Economic & Market Commentary

The events of the first quarter provided enough drama to create fear and trepidation in the minds of ordinary investors. Crashing off the fiscal cliff was avoided by a deal in the early hours of the New Year. Sequestration soon followed, and its full impact was postponed by Congressional rule making. Finally the tiny island nation of Cyprus, whose banking system is larger than its GDP, got caught in another Euro debt crisis that could have precipitated a run on its banks as well as banks elsewhere. This was averted after much haggling, by imposing a penalty on large depositors, a draconian policy which could be seen as precedent setting. But “ordinary investors” were not to be found. These events were shucked off and stocks advanced, into double digit territory. The major indices succeeded in edging past their prior 2007 closing highs, with the S&P 500 doing so on the final trading day of the quarter. With expectations that 2013 gains in the high single digits would be reasonable, the year has started stronger than expected.

U.S. equities were the place to be in the first quarter. They outperformed bonds (which were flat to down depending on the sectors), gold and most non-U.S. equities (which were up mid-single digits in local currency, with a strong dollar diminishing those returns). The Japanese stock market was the notable exception, as they joined the Quantitative Easing (QE) crowd. In the U.S., small and midcap stocks did better than large, as did value versus growth. Once again low quality outpaced high. In terms of sectors, six of the ten S&P sectors did better than the index, with the standouts being healthcare, consumer staples, and utilities (a mirror image of the prior quarter). The most notable laggard was technology, as it was in Q4. Energy continued to struggle as it has for some time, while financials have begun to pick up and did better.

The first quarter of 2013 is eerily similar to the prior two first quarters. In both 2011 and 2012, stocks produced significant gains in the first period (for the year 2011 stocks ended lower than the Q1 close, and in 2012 more than 75% of the full year’s gain was in Q1) followed by rocky periods during the balance of the year. In fact, it would not have been bad to “sell in May and go away”, as the Wall Street adage suggests. Two years ago, there was a rancorous debate in Congress about spending and our deficit which, coupled with the downgrade of our Treasury debt and Europe’s debt crisis, called into question the sustainability of the U.S. recovery. Last year, the European debt crisis, which forced European Central Bank president Mario Draghi to commit to supporting European Sovereign bonds, once again raised the spectre of a U.S. double dip recession. This coincidence begs the question – will this scene repeat?

Europe is still a mess and the Cypriot crisis adds another dimension. The economic data out of the core European countries is weak, which is not good for the peripheral states. The recession that started a while ago is still in progress. While Cyprus itself is small (with the economic impact about the size of Rhode Island), the precedent of imposing a haircut on depositors is chilling. This underscores how far Europe is from a banking union. The northern tier (Germany particularly) does not want a banking union, but nor do they want the euro area to splinter. With German elections upcoming in September, there is a fine line to walk. Were another, larger country (say Italy with its “bring in the clowns” government) to get into the same situation as Cyprus, that could be a problem.

The rest of the world appears to be in better economic condition. China shows signs of bottoming and avoiding the hard landing that has been feared. Japan has joined the QE club, with the Bank of Japan’s latest moves to try to extricate the country from its multi- decade funk. Of course, geopolitical turmoil in the Middle East or Korea could add a chilling dimension to this view.

Our economy is further along in its recovery than it was during the past two years. GDP expectations for Q1 are being ratcheted up by most observers. After an anemic (less than 1%) GDP report for Q4 2012, the expectation was for a +2% performance in Q1. That +2% is now being increased to +3 - 3.5%. Most of this increase appears to be due to what could be considered "non-recurring" factors. Inventory accumulation is expected to add 1-1.5% to growth, after detracting about the same from the prior report. In addition the pent up effects of Hurricane Sandy are expected to add close to 0.5% to growth. Finally the sequester impact, which didn't start until the last month of the quarter, will not be fully reflected. The first two positive items will diminish after Q1, and the contractionary impact of sequester and tax increases will increase as we go through the year. Most observers estimate the fiscal drag from these items to be close to 2%, which will affect the final three quarters of the year. There are however several offsets to what could be a difficult economic prospect. Housing, at the margin, is a stronger contributor than it has been in many years, while domestic oil and gas activity and agriculture recovery will be additional positives. It also appears that state and local government spending will be less of a drag on overall activity than in recent years. Finally, we would expect corporate capital spending to pick up. The Bank Credit Analyst points out that per capita capital stock in the U.S. has barely grown over the past 5 years, and capital expenditures as a percent of GDP topped out in 2000 and have been in a steady decline since. The average age of our capital stock has increased sharply over that period. This has set the stage for a recovery in capital spending and the wherewithal is there with close to $2 trillion cash on corporate balance sheets. We expect this to begin soon and be an added source of growth.

