Market Insight - Monthly Newsletter

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Last month's market trends and forward-looking commentary.

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Strong First Quarter Leads to New Record High for U.S. Equities

The first quarter of 2013 had a U.S.-centric tone as domestic stocks outperformed most major foreign equity indices. The S&P 500 reached a new, all-time record high on the final trading day of March, ending the first quarter with a gain of 10.6%. It took the S&P 500 nearly 5 ½ years to regain its previous peak of 1565, reached back in October 2007. For the month, the S&P 500 gained 3.8%.

Asset Class Performance

	Mar.	2013
U.S. Equities – S&P 500 Index	3.8%	10.6%
Global Equities - MSCI All World Index	2.4%	7.9%
Real Estate – DJ-Wilshire REIT	2.6%	7.0%
Developed Foreign Equities – MSCI EAFE Index	0.9%	5.2%
U.S. Dollar – DXY Index	1.8%	4.1%
Bonds – Merrill Lynch High Yield	1.0%	2.9%
Commodities – RJ Commodities Price Index	1.2%	0.5%
Bonds – Barclays U.S. Aggregate Bond Index	0.1%	(0.1)%
Emerging Market Equity Index – MSCI Emerging Mkt Index	(1.7)%	(1.6)%
Gold - Front Month Future	1.6%	(4.8)%

The MSCI EAFE index, which measures the performance of international developed equities, gained 0.9% for the month and 5.2% for the first quarter. While it underperformed the S&P 500, its positive first-quarter performance was encouraging considering that the Italian election and the Cyprus bailout marked two events in Europe that in prior periods would likely have sent the index reeling. A major reason for the better EAFE price action is linked to European Central Bank (ECB) President Mario Draghi's speech last July in which he said the ECB will "do whatever it takes" to save the euro (by effectively backstopping its banks). Several measures of European credit risk confirmed the resilience of its equity markets, as both Italian (4.38%) and Spanish (4.75%) 10-year sovereign debt yields remained well below their peak levels of over 7% reached in late 2011 and mid 2012, before Draghi's speech.

The MSCI Emerging Markets Index also underperformed the S&P 500 for the month and the first quarter as it declined 1.7% in March, pushing the index back into negative territory year-to-date. Investors remain concerned about the sustainability of China's recent economic reacceleration (its GDP trough was reached in the third quarter of last year) as well as its government's efforts to reign in its real estate market. Despite these concerns, Chinese manufacturing activity actually accelerated in March, reaching an 11-month high, while Chinese exports grew ahead of expectations in February, rising 21.8% year-over-year. Rounding out the U.S.-centric first quarter, the U.S. dollar gained 4.1% which, in turn, contributed to gold's 4.8% decline — its worst first-quarter performance since 2001.

U.S. Economic News

U.S. economic news started off the month on a strong note as many reports came in ahead of expectations although, as the month progressed, employment, manufacturing and consumer confidence figures were all disappointing, raising concerns over the possibility of yet another "spring pause" in the pace of the ongoing recovery. Positively, the wealth effect from rising home values and stock prices appears to be neutralizing some of the negative fallout from government spending cuts (i.e., sequestration) and higher payroll taxes as consumer spending has remained resilient thus far. U.S. retail sales increased 1.1% in February, ahead of expectations for a 0.5% increase.

S&P/Case-Shiller Home Prices

City	Month over Month % Chg (Dec.'12-Jan.'13)	Year over Year % Chg (Jan.'12-Jan.'13)
Las Vegas	1.59	15.28
Phoenix	1.09	23.19
Atlanta	0.99	13.41
Los Angeles	0.92	12.12
Tampa	0.88	8.91
Miami	0.75	10.77
Charlotte	0.20	6.03
San Francisco	0.14	17.52
New York	0.10	0.61
Denver	0.02	9.15
Dallas	0.00	7.00
Boston	-0.01	4.01
Seattle	-0.32	8.67
Portland	-0.39	8.29
Cleveland	-0.49	4.76
Minneapolis	-0.55	12.09
San Diego	-0.63	9.78
Washington DC	-0.68	5.93
Chicago	-0.88	3.31
Detroit	-0.89	13.84
Composite 10 City	**0.16**	**7.25**
Composite 20 City	**0.13**	**8.08**

Source: Bespoke Investment Group

The U.S housing recovery barreled ahead in February as sales of new and existing homes increased 12.3% and 10.2%, respectively, over the previous year. Existing home sales have now increased on a year-over-year basis for 20 consecutive months. The S&P/Case-Shiller home price index showed that prices rose in all 20 cities that make up the index on a year-over-year basis by an average of 8.08%, its largest increase since 2006. As shown in the table on the previous page, the price gains were led by a 23.19% increase in Phoenix, a 17.52% increase in San Francisco and a 15.28% gain in Las Vegas.

