Economic & Market Commentary

There were three headlines that affected investors during the final quarter of 2012:

- The reelection of President Obama
- The announcement by the Federal Reserve of a fourth iteration of Quantitative Easing with hard economic targets
- The dysfunctional efforts on the part of the Executive and Legislative branches of our government to avert the "fiscal cliff", led to a 13th hour deal at the start of the New Year

Stocks reacted to these events by declining close to 8% from their September peak through mid November in reaction to the election, rebounding close to 6% through mid December in response to QE, then giving some back through year end in response to the bickering in Washington. The result of these gyrations was an S&P 500 that declined 1% for the full quarter. The year as a whole, on the other hand, produced a return of 16%, much stronger than most had anticipated. 75% of this return occurred in the first quarter when "risk-on" was the mode, followed by a swoon from late March through early June, a rebound through early September, and the final period as described.

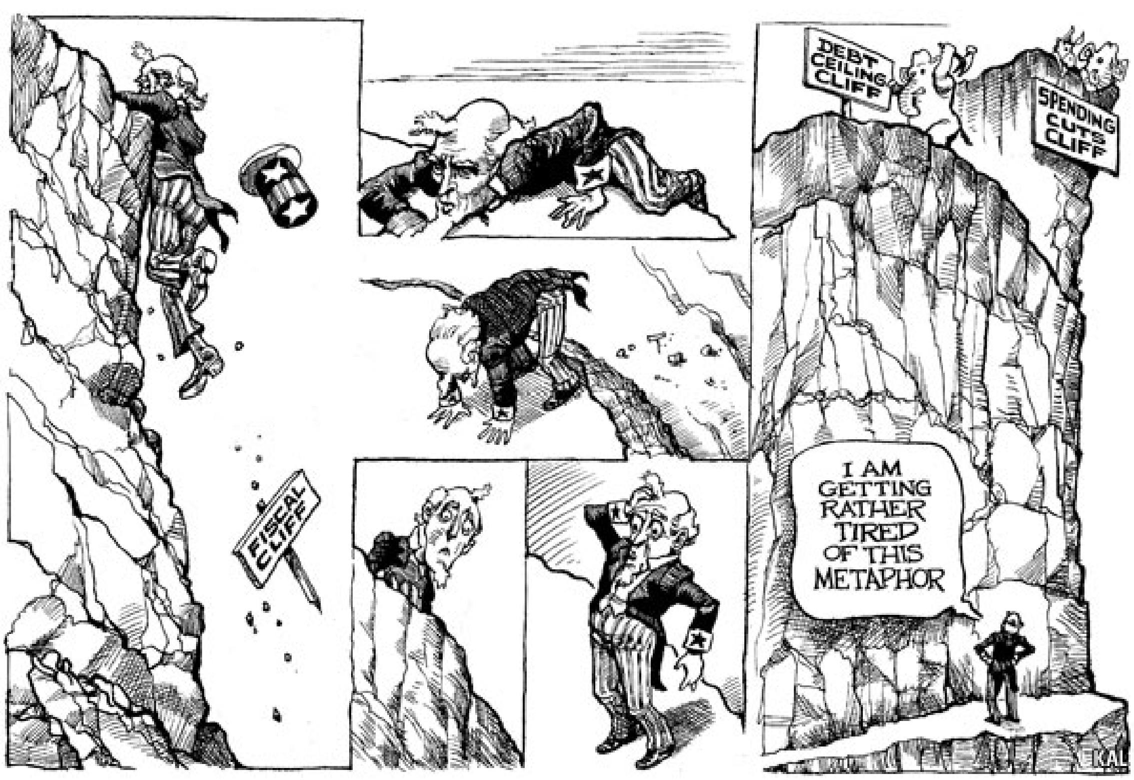
As they have for most years, stocks outperformed bonds for the quarter and the year. On the equity side, only 2 of the close to 50 world markets monitored by the Wall St. Journal reported negative performance for the full year, and 60% of them were up double digits - it was a good year for stocks around the globe. Small and midcap were positive performers during the final period, which allowed them to catch up to large cap, and all were up in the mid teens for the year. Likewise, value caught up to growth in the final 3 months, allowing that style to pull ahead for the year. Low quality again dominated high quality and risk was an important factor, particularly during the first quarter which produced the bulk of the year's gain. Interestingly Merrill Lynch reported that stocks with the highest dividend yield were at the bottom of the performance list. The narrowness of the market continued to be evident in the final period, as well as the full year. Only 4 of the 10 S&P sectors did better than the index for the quarter and only 3 did so for the year. The financial, consumer discretionary and healthcare sectors were the best performers for both periods, while notable laggards were energy, consumer staples, and utilities. Information technology was weak in the final period, largely due to Apple's negative performance. In spite of that, Apple accounted for about 8% of the S&P's increase for the year.

Underlying these mood swings during the year was the fact that the US economy performed reasonably well. As we review the year, we conclude that economic performance was about as we expected; in line with what we suggested a year ago. Most estimates are for a final quarter that was weak (+1.5%), which will produce real GDP growth for this year of slightly more than 2%. Since the recovery began, the U.S. economy has averaged 2.5% annual growth. As we have pointed out in the past, this is a sub par performance. U.S. economic output remains about 10%-12% below where it should be based on past trend growth. Since 2007 the world's central banks have flooded the global economy with $11 trillion in stimulus with no end in sight. Central bank balance sheets have exploded from $8 trillion to $19 trillion, yet global growth remains tepid. Most observers agree that the initial flood of liquidity was necessary and welcome to defuse the then financial crisis, and calm financial markets. It was thought that by injecting liquidity and keeping interest rates low, saving would be discouraged and spending encouraged. Lower rates also reduce the discount factor and inflate asset values which would increase the propensity to spend. Growth in the central bank's balance sheet would also put pressure on currency values, and aid exports. This was the theory, yet the result has been less than desired. We must now ask the question of how the central bank unwinds the balance sheet bloat it has created. The Fed claims it has the means and a plan. Whatever is done will cause market turbulence and may lead to higher than normal interest rate and inflation risks. However, the fact of the matter is that monetary policy may be the only game in town, as future fiscal policy will be contractionary, so we expect the central bank to be accommodative for the foreseeable future.

