along. I will be the first to admit that the correction I have been awaiting has not happened. This is partially due to the continued low interest rates finally chasing investors out of cash, and partially due to the lukewarm economy that continues to be soft enough to warrant continued global stimuli, but not strong enough to spook inflation concerns. I think the plan of attack in this letter will be to take a quick trip around the globe and see what merits watching for the next few quarters.

The Markets

Index	December 31, 2012 Close	March 31, 2013 Close	Percentage Change
Dow Jones	13104.14	14578.54	11.25%
NASDAQ	3019.51	3267.52	8.21%
S & P 500	1426.19	1569.19	10.03%
Dow Jones Corporate Bond Index	322.2	321.74	(0.14%)

January is viewed as an omen for the rest of the year. In theory this means 2013 shapes up as a good year for stocks since the first week of January was the best week for stocks in over a year; and this was the best January for stocks since 1997. This indicator has worked 3 of the last 5 years and given we keep setting records every few days we would need a substantial drop for the whole year to finish down, invalidating the signal. Although the Super Bowl winner accurately predicts the direction of the market over 75% of the time. In this case that is a down prediction as an AFC team won—however, the results work better if you consider pre-merger teams. As the Ravens were originally the Browns, and a pre-merger NFL team, that might still count as an up prediction (I may have to go to the review booth to get a ruling).

February was mostly flat, although after the massive upswing in January starting with the fiscal cliff compromise by Congress this was not surprising. Concerns around the uncertainty of the Italian elections and the Fed discussing ending the QE purchases sooner than expected gave the markets reason to pause. But strong economic data, especially in housing, kept stocks on track.

March however was back to the races. The DJIA was up ten days in a row during March, the longest streak since November 1996. Solid data, especially a better than expected jobs report, and confidence a compromise would be reached in the Cyprus situation gave investors confidence.

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The United States

We will start our journey by looking at the homeland first. There are significant positive signs in housing (the median existing home price was 11.6% higher than a year ago, the twelfth consecutive increase and the strongest increase since November 2006—plus housing starts rose 7% to an annual rate just over 1million, the highest in almost five years, and inventory was at its lowest level in 13 years); the unemployment rates continues to drop; corporate earnings continue to surprise to the upside on average and inflation remains muted.

There are reasons to be concerned though. The first look at GDP for the fourth quarter was negative; while it was subsequently revised to 0.4% and combined with a weaker than expected first read on the 1Q13 GDP, it shows the economy is struggling. While unemployment is falling it is tempered by the fact it seems to be driven more by people leaving the workforce than by people finding jobs. Only 63.3% of the working age population is employed or looking for work, the lowest since May 1979. If that level were closer to the 66% it was before the Great Recession, the unemployment level would be closer to 11.5% (Randall W. Forsyth, *Barron's*, 4/8/13).

So the US is a mixed bag. This shows in consumer confidence surveys that were mostly strong during the quarter but fell off toward the end. It would appear that people took heart that Congress reached a compromise but perhaps are starting to feel the tax hikes and sequester effect. The savings rate is down to 2.4% and people are increasingly raiding 401(k)s for non-retirement expenses. 25% of all 401(k)s have loans outstanding, up from 11% in 2006. While debt levels have been falling, currently at $12.9trillion down from the peak of $13.8trillion five years ago, the current level is still higher than 2006 and three times higher than 1998 (Brett Arends, marketwatch.com, *The Denver Post*, 1/20/13).

The Eurozone

Europe is decidedly not a mixed bag, but continues to struggle. Growth in Germany has slowed, has all but stopped in France, and has gone negative (recession) in Spain and Italy. Greece is still a disaster and of course we had the Cyprus bailout concern this quarter as well. GDP in the Eurozone as a whole fell 2.3%, the worst since 2009. The International Monetary Fund (IMF) recently dropped its outlook for global growth to 3.3% and put the outlook for Europe as a whole at (.3%). It also called on the US and the UK to halt austerity measures in the interest of global recovery.

A quick word on the Cyprus problem: We all know Cyprus GDP by itself is far too small to matter in the global scheme of things. What caused the problem was the relative size of the banking system. When the Cypriot banks' deposits were frozen, subjected to a large tax on deposits over €100,000, and then certain officials indicated this would be something of a roadmap for future crises the situation worsened. This created a situation where anyone who previously had large deposits in ANY European bank was forced to reconsider that exposure should Portugal, Spain, Italy, etc. be the next country to experience a Cyprus-like problem. The bottom line is that seizing depositors' money has been a barrier that has not been crossed since the 1930s. That is why a tiny country with a tiny economy caused such a global headache.