The most significant economic "cold water" came in early April as the U.S. Labor Department reported that only 88,000 non-farm payrolls were added in March, significantly below both consensus expectations for a March increase of 200,000 jobs and the monthly average of 220,000 jobs added over the previous four months. The disappointing March jobs report caused the Dow-30 to initially lose 172 points after its release as investors saw the news as confirmation of economic deceleration. Given the frequency of government employment revisions, we will need to see a couple of more months of employment data to determine the extent of any slowdown but, positively, so will the U.S. Federal Reserve, which is now likely to remain accommodative. This past month, one Fed official suggested that the U.S. labor market might be strong enough by summer to begin scaling back the Fed's stimulus. However, the March jobs report is likely to raise doubts inside the Fed about how quickly the job market is healing and deflate that possibility.

Inflation perked up as a rapid increase in gasoline prices in February led a 0.7% increase in the Consumer Price Index (CPI), its largest monthly increase since June 2009. The Federal Reserve has stated publicly that it intends to remain accommodative as long as the U.S. unemployment rate remains above 6.5% and the inflation rate remains below 2.5%. The Fed tends to focus on core inflation (e.g., food and energy costs), which increased only 0.2% in February, a level likely to keep the Fed's $85 billion per month quantitative easing (QE3) program in place. Additionally, gasoline prices dropped in March, further easing inflationary pressures.

Cyprus Crisis Troubles Markets

The world's attention was focused on the tiny Mediterranean island-nation of Cyprus in March, after eurozone officials requested its banks impose a tax on their depositors to help pay for the country's €10 billion bailout package. While the Cypriot economy accounts for only 0.2% of Europe's total GDP, anxiety spiked following the unorthodox request due to concern that other troubled eurozone countries, namely Italy and Spain, would likewise confiscate depositor assets potentially causing a run on their banks. As part of the bailout deal, Cyprus will shut down its second-largest bank and impose large losses on deposits over €100,000. According to Reuters, accounts over €100,000 will be subjected to a 22.5% confiscatory tax while 37.5% of cash deposits over €100,000 will be involuntarily converted into equity in Cyprus's largest remaining bank. The outcome was worse than many major depositors had feared and effectively ends the island nations' status as an offshore banking haven. Although depositors with more than €100,000 will effectively lose 60% of their savings, the bailout plan averted a collapse of the entire Cypriot banking system.

Global Equity Valuations Remain Attractive

In light of the first quarter's broad global equity rally it is worth taking a look at equity valuations for signs of froth. The table below shows the current price-to-10-year-average earnings for a number of the world's largest equity markets. The valuations are based on each MSCI country index as of March 31. What is apparent from this data (and consistent with other metrics we track) is that international equities generally appear very cheap relative to U.S. equities. With the caveat that earnings data for emerging markets generally only dates back to the mid-1990s, many emerging markets also appear undervalued relative to their historical norms, including Brazil, China and Europe.

MSCI Country Index (in local currency)	Current P/E 10	Historical Mediam P/E	# Standard Deviations from Median
Brazil	**11.3**	**17.0**	**-1.34**
Japan	21.1	39.6	-0.91
China	16.7	22.9	-0.88
Europe ex. U.K.	13.6	20.2	-0.77
U.K.	12.6	14.8	-0.49
Russia	6.3	8.0	-0.27
Canada	18.0	19.7	-0.18
Australia	16.5	16.6	0.00
U.S.	19.6	19.2	0.05