While it seems probable to us that we will have a slowdown in reported economic growth after the first quarter report, we do not think the swoon will be enough to tip the economy to an appreciable degree. We should remain above stall speed and pick up steam toward the end of the year. This assumes no political or geopolitical thorns that might derail the recovery. Here in the U.S. we have the debt ceiling and budget issues, which will likely come to a head during the summer, and globally there is always the Middle East and North Korea which could be problems.

In the face of all this, stocks have done very well, with broad market gains of 10-11% for the quarter. At the beginning of the year we stated that a gain of 6% for the full year would be reasonable, and equity markets have surpassed that in only three months. As we thought, the gain has been P/E driven rather than earnings driven. With worldwide conditions showing less stress, investors became more tolerant of risk and the Equity Risk Premium (ERP) declined (P/Es increased). Over the course of the year, we expect risk tolerance will continue to increase, allowing a further modest decline in the ERP, and similar increase in P/E ratio. We feel stocks are currently at the upper end of fair valuation – not yet expensive, but difficult to call cheap. Faced with the economic circumstances described above, we fully expect some air pockets in the financial markets over the next few months. We don't expect these to be severe, and if we had to offer a guess would say stocks will end the year flat to up slightly from here, rather than the reverse. There are several factors that mitigate against significant market declines.

> First, as said earlier we don't think stocks are expensive, and we expect modest earnings growth.
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> Second, the world economic situation continues to improve, albeit slowly. While Europe remains problematic, the U.S. and other areas should continue to show positive growth allowing the ERP to continue to come down.
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> Finally, there appears to be recognition on the part of the investor that equities are a preferred investment. International Strategy and Investment points out that U.S. equity mutual funds have received net inflows for 12 consecutive weeks, other areas should continue to show positive growth allowing the ERP to continue to come down.

> Finally, there appears to be recognition on the part of the investor that equities are a preferred investment. International Strategy and Investment points out that U.S. equity mutual funds have received net inflows for 12 consecutive weeks, aggregating $73B. Interestingly most of this has come from money market funds, not bonds. Over the past couple of years, bond funds and ETF's have been the largest beneficiaries of the search for yield; a significant reversal of this has yet to occur. There are some reasonable arguments against this shift in preference being a long term trend (i.e. for every buyer there's a seller; major buyers/owners of stocks are not necessarily underweighted; etc.). However, there is no question that as the tolerance for risk grows, asset allocation models could shift in favor of equities.

So we think the case against a severe decline in stock prices is a good one. As mentioned earlier, this assumes there will be no major political or geopolitical event which could throw sand in the gears.

With that as our most likely outcome, we will concentrate on finding companies whose economics we like and whose valuations are reasonable, rather than trying to determine when stocks are poised to decline or advance. We do not believe it is possible to consistently forecast the direction of the market and think our energy can be better spent looking for businesses that we think can produce earnings and cash flow growth, and whose prices do not reflect these positive prospects.

Fixed Income Review and Outlook

After a strong 2012, fixed income securities produced lackluster returns to start the year. Overall, the Barclays Aggregate generated a -0.12% return for the three months ending in March, the first negative quarterly return since the fourth quarter of 2010.

Treasuries lagged the market with a -0.19% return. Yields were little changed in the front end of the curve and higher by about 10 basis points in the longer end. Most of the rise in rates occurred in the first two trading days of the year. On January 2, the market heaved a collective sigh of relief when Congress agreed to a tax package that avoided the fiscal cliff. On January 3, the market was caught by surprise by the minutes of the December Federal Reserve meeting where the Fed Governors discussed the end of the QE3 stimulus program they instituted at that very meeting. These events sparked a general trend of higher yields in the quarter that peaked in early March and has since reversed. Interestingly, both the ten and thirty year Treasury yields closed at higher levels than those of December 31 every day of the quarter.

We continue to believe Treasury rates will rise in 2013. However, the increase will not be a one way street. There will be periods when rates rally (go lower) though the general bias is upward. As noted above, GDP growth is modest, not great. There will be times when economic data disappoints. The Non-Farm Payroll number could come in lower than expected as it did for March when the economy added 88,000 jobs versus an expected 190,000. Macroeconomic factors such as a banking crisis in a country larger than Greece or Cyprus or a policy mistake in dealing with the crisis could spark a "flight to quality" that is supportive of lower yields.

Federal Reserve efforts to drive interest rates lower continue. At its December meeting, the Fed announced a plan to purchase longer term Treasuries at an initial pace of $45 billion per month or about $540 billion this year. The Fed essentially committed to take out most if not all of the supply of longer maturity Treasuries in 2013. Despite some discussion by Fed members and press speculation about the end of QE3, we see a greater likelihood of a reduction in the scope of the Fed's purchase than an outright cessation. When the Fed started QE3, it made the timing for the removal of the stimulus dependent on economic factors (a 6.5% unemployment rate and future inflation expectations of 2.5%) rather than a specific date. While the unemployment rate has been falling, due more to participants exiting the work force than strong employment growth, inflation expectations remain muted.

Agencies returned -0.03% for the quarter. Bullet agency spreads over Treasuries declined steadily through early March and widened as the underlying Treasuries rates fell. Bullets trade at such low levels that a slight widening of spreads causes agencies to underperform Treasuries as they did in March. In a low volatility environment, we prefer to use callable agencies as a yield enhancing strategy. With short term rates held artificially low by the Federal Reserve, investors in callable agencies are compensated for owning the bonds. Ideally, we look for callable agencies with a coupon that will "step" or increase in the event a bond is not called on specified dates. The coupon step incentivizes issuers to call the bonds and provides investors with more certainty about callable cash flows.

Investment grade corporate bonds provided investors with -0.11% for the quarter. Low Treasury rates and tight agency bullet spreads make high grade and high yield bonds attractive alternatives even as absolute yields hover near all time lows. The low yields and demand for the product continues to encourage companies to add debt to their balance sheets. Gross fixed rate investment grade issuance was $294 billion for the quarter, about 15% lower than last year's $346 billion. Expectations are for $1 trillion in new issues this year.

Event risk in the form of the Leveraged Buyout (LBO) has returned to the consciousness of the investment grade investor. Private Equity firms are flush with cash and low bond yields coupled with easily available financing makes it more important than ever for bond investors to manage the downside risk of their holdings. Two examples of well-known US-based companies, Dell and H.J. Heinz, illustrate this. In January, word surfaced that Michael Dell, founder of Dell Inc., was considering a bid to take the company private. The Dell 4.625% due 2021, an A-rated bond, fell from a price of $107.422 to $92.759 in the course of a week. In February, Warren Buffett and 3G Capital teamed up to take H.J. Heinz private in a $20+ billion deal. The Heinz 3.125% due 2021 fell from $103.03 to $99.98 in the next week.

Why the difference? The Heinz bonds have a covenant that allows a holder to sell the bond back to the company at $101 if there is a change of control of the company and downgrade to high yield. The Dell bonds have no such covenant. While the taking on of more debt is detrimental to balance sheets, holders of Heinz debt won't be as adversely affected. They are backstopped at $101. This example illustrates the importance, especially when the investment environment is favorable, of managing the downside risk of a portfolio while looking to capture the upside.

We intend to remain overweight corporate bonds. We look to manage the potential for event risk through diversification of our holdings, finding securities with covenants that offer downside protection and increased holdings in major banks. We prefer banks that are reducing debt, raising equity and employing more prudent lending than was practiced during the housing bubble.

Mortgages beat the overall index in the first quarter, returning -0.05%. The strategy of buying lower coupon mortgages, which worked in 2012, fared worse in the first quarter. Higher coupon securities, which have less interest rate sensitivity and offer higher income, returned a modest positive figure, while low coupons returns were negative.

The Federal Reserve continues its efforts to stimulate the economy via mortgage purchases. At the end of the meeting in March, the Fed reaffirmed its intention to buy $40 billion mortgages per month. In the face of investor demand for high quality assets with an attractive yield over Treasuries, mortgage-backed securities should continue to be well supported for the remainder of the year.

Municipals bested the returns of the Barclays Aggregate in 1Q, returning 0.29%. Municipals benefited from improving fundamentals in the form of increasing revenues and continuing investor appetite for yield.

High yield bonds posted a 2.89% return for the quarter. The factors that produced the strong returns last year remain in place. However, the overall yield of the high yield market has fallen below 6% from a high of 8.35% in December 2011. The average price of a high yield bond has risen to more than $105. Many of these bonds are callable at par or $100. Opportunities for significant price appreciation are fewer and further apart.

Investors looking for income should be rewarded, but those looking for price appreciation could be disappointed.

We remain cautiously optimistic on the bond market. We think Treasury rates will rise gradually over the course of rest of the year as growth picks up later in the year. We like spread product in the form of corporates, mortgages and are eschewing bullet agencies.