2013
Investment Outlook

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Introduction

Economic activity remained sluggish last year as U.S. real GDP growth averaged just over 2%. Historically low interest rates persisted throughout 2012 causing investors to seek higher returns in stocks, bonds and real estate leading to strong investment results for the year. With the economy and financial markets about to conclude their fourth year of recovery after the devastating financial crisis of 2008-2009, we believe it is instructive to offer our views on the themes that will likely influence markets in the years ahead and to highlight the most relevant factors driving prospects in 2013. The global trends outlined below can be divided into those impeding growth and those aiding growth. After identifying and commenting on each of these themes, we will lay out, with the assistance of numerous charts, our view of the economy and issues which are likely to sway investment performance this year.

Global Investment Themes

Structural Headwinds

- **Debt/Deleveraging**
  Developed countries in Europe, Japan and the U.S. are all struggling with far too much debt relative to the size of their economies. Austerity policies are likely to dominate these economies, hindering growth prospects by 1-2% annually for nearly a decade.

- **Globalization**
  Historically, globalization has been a stimulant to growth, but with developed market economies barely growing, slow growth has been exported around the world. Under these circumstances, policy changes and economic activity coming out of China have a profound influence on global growth.

- **Technology**
  Technology has historically produced enormous productivity benefits as advanced economies have sought to counter the influence of cheap developing economy labor pools. Recently, there has been concern that workers displaced by technology aren't being retrained and rehired, leading to higher structural unemployment. This issue needs to be monitored to determine whether it is transitory or a longer term concern.

- **Demographics**
  History has shown that when a society exceeds a certain average population age demand slows. In today's world, with average life expectancies of 70 to 80 years in most countries, the dynamic economic segment of the population is the 20- to 55-year-old age group. Individuals from within this group are the ones who form households, have families, consume and become increasingly productive. However, in nearly all developed economies, including the U.S., societies are aging and witnessing a greater and greater proportion of their adult populations move beyond the critical 55-year-old mark. As a result, there are a number of critical factors that will affect supply and demand. On the supply side, productivity and employment growth rates will slow, and on the demand side, savings rates will rise and consumption will likely fall.

Secular Growth Drivers

- **Energy Technology**
  Emerging markets energy demands continue to rise as highly populated countries in Asia, Latin America, and Africa are buying cars and building out their physical infrastructure. As these economies' consumption patterns develop, their energy demands will continue to intensify. New energy technology including horizontal drilling and hydraulic fracturing is leading to increased supply of oil and natural gas in the U.S. In time, there is great opportunity for U.S. energy companies to either export production or technology to developing countries, potentially providing lower raw materials costs for many years.

- **Global Infrastructure Development**
  Developing markets are experiencing an enormous transformation in their societies from rural to increasingly urban. This trend, which began more than a decade ago, is still in an early stage. Almost half a billion Chinese are expected to move from farms to cities. This shift requires the development of roads, bridges, buildings, housing units, and airports, all of which need to be built with raw materials such as iron ore, copper, nickel, cement, and lumber. As a consequence, heavy equipment and power generation will continue to be in great demand.

- **Population Growth**
  Driven once again by emerging economies, global population is expected to rise from 7 billion today to 9 billion by 2050. In addition, as societies become more advanced, their dietary needs expand, suggesting that up to 70% more food and increased supplies of clean water may be required over the next several decades.

Outlook

The outlook for 2013 has improved compared with where we were a year ago. Domestic economic growth prospects are less worrisome, the election is over, Europe has agonizingly and slowly made progress in reducing its own budget issues and China's growth appears to be reaccelerating. Nevertheless, there remain areas of concern. Europe remains a work in progress and geopolitical risks involving North Korea, Iran, and all of the rest of the Middle East persist. And, while the fiscal cliff debate resolved tax policy for now, the battle over the U.S. budget will resume soon. With these realities in mind, we expect volatility in financial markets, especially in the early part of the year, but the upward trend in stock prices should remain intact. This could also be the year that Treasury bonds and other long-term fixed income securities begin to reverse their three decade bull market.