Source: Ned Davis Research

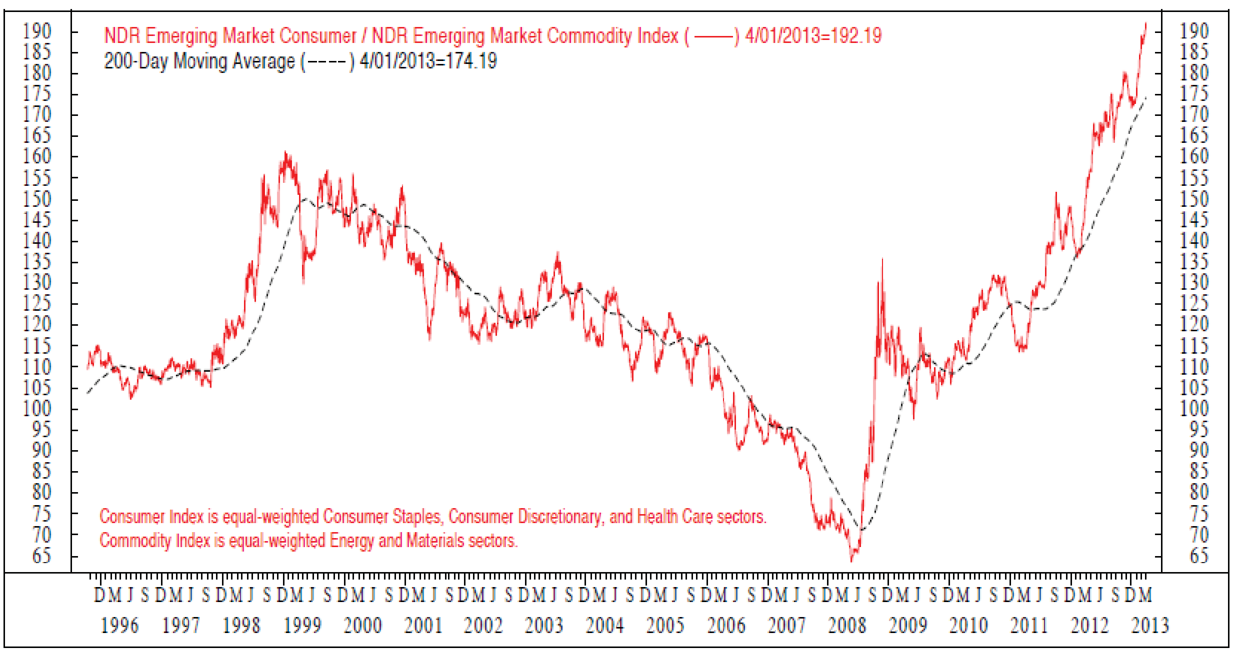
Meanwhile, the U.S. market appears only modestly overvalued based on its historic median price-to-10-year-average earnings since 1979. We also track a longer-term history of this measure for the S&P 500 with data going back to 1871, which shows the U.S. market as significantly overvalued. However, we weight recent history more heavily in our analysis given the dramatic changes in accounting standards, corporate disclosure practices and monetary policy that have occurred over the past 100 years. The weight of the evidence suggests that U.S. large-cap stocks are only slightly overvalued from a long-term perspective and, arguably, fairly-valued when considering the current low inflation environment.

Emerging Markets Theme Update

One of our long running themes, which lagged notably in the first quarter, has been emerging market equities. Given the severity of first-quarter underperformance, it is worth briefly revisiting the emerging market theme to see if it continues to make sense from an investment point of view.

Perhaps the most important factor facing emerging economies over the next five years is the long-anticipated shift away from heavy investment in fixed assets toward a greater reliance on consumer spending. This is particularly true in China, where economists have worried for several years that its efforts increase consumer spending appear to have yielded little progress. However, several recent studies indicate that official Chinese government data that shows household consumption languishing at 35% of GDP may actually be understating the true level of consumer spending. For example, an article from the March 30, 2013 edition of The Economist magazine cites data from economists at Morgan Stanley that shows Chinese consumers spent over $370 billion on tourism in 2012, which went largely unreported in official GDP statistics. Similarly, Chinese official data appears to do a poor job of picking up spending related to financial services, healthcare and housing. The following chart from The Economist compares Morgan Stanley's estimates of China's household consumption as a percentage of GDP versus the official government data:

Market-based indicators also seem to imply that a healthy rebalancing toward private consumption is quietly underway in emerging markets. For example, this chart from Ned Davis Research compares the performance of emerging market consumer stocks (consumer staples, consumer discretionary and healthcare) to emerging market commodity stocks. As shown, emerging market consumer stocks have exhibited notable outperformance over the past two years.



The strength of consumer stocks in emerging markets suggests to us what we deem to be necessary economic rebalancing toward private consumption is making more progress than is currently understood. A side effect of this trend is that consumer stocks may become larger weights in emerging market indices over time and, as a result, emerging market equities may become less correlated with commodity prices. The underlying rebalancing in emerging market economies toward more reliance on consumer spending is likely to lead to renewed outperformance by emerging equities over the intermediate term in our opinion and is one reason we believe is prudent to maintain emerging exposure despite the recent disappointing relative performance.

A Word on Corporate Profit Margins

One long-standing concern that we share with many other analysts is the sustainability of near record-high profit margins for U.S. corporations. Historically, margins have tended to revert to their mean over time, which suggests a sharp drop in corporate profitability is on the horizon. However, the two conditions that have tended to create intense pressure on corporate margins have been bouts of high inflation or, alternatively, economic recessions. Although domestic economic data has shown some recent softening, our base-case expectation is that the U.S. economy will continue to grow at a modest pace throughout 2013. In terms of near-term inflation concerns, the type of inflationary pressures that have typically resulted in profit margin declines is not currently evident.

The chart below compares the relationship between S&P 500 profit margins and the year-over-year change in the Consumer Price Index (CPI). Historically, inflation rates of below 3% have been associated with increasing profit margins. The data in the chart reflects the January inflation rate of 1.6%, which rose to 2% in the February data. However, as discussed earlier, recent evidence points toward moderating near-term inflationary pressures and we believe the odds favor corporate profit margins remaining very strong in the near-term.

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