<u>The Asian Continent</u>

Japan—After playing second fiddle to China for much of the past few years, Japan suddenly became very relevant in the global economy due to "Abenomics," the policy of Shinzo Abe, the new Prime Minister, to double the monetary base and get inflation back to 2% and growth to 1% in 18months (1990 was the last time Japan performed at that level—Michael Cembalest, JPMorgan Private Bank, 1/31/13). Let me say that again—"Double the monetary base." That is a feat of epic proportions; imagine if 18 months from now everyone in the US had twice as many dollars in their pockets….that would cause some serious purchasing. But the question is whether even this is going to be too late to make a difference.

Two decades of low-interest rate policies have made Japan the most indebted nation in the developed world (debt:GDP of 240%). The population is aging (currently 12% of the population is over 65, 20 years from now it is expected to be 23%) AND shrinking (current population: 128m, 2050 estimates: 90m). The combination of demographics and high debt would severely reduce consumption (current World Bank estimates for GDP are 0.8% in 2013 and 1.2% in 2014). If Japan cannot generate inflation and a moderate rise in interest rates they will be forced to dramatically raise rates which will likely cause a collapse in the Yen. In October 2011 the Yen hit a post WWII high of 75.35—it is now near 97.5 (stats in parentheses from Jim Jubak, money.msn.com, 1/18/13).

China—The question around China is how much has the economy slowed. Clearly the days of 10% growth are behind them, but can we expect 8% or 6.5% going forward? From 2009-2011 China used more concrete in infrastructure building (roads, bridges, buildings, etc.) than the US did in the entire 20th century. In 2004 GM sold ten cars in the US for every car it sold in China; that ratio is now 1:1 (Michael Cembalest, JPMorgan Private Bank, 2/11/13). China is trying to slow its real estate market again by raising minimum down payments and interest rates on second homes. China's currency, the yuan, reached its highest level v. the dollar since the Chinese government opened the currency to controlled market rate fluctuations in 1993. China is still a conundrum as the slowing growth, continued stimulus and trustworthiness of government data create problems, but there is evidence of real growth that causes me to doubt the disaster hard landing scenarios.

North Korea—Another round of saber rattling or something more significant? North Korea is now a nuclear power; a destitute, backwards power, but a power nonetheless. The new leader, Kim Jong-un, has increased rhetoric this quarter about attacking the US (unlikely they have the delivery capacity even if they do have the weapon capacity). Historically, the pattern of North Korea is to rattle the saber and threaten war with the South, or an attack on US interests until the global powers send more aid their way in return for ceasing weapons development. It is unknown at this point if this is just another attempt to repeat this process or if Kim is trying to shore up his ascension to power with bold statements that he may intend to act upon. I have long said that a nuclear North Korea is less of a threat than a destabilized North Korea as the amount of refugees streaming towards the South would overwhelm the South Korean economy. However, the addition of an insecure leader creates enough possibility of an actual attack to give one pause. Personally, I think cooler heads will prevail like in previous instances, but we are monitoring the situation.

The Future

It seems counterintuitive that the markets would continue to soar despite all the warnings signs evident. A big answer to that riddle is the massive global stimuli. Since January 2007 the four main central banks have made $6.5trillion of bond purchases and banking stimulus. During that same time China has made $3trillion in foreign asset purchases (Michael Cembalest, JPMorgan Private Bank, 4/16/13). That is a lot of money being forced into the system!

A second big piece is related to that, specifically the ultra-low interest rates. I have serious concerns about how long they can last. An increasing number of corporations are issuing debt lower than their dividend yields and just a few (30-40) basis points over the US 10yr Treasury bond. More money went into bond funds from mid-2008 to mid-2010 than went into stock funds during the last two years of the tech bubble. It is only within the last six months that equity funds have started to see increased inflows (the first four weeks of the year was the best 4-week inflow into stock funds and ETFs since January 1996—Sarah Max, *Barron's*, 2/11/13), yet this has not been at the expense of bond funds.

Conclusion

This letter contains a number of cautionary statements and projects the US economy to be a mixed bag, China to be experiencing growth—but at what level in doubt, Europe to be in recession and showing few signs of improvement, and Japan to be in real danger. Yet the US stock market is setting new highs every few days. This is a testament to the strength of the US based corporations and the relative strength of the US economy in general.

I remain wary of the stock market in the short term, but the longer term fundamentals look better to me; however, the bond market looks more uncertain. Eventually I think one or more of the four main central banks will be forced to raise interest rates. Once this happens, it could gain momentum quickly. The stock market offers dividend yields, which exceed bond yields, on companies that arguably have better credit than most governments as many corporations have extremely healthy balance sheets. The next few quarters look to be more of the same, but the timing of the corrections, especially the bond market turn, are difficult to predict. We continue to shorten our maturity exposure in bonds, which is our strategy to confront the uncertainty in the bond market (but please note, we are not advocating exiting the bond market). We continue to invest in dividend paying stocks as we think that is a better strategy from a risk v. return perspective, and finally, we continue to hold cash to take advantage of an expected stock market correction, at which point we would be more comfortable adding to equity positions.

Warm Regards,

ED

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