Within the next few weeks, the U.S. federal budget battle is likely to intrude on the relative calm we've experienced out of Washington since the beginning of the year. With both political parties entrenched in their views, we could be in for another nasty confrontation, one that could shut down parts of the U.S. government, at least briefly. With Republicans having surrendered on an increase in tax rates for upper income households without getting any spending cuts, they may decide to link a vote on increasing the debt ceiling to a reduction in federal expenditures. Entitlements are the largest and fastest growing component of government spending and most experts do not believe it is possible to reduce the budget deficit to manageable levels without curtailing entitlements. However, it appears that Democrats won't accept such spending restraint without a cut in tax deductions on the same upper income households that received tax rate hikes as part of the fiscal cliff negotiations. But Republicans view the issue of tax policy as settled, so another messy fight is likely which could be unnerving to investors.

Nonetheless, we expect the economy to sustain its moderate growth trend, with some weakness in the first half due to higher taxes followed by some upside potential in the second half, if our policymakers are able to resolve budget issues without severe political turmoil. Consumer spending has held up well despite ongoing fiscal policy battles and the corporate sector is very healthy. The housing market now appears to be gaining momentum and state and local spending will be far less of a drag on growth after a few years of severe budget restraint. The mild recession in Europe is expected to end later this year and growth prospects are improving across all of Asia, especially China which has seen an uptick in growth recently. Even Japan, which has been in recession for much of the past twenty years, is discussing policies intended to be more growth oriented. Overall, the global economy is healthier than any time since 2007.

The economic environment outlined above would enable corporate profits to continue trending higher and concerns over growth prospects should begin to diminish. These are conditions that bode well for equity performance, especially since stock valuations remain reasonable and equities have become an unloved asset class. Statistics reveal that most retail investors have been underinvested in equities since the financial crisis. Having missed so much of the stock market's recovery, it may not be easy for these retail investors to buy at higher prices, but the longer the rally continues and the calmer markets become, the more likely it is they will begin to return. In our view, equities still have considerable upside potential after thirteen years of consolidation, especially in comparison to other asset classes such as bonds and cash.

Another year of economic growth will heighten debate regarding the stance of monetary policy. A number of Fed officials already think policy has been too accommodative for too long. But further declines in the unemployment rate will justifiably raise questions about current policy during the course of 2013, particularly the Fed's bond buying program, better known as quantitative easing (QE). The Fed may continue to keep its policy interest rate targets at zero for all of 2013, but if the economy continues to grow and unemployment rates fall further, the Fed may decide to gradually wind down QE. With the Fed no longer buying a majority of newly issued U.S. Treasury and mortgage-backed securities, investors are likely to demand higher yields on longer bond maturities. As interest rates rise and bonds fall in value, investors may become willing to shift assets back into equities, eventually providing a new tail wind to the equity rally.

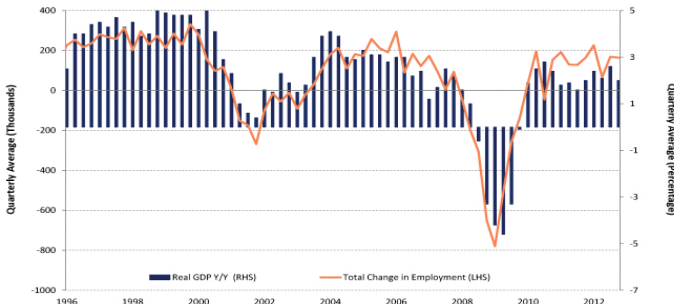
As always, geopolitical events could be wild cards. Iran continues to make progress in developing a nuclear weapons capability, despite rising sanctions and definitive statements from President Obama and European governments that this outcome will not be permitted. Tensions between Iran and Israel and the western world have the potential to be a serious disruptive force in the global economy. In addition, Syrian President Assad is likely to fall in the coming weeks, but it is totally unclear who may take power, whether a new regime will be friendly to the West, or whether Syria would remain in civil war. Venezuela may suffer upheaval should Hugo Chavez succumb to his illness and a nuclear armed North Korea continues to be run by a tyrant.

