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Financial Market Commentary: 1st Quarter 2013

The Domestic Market Rally Continues

Driven in part by an extremely accommodative Federal Reserve Policy, the U.S. economy is gaining traction, but Europe continues to flounder. Despite the excitement over market performance in the first quarter, the period actually represented a disappointment compared to the broad global rally during the first three months of 2012. Why does it seem like this year's bull market is so much better than last year's first quarter rally? Financial market observers called 2012 a "stealth" rally, implying that many investors were either unaware of the gains being generated by the equity markets or unwilling to expose themselves to the perceived risks.

U.S. Has Growth; Europe Hopes for Growth

As part of its $85 billion per month quantitative easing program, the Federal Reserve purchased about $255 billion of U.S. Treasury and mortgage-backed bonds during the first quarter. That new money has helped drive investors toward riskier assets; notably, fund flows into equities, which had been negative for five years, turned significantly positive in first quarter 2013.

Remember "Eurosclerosis"? It was a derogatory term coined in the late 1970s/early 1980s to describe the consistently disappointing growth trend that gripped much of Europe for years. The regions policymakers sought to combat this malaise and compete with the U.S. via the establishment of a common currency, the euro. As it turns out, having the benefits of a common currency without the accompanying accountability can cause lots of problems; most recently, we've seen Cyprus nearing financial collapse, Italy without a government, Spain with 26% unemployment, and France and the U.K. teetering on the brink of recession.

On this side of the pond, the U.S. is prospering as a result of tremendous natural and structural advantages emanating from what we call "tectonic shifts" in the global economy. These trends include:

- Global trade through our trade ports on both the Atlantic and Pacific coasts
- Energy, as we benefit from our abundance of natural gas, coal and oil resources
- Technology, where we lead the world in productivity gains driven by new innovations such as Big Data
- Frontier markets in which U.S. companies are poised to derive huge profits. This is the case of new Starbucks construction overseas utilizing Caterpillar equipment. Additionally, foreign consumers will drive Fords to get their daily cup of $5 latte.

Can equity markets prosper with Europe contracting but the U.S. expanding? With the most pronounced central bank stimulus in the modern era it sure seems that way - at least for now.

So Far, Washington, DC is all Bark and No Bite; Consumers are the Game Changers.

Some progress has even been made by our divided government. Although at the beginning of the year Congress and the White House had appeared set to continue to battle, so far they have agreed to disagree and managed to avoid a government shutdown. The perceived reduction in political risk, combined with continued economic growth, has presented investors with an environment where most major risks seem less serious than a few months ago.

A positive surprise for the quarter was the lack of damage that the fiscal cliff tax increases did to the economy. Although the increases reduced personal income, consumer spending continued strong, and the economy appeared to remain on track.

Similarly, the sequestration spending cuts that took effect in early March seem to have done little so far to hurt the economy. It is, however, still too early to tell how much growth could be affected by the cuts, as they will be implemented over time. Federal spending comprises from 20 percent to 25 percent of U.S. gross domestic product, and the 2013 cuts amount to roughly 2 percent of government expenditures.

Consumers took the end of the payroll tax holiday in stride and continued to push the economy forward. Despite GDP growth of only 0.4% in the fourth quarter, it sure feels like a good economy at the consumer level.

- Retail sales reached an all-time high of $421 billion in February.
- Housing prices, as registered by the S&P/Case-Shiller Index, posted an 8.1% year-over-year increase in January- the strongest growth rate since June 2006- to reach the highest level since September 2010.

Broad Global Diversification is Key

Without any doubt, the Federal Reserve is intentionally promoting asset inflation for the housing and equity markets in order to support economic growth. Investors, especially those who previously remained on the sidelines have rushed into the market. However, beware of taking risks that are excessive.

U.S. economic growth appears on track while Europe is clearly in contraction and remains exposed to periodic negative surprises like Cyprus that send shockwaves into the global economy. In order to participate in a surging market and inoculate oneself from negative market surprises, a portfolio diversified both globally and broadly across equities and fixed income is best. When markets display extreme and unpredictable bouts of instability, this is the most practical approach to protecting assets while also being positioned for growth.

Overall, we are in a relatively good place at this time, certainly better than other areas of the world. As such, U.S. investors have reasons for optimism, even as they should be mindful of the risks.

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Equity Performance

Equity Index	Style	YTD Return As of 3/31/2013	1 Year Return As of 3/31/2013	3 Year Return As of 3/31/2013	5 Year Return As of 3/31/2013	10 Year Return As of 3/31/2013
Russell 1000 TR	U.S. Large Cap Stocks	10.96%	14.43%	12.93%	6.15%	8.97%
Russell MidCap TR	U.S. Mid Cap Stocks	12.96%	17.30%	14.62%	8.37%	12.27%
Russell 2000 TR	U.S. Small Cap Stocks	12.39%	16.30%	13.45%	8.24%	11.52%
MSCI EAFE NR	Foreign Developed Stocks	5.13%	11.25%	5.00%	-0.89%	9.69%
MSCI EM NR	Foreign Emerging Stocks	-1.62%	1.96%	3.27%	1.09%	17.05%
DJ US Real Estate TR	Real Estate	8.41%	16.39%	16.60%	6.43%	11.48%
DJ UBS Commodity TR	Commodities	-1.13%	-3.03%	1.42%	-7.11%	10.10%

Fixed Income Performance

Fixed Income Index	Style	YTD Return As of 3/31/2013	1 Year Return As of 3/31/2013	3 Year Return As of 3/31/2013	5 Year Return As of 3/31/2013	10 Year Return As of 3/31/2013
BarClays US Aggregate Bond TR	U.S. Core Bonds	-0.12%	3.77%	5.52%	5.47%	5.02%
BarClays US Corporate High Yield Bond TR	U.S. High Yield Bonds	2.89%	13.13%	11.24%	11.65%	10.12%
BarClays Global Aggregate Bond TR	Foreign Developed Bonds	-2.10%	1.25%	4.52%	3.66%	5.47%
Morningstar Emerging Market Bond	Foreign Emerging Bonds	-0.28%	9.32%	7.94%	9.87%	10.10%
CitiGroup 3-Month T-Bill	Cash	0.02%	0.08%	0.09%	0.31%	1.66%

Source: Morningstar®