Since this recovery began, the consumer has been the backbone of the U.S. expansion, holding up with great resilience in spite of weakness in employment, incomes, and a wounded balance sheet. Significant household deleveraging has taken place (much through default), but it is estimated that it will still take a few more years to complete the process. In the meantime household balance sheets have improved. Assets (securities and housing) grew by $800 billion last year, recouping 80% of the wealth lost during the crisis. This allowed the "wealth effect" to boost consumer spending by an estimated 1½%. Home prices appear to have bottomed, which should continue to be beneficial to balance sheets. Housing also made a positive contribution to overall growth for the first time since 2005. Residential investment swung from a negative to a positive during the year and accounted for 16 % of the growth in real GDP for the first 3 quarters of 2012.

Business on the other hand, did not do its share to promote growth. Profits were good, but they merely added to the stash of cash on corporate balance sheets. Spending on jobs and equipment were not as strong as hoped. Unfortunately, until clarity and confidence returns, this will probably be the case going forward. The $1.5-$2.0 trillion in cash on corporate books is a potent tool, which at some point in the next few years will be a significant source of added stimulus.

Government spending, Federal, State and Local, was in a contractionary mode, and will probably continue to be for some time. We ended the year with a 13th hour deal, which prevented us from going over fiscal cliff #1. We are, however, faced with other "cliffs"- government debt ceiling, sequestration, and the huge issue of spending- which must be addressed in the next few months. The Economist captures the dilemma in the following cartoon.



The revenue side of the fiscal equation was supposedly dealt with in the cliff #1 deal, yet in truth much more work needs to be done. Most are in agreement that the whole tax code needs a redo. The U.S. relies more heavily on income and corporate profit taxes than most countries. 47% of our tax revenues are derived from those sources, compared to only 30% for the OECD average (social security, property, and sales tax are the balance). So loopholes need to be addressed, and a broadening of the base needs to be accomplished. With 47% of the population paying no income tax, a broadening of the base would go a long way. Like many other countries that already have one, a national sales tax should be part of the discussion.

The spending side of the equation is another huge issue. Keynesian theory holds that government spending is a more effective way to create immediate demand than tax cuts. Tax cuts involve leakage, as some of the cuts may be saved; therefore there is less of a multiplier effect. Yet the private sector is the income and wealth creator, while government primarily serves as an income distributor. While some of the government spending like infrastructure, education, and health care, enhances productivity and growth, the most significant part of government spending is on entitlement programs which are largely non productive. The spending debate needs to include these issues. The fact that government's share of GDP has gone from 27% in 1970 to 40% today underscores this point.

So the next several months will be critical as we deal with the remaining cliffs. The discussions surrounding this will be tough and contentious, and provide opportunities for volatile swings in financial asset prices. Yet investors may be getting inured to the constant bickering in Washington, and believe that politicians will not hold the economy hostage to their partisanship. This could lead to a more muted response in the financial markets. The last time the debt ceiling issue was on the table (summer 2011) stocks declined close to 19%. We are optimistic that we will not see a repeat of that scenario. Back then there were several other negatives in the picture - Europe was in more difficult straits, there was concern about an economic hard landing in China, and the durability of the U.S. expansion was questionable. The world is in much better shape now, so we do not foresee a repeat of 2011.

Regardless of the outcome of these negotiations, we will face greater fiscal drag in the coming year than in the last, with current estimates centering around 1-1½ percentage points of drag. The consumer, faced with higher taxes (both payroll and income) and continued deleveraging, will be the primary negative. This should be partially offset by a series of positives in residential housing, business spending, agriculture and energy. While the drag will dampen growth, it is interesting to note that last year private sector growth was greater than aggregate GDP (+3.1%) and a decline in government spending reduced that. So we should be able to handle the fiscal drag and still show positive growth.

Our base case for the coming year is that we will continue to muddle through and show some growth. We have been saying that the central tendency is for 2-2½% real GDP growth; we expect that to be shaved as described above. The muddling will be accompanied by similar volatility as we have had for the past several years, particularly as we go through the next several months. On the global front, we recognize that the world's problems are not solved, but enough progress has been made to calm the waters. Europe's problems still exist. 17 sovereign states, each with its own agenda, and no fiscal union will take years to sort out. Yet things have gotten better. Mario Drahgi and the ECB will do "whatever it takes", Greek debt has been upgraded. All periphery countries (ex Ireland) are expected to be in primary surplus in 2013. The need for growth and any movement toward a fiscal union has not been solved, but things are better than a year ago.

China has accomplished their political transition, and the economy appears to have bottomed. Growth should resume at a rate that may be closer to 7% than 9%, but there is evidence they are out of the woods.

Japan's election has led it to join the ranks of countries adopting stimulative policies. So across the globe the economic situation has improved. This should have a salutatory effect on investor's confidence.

Stocks did well in 2012. In fact they did better than we had expected. At the beginning of the year, we