We have highlighted some of the most important issues likely to command investors' and media attention this year. The fundamentals appear healthy enough to produce another solid year for U.S. equities, and after a strong rally late last year, we are particularly positive about the outlook for non-U.S. equity investments in 2013. In contrast, the improving economy may well initiate a long-term bear market for bonds. In the year ahead, we look forward to reviewing your individual objectives and circumstances and matching them with our investment outlook to fashion the appropriate mix of domestic and foreign stocks, bonds, REITs, commodities and fixed income securities. Please accept our best wishes for a safe, healthy and prosperous 2013.

Bloomberg Consensus: Survey of Forecasters

	Q4 12	Q1 13	Q2 13	Q3 13	Q4 13
Real GDP	1.40%	1.60%	2.10%	2.50%	2.80%
CPI	2.0%	1.70%	2.0%	1.90%	2.10%
Core PCE	1.70%	1.60%	1.60%	1.70%	1.80%
Unemployment	7.83%	7.80%	7.80%	7.70%	7.50%
Central Bank Rate	0.25%	0.25%	0.25%	0.25%	0.25%
2-Year Rate	0.25%	0.26%	0.29%	0.34%	0.41%
10-Year Rate	1.76%	1.76%	1.86%	1.99%	2.14%
EUR/USD	$1.32	$1.29	$1.28	$1.27	$1.27

Jobs and Growth



Source: Bloomberg

R^2=.77

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Dollar Depreciation Likely to Continue

Source: Bloomberg

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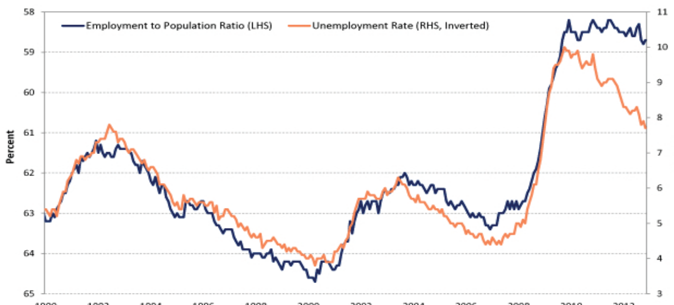
BloombergBriefs.com

Labor Market Slack Persists



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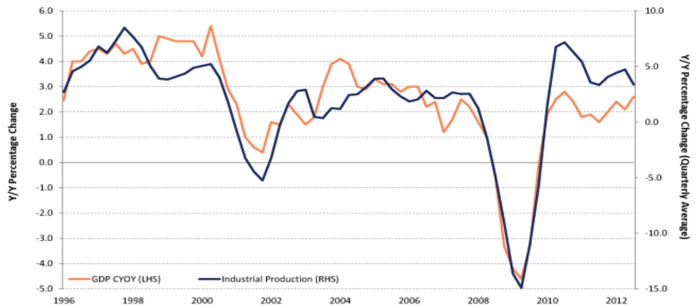
Industrial Production and Growth



Source: Bloomberg

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R^2=.76

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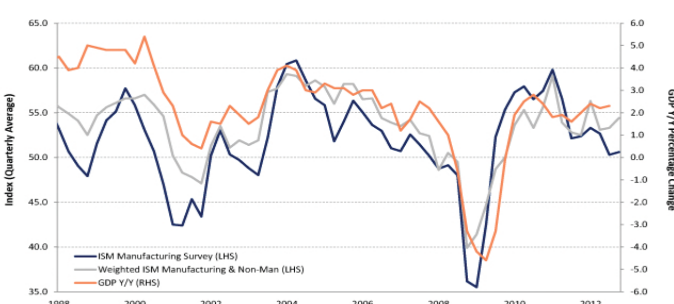
Slow Growth Likely to Define 2013



Source: Bloomberg

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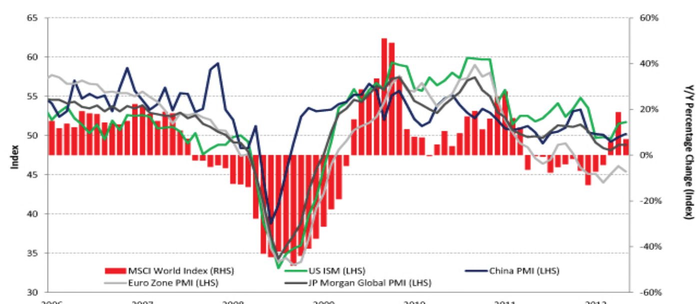
Excluding Europe Global Manufacturing Rebounds



