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Review & Outlook: First Quarter 2013

Review

US stock prices started the year with a bang, despite the Washington DC fiasco that resulted in the "sequester", and the continued turmoil in Europe. The S&P 500 Index achieved a total return of 10.61% in the first quarter of 2013. High quality, intermediate-term bonds did not fare as well, with prices declining slightly.

The strong performance in equities resulted from a variety of factors. Low bond yields probably increased the demand for equities. Fear that rising interest rates in the short-term would drive intermediate and longer-term bond prices down has probably been a factor. Strong corporate earnings have also helped the stock market and the labor market this quarter.

It is worth noting that the solid performance at the start of 2013 comes on the heels of a strong year in 2012. The market is up more than 20% over the last five quarters.

As we have noted in previous Review and Outlook reports, we see slow economic growth for the next several years. The U.S. energy boom might change the picture longer-term, but we have the burden of gridlock in Washington, difficult conditions in Europe, the cost of the Federal Reserve's stimulus programs, and other factors to consider in the near term. If history can be a guide, the stock market simply cannot continue to do as well as it has in recent quarters with such weak macroeconomic conditions, and risks as a backdrop. Ironically, the best economic condition for the stock market may very well be slow, continued growth (more on this below).

We have been talking with clients about their allocations to bonds. Yields are near zero in real terms (subtracting out inflation). Holding bonds can still help reduce portfolio volatility. However, bonds will not provide the boost to returns in a bear stock market as they did in the past, and will be a drag on performance in a bull market.

Figure 1: 10-Yr Treasury Yields (Jan 1980 – Feb 2013)

Source: http://finance.yahoo.com/

The current reality with bonds makes it more difficult to balance risk and return, and invites questions about diversification.

We are trying to protect some of the gains we enjoyed in the first quarter, and are managing diversification in the face of low bond yields by taking the following steps:

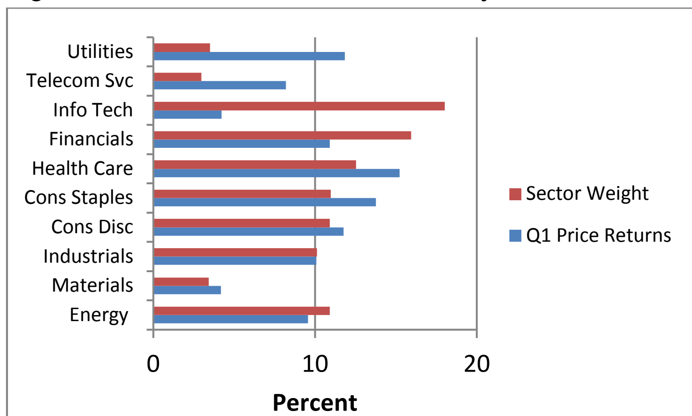
- Tightening our sell rules for individual equities;

- Exploring opportunities in commodities, international markets, and other asset classes not directly correlated to US stock prices; and
- For portfolios that hold bonds, moving exposure to shorter maturities and favoring individual bonds over bond funds.

S&P 500 Performance by Economic Sector

We regularly provide a glimpse into the S&P 500 Index. This quarter we show price returns and weighting for the different sectors in the index.

Figure 2: S&P 500 Index Performance by Sector



Source: Standard and Poor's Financial Services, LLC website.

The strong price return in utilities, health care, and consumer staples may be due to investors seeking more defensive stocks.

Outlook

The outlook hasn't changed appreciably since our previous Review and Outlook. The Blue Chip Consensus Forecast, many of the Federal Reserve banks, and others, are calling for GDP growth just above 2%, with notable downside risks.

While this may seem to be a gloomy outlook, imagine the consequences of a much stronger economy. A recent article in *Bloomberg Businessweek* noted that if economic growth picks up too much, people would sell bonds in anticipation of tighter monetary policy. This would push interest rates up, and push bond prices, and probably stock prices, down. At the same time, much slower growth would point towards recession. So the somewhat worrisome forecast of slow growth may actually be the best path to be on, given current conditions.

We note the low relative value for the U.S. dollar. The low value helps U.S. trade balances to be sure, but also invites questions about where it might go, and how fast. The tension we see is between fundamentals pushing the US dollar up, versus downward pressure due to current debt levels and inflationary monetary policy. In the short-run, we expect to see the dollar strengthen and global rebalancing to favor the U.S. We see tighter monetary policy and/or worrisome inflation on a slightly more distant horizon. Fiscal conditions in Europe will continue to be a problem for quite a while, but Japan and other parts of Asia are doing relatively well.

Given an outlook that calls for slow growth, global rebalancing, and continued trouble in Europe, we believe it is important to stay invested. We expect increased volatility in the coming quarters, realize dividends may be an important source of returns, and (as noted) are exploring new asset classes to ensure portfolios are thoughtfully diversified.

We remain grateful for the opportunity to assist you with your investment needs.

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