2nd Quarter 2013 Investment Outlook

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Introduction

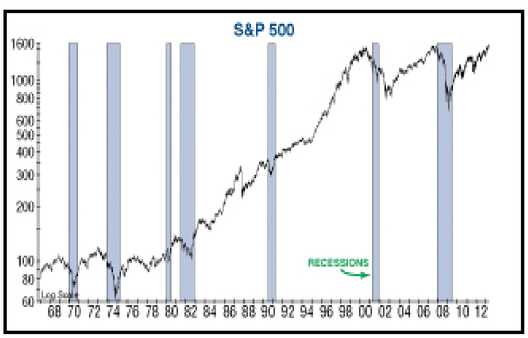
The stock market rally that began last November continued and gained momentum in the first three months of this year. When the quarter ended, both the DJIA and the S&P 500 were up by more than 10% for the year and were sitting at new all time high levels. With such strong performance to start the year, clients may be wondering what this portends for the rest of the year. A look at history suggests that investors should be encouraged. The table at right lists each year since 1950 when the S&P 500 gained 10% or more in the first quarter and the subsequent performance in the remaining three quarters. In 8 of the previous 9 years in which double-digit gains were achieved in the first quarter, the S&P 500 went on to add further gains by year-end, with an average gain of 6.1%. So the odds are good for continued gains, but what is the likelihood of a sharp pullback from current record high levels before further gains are realized? The far right column reveals that in only 3 of the 9 occasions when the S&P 500 rose by 10% in the first quarter did a correction of 10% or more ensue in the following nine months and only once, in 1987, did further gains not occur by the end of the year.

S&P 500 Performance After First Quarter Gain of 10% or More (1950 - Current)

		Q2 through Q4	
Year	Q1 Gain	Gain/Loss	10% Correction
1975	21.6%	8.2%	Yes
1987	20.9%	-15.3%	Yes
1976	14.0%	4.6%	
1991	13.6%	11.2%	
1998	13.5%	11.6%	Yes
1986	13.1%	1.0%	
1967	12.3%	7.0%	
2012	12.0%	1.3%	
1961	12.0%	10.0%	
2013	10.0%	?	
Average:	14.3%	6.1%	

InvesTech Research

Quarterly Review



For all of the strength in the first quarter, a curious dichotomy occurred. Rather than being led by growth sectors, the market was led by Healthcare, Consumer Staples and Utilities, traditionally considered defensive sectors. The slow pace of global economic growth coupled with the hunt for current yield may have led investors to tread into U.S. stocks in a cautious manner with dividend yield and price stability foremost in their minds as opposed to earnings growth. Recent strength in the U.S. dollar against the Euro and Yen may have been additional factors as European and Japanese investors sought to exit their currencies for the safer haven of U.S. dollar denominated investments with higher yields.

Another positive development for investors is the lack of attention paid to fiscal policy debates in Washington. Now that the fiscal cliff crisis and sequester have come and gone, investors have concluded that, for the foreseeable future, no material U.S. fiscal policy changes are likely. Additionally, for the first time since the financial crisis, some stability and permanence can be planned for in tax policy and the federal budget. This development has allowed the investment community to focus to an even greater extent on monetary policy, which continues to be extraordinarily accommodative in the U.S as well as virtually every developed country or region around the world. The latest entrant to the philosophy that domestic growth can be enhanced by aggressive devaluation of the currency is Japan. The new regime in Japan has embarked on the largest quantitative easing program yet, tripling the size of its bond buying plan vs. the U.S., proportionate to the size of their economy. This policy has resulted in the Japanese yen collapsing by

more than 20% vs. the U.S. dollar since November and the Japanese stock market climbing by 50% on the expectation of renewed export-driven economic growth. While there may be a debt crisis looming in Japan's future, investors are currently more interested in the near-term benefits of a weaker yen.

Commodity Collapse

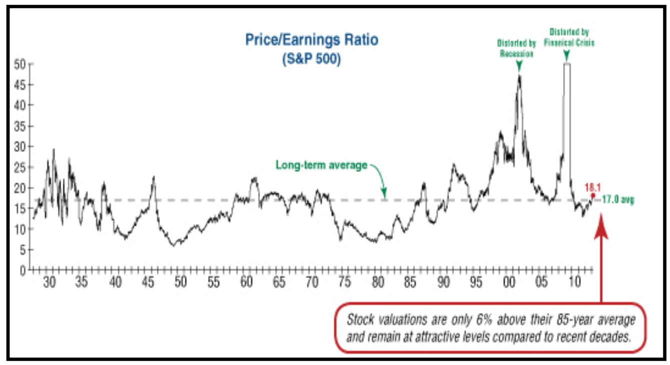
The other major development within financial markets has been the recent breakdown of commodity prices, specifically gold and oil. The directional change in commodity prices can be attributed to a stronger U.S. dollar, recession in Europe and slowing global economic growth, particularly in China. Concern that Cyprus and other highly indebted European countries may need to sell some of their gold reserves to help fund their bailouts has also been mentioned as one of the reasons for the recent collapse in prices. With many hedge funds and speculators owning gold through gold ETFs in a leveraged fashion margin calls may also be a factor in driving prices lower so quickly. The reality however is that the fundamental reasons to own gold or commodities hasn't changed much unless a strong case can be made for a persistently strong U.S. dollar. A strong dollar is unlikely to be perceived favorably by Ben Bernanke and the Fed as part of their monetary policy prescription has been tailored around a weaker dollar helping to bolster U.S. economic growth on the back of stronger exports. In addition, gold typically performs best during periods of financial and geo-political instability which, despite recent hopes, is likely to be with us for some time as increasing public debt in developed countries is akin to a ticking time-bomb and geo-political concerns involving North Korea, Iran and much of the Arab world are unlikely to subside anytime soon. Until there are clear signs to the contrary, we continue to view gold as a strategic holding which should play a role similar to insurance where you hope it is unnecessary, but it is important to own in case of emergency. On a tactical basis, however, it may be sensible to reduce the allocation to gold and other commodities due to the short-term and technical factors cited above.

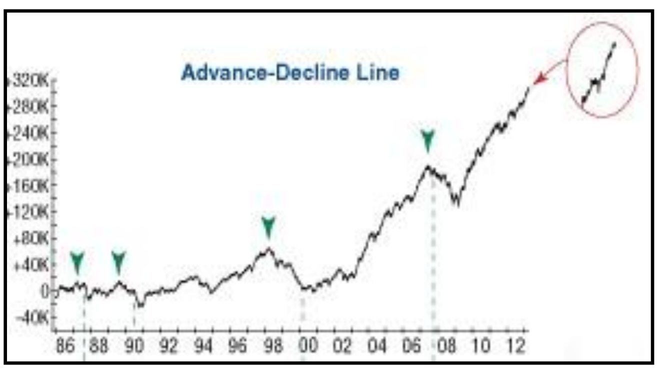
Interest Rates

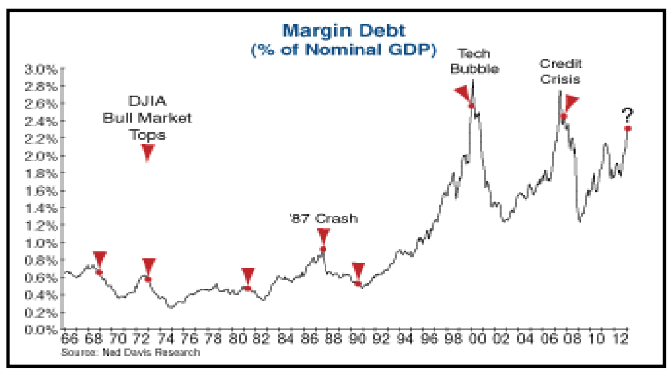
Earlier this year, optimism that U.S. economic growth was improving caused bond yields to rise with the ten-year U.S. Treasury yield climbing to 2.10%. These hopes appear to be premature as a recent string of economic reports have suggested that economic growth in the U.S. is slowing once again, causing the ten-year yield to retreat back to 1.70%. Perversely, in the eyes of investors, this has the benefit of keeping the Fed's bond buying program going for a longer period of time. This program, better known as quantitative easing or QE, has the Fed buying $85 billion of U.S. Treasury and mortgage-backed securities each month in order to keep interest rates at extraordinarily low levels. It has been widely expected that the Fed would continue buying bonds at this pace through year-end. Improvement in the U.S. economic outlook might provoke the Fed to reduce the size of their monthly purchases and hasten the timeframe in which they begin raising short-term interest rates. The importance of all this is that we do not believe a major correction in stock prices (better than 10%) is likely until it becomes clear that a change in the Fed's monetary policy is at hand.

Valuation and Technical Indicators

Additional factors which may drive financial markets in the months ahead include corporate earnings growth, valuation levels and technical indicators. The good news is that in spite of the recent rally to all time highs and lackluster corporate earnings, the stock market still appears reasonably valued. The price-to-earnings ratio (P/E) of the S&P 500 at approximately 18.1 is only slightly above the long-term average as indicated by the chart to the right. In addition, despite the rally in stock prices, the dividend yield of the S&P 500, at 2.1% was higher at the end of the quarter than at the beginning, as corporations increased dividend payouts faster than stock prices rose. As far as technical indicators are concerned, one of the most reliable early indicators of trouble ahead for stocks is the Advance-Decline Line which virtually always peaks months ahead of the major market indexes. As can be seen in the accompanying chart, presently there is no sign of a top, as the A-D Line has recently reached an all-time high. One worrisome trend that is worth noting is that of margin debt. As an indication of the level of speculation in the market, high margin debt can be an early warning flag.







Investment Strategy

To summarize, the current breadth of evidence suggests that neither a recession nor a bear market in stocks is likely to begin in the next 2-3 quarters. With this in mind, we would use market pullbacks to add or initiate stock positions in line with optimal client asset allocations. We continue to find many areas of the bond market risky and would avoid long-dated bonds. For investors seeking current income, we prefer high yield bond funds, REITs, MLPs and high yielding common stocks. In addition, depending on client risk parameters, an appropriate allocation to international stocks & bonds as well as commodities should be used as a strategic part of most portfolios.