Source: Bloomberg

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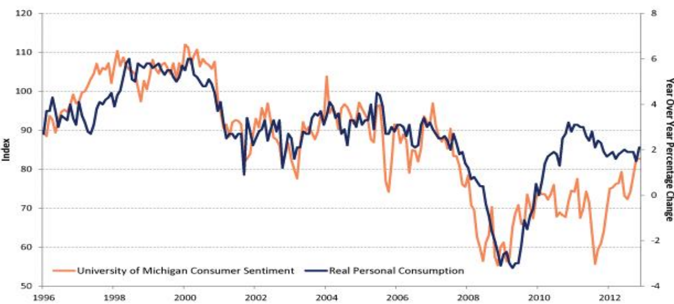
Real Consumption and Consumer Confidence



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Source: Bloomberg

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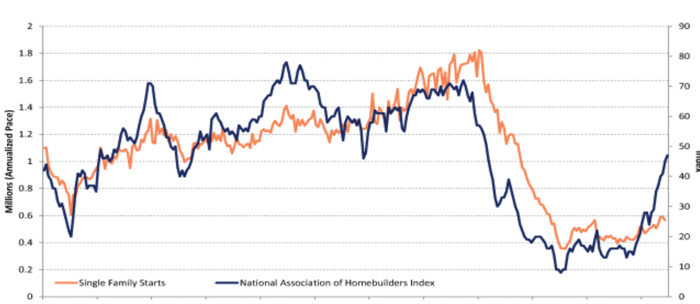
Housing Starts Stabilize



Source: Bloomberg

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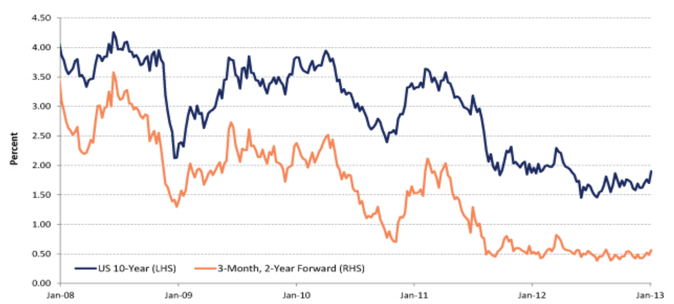
Projected Path of Long- and Short-Term Rates



Source: Bloomberg

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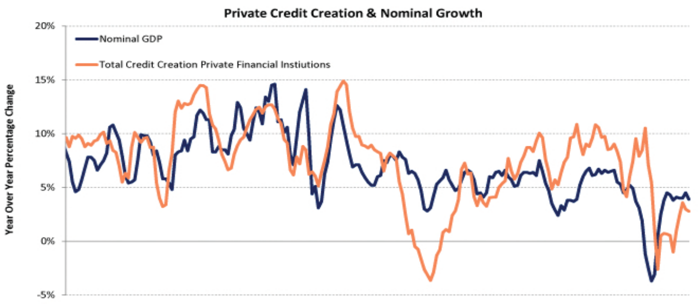
Credit Markets Healing



Source: Federal Reserve, Bloomberg

Adjusted R^2=.64

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Dow Jones Industrial Average 1900-Present

$INDU (Dow Jones Industrial Average) INDX
6-Nov-2012
$INDU (Daily) 13245.68

Open 13113.89 High 13290.75 Low 13112.90 Close 13245.68 Volume 523.5M Chg +133.24 (+1.02%)

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19 Year Consolidation (1906-1925)

13 Year Consolidation (1937-1950)

16 Year Consolidation (1966-1982)

Current Consolidation (2000-present)

Dow Jones Industrial Average 2000-Present

$INDU (Dow Jones Industrial Average) INDX
6-Nov-2012
$INDU (Daily) 13245.68

Open 13113.89 High 13290.75 Low 13112.90 Close 13245.68 Volume 523.5M Chg +133.24 (+1.02%)

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