

April 2013

Summary

The U.S. economy continued to grow in the first quarter, but it appeared to have slowed in March after a good start in January and February. Although the ISM manufacturing and non-manufacturing indexes remain above the magical 50 level, indicating growth, they both declined in March. The non-manufacturing index, the more important of the two because it represents more than 80% of the economy, fell to its slowest pace in seven months. The slowdown in March is linked to the sequester and the increase in the payroll tax early in the year. The payroll tax increase did not seem to have an impact on consumers at the beginning of the year, because spending was covered by savings. However, when the sequester hit in March, it appears consumers lost some confidence and began to pull back. The Conference Board's consumer confidence index fell in March to 59.7, a decline of 8.3 points. Consumer expectations, which probably reflects many fears about the sequester, fell 11.5 points.

The labor market also seems to have been affected in March by the sequester and its impact on government payrolls. Total non-farm payrolls rose by only 88,000 jobs, much slower than the rate of recent months. It was not quite as bad as it seems, since January and February were revised upward, but still the net was 50,000 jobs less than the average over the past six months. The two weakest areas in terms of hiring were government and retail, which seems to make sense given the aforementioned facts. Until Washington resolves the problem, there will likely be an overhang on the economy. However, growth continues in the overall economy and is expected to continue, although it will likely be constrained. Improvement in the housing sector and continued positive job growth should lead once some uncertainties are alleviated and consumer confidence returns.

POSITIVES

- ☐ Housing market continues gradual improvement as starts and sales rise in February
- ☐ While slower, ISM manufacturing and non-manufacturing indexes remained above 50
- ☐ Leading economic index rose in February, the fifth increase in the past six months

NEGATIVES

- Conference Board's consumer confidence index fell in March, the fourth decline in the past five months
- ☐ Hiring appeared to slow in the wake of a lower-than-expected increase in non-farm payrolls
- ☐ Foreign economies continue to struggle and have an impact on domestic exports

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☐ The ultimate impact of the sequester on payrolls, spending, and overall economic growth



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Summary

Wrapping up the first quarter, U.S. stocks turned in a stellar performance, as the S&P 500 gained 10% (all returns price only) – all the more impressive given the considerable political headwinds the markets faced earlier this year. The health care and consumer staples sectors led the performance parade, gaining 15.2% and 13.8%, respectively. Technology and materials lagged considerably, each sector rising only 4.2%. Weighed down by Apple's price collapse, the Nifty-Fifty lagged the broader market index, while investors' search for yield in the wake of a benign dividend tax verdict powered returns for dividend-paying stocks.

In the near term, the leap in the market has driven investor sentiment to euphoric levels, usually a reliable contrarian indicator of an imminent correction in equity markets. Beyond short-term sentiment, several catalysts support higher prices in 2013.

Analysts predict US corporate profits will rise approximately 5% this year, driven by small revenue gains and a slight uptick in margins. With the tailwind of favorable monetary policy, we believe auto sales, housing and energy markets in the U.S. should continue to power economic growth this year.

Even factoring in market gains this year, valuations on the whole have not been stretched to unreasonable levels, in our view. The dividend yield on the S&P 500 still exceeds 2%.

The outlook is different overseas. Europe struggles with enforced government austerity, which is having a more significant economic impact than forecast. While GDP estimates have been ratcheting downward, central bankers recently hinted at further monetary accommodation as soon as next month.

We believe growth in emerging market economies, while well below recent historic levels, should continue to fare better than that of developed economies, although we believe tangible evidence of acceleration is unlikely until well into the second quarter.

POSITIVES

- ☐ Fed policy positive
- Euro crisis mechanisms holding
- □ Strong pockets of growth in the U.S.

NEGATIVES

- Sequestration will have a negative impact on GDP
- ☐ Short-term enthusiasm too high

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■ North Korea



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Summary

Since last summer, interest rates have traded within historically tight monthly ranges. March was no exception, with the 10-year Treasury trading within a 22-basis-point range. The 10-year ended at 1.85%, just a few basis points lower on the month, and the 2-year ended approximately one basis point higher, at 0.24%. With little change, intermediate Treasury debt just about earned its coupon, returning 0.13%. Despite the reemergence of credit concerns in Europe, intermediate corporate credit bonds outperformed Treasury debt, with a return of 0.22%.

Events that normally would have had an impact on the bond market have had little effect recently. Good economic data, bad economic data, the banking crisis in Cyprus and sequestration in the U.S. have either been dismissed as unworthy of moving the market, or offset each other.

We believe bond market volatility will be lower in 2013, and probably in 2014, than at any time within the past 10 to 15 years. With short rates well anchored by the Fed's commitment to keep the overnight rate below 25 basis points and its \$85 billion per month open-market purchases of government bonds, we see little reason to fear that rates will rise sharply anytime soon. We believe corporate credit should again provide a measure of incremental return as investor demand pushes spreads modestly lower.

POSITIVES

- ☐ Inflation is well within target ranges
- ☐ Mixed to weak economic growth, so the Fed continues to purchase assets
- Strong equity markets could cause rebalancing in favor of bonds

NEGATIVES

- ☐ China's economy is rebounding from a temporary lull
- Current yields are lower than expected inflation
- Bonds reflect manipulation by central bank purchases

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■ Secular shift to/from equities to/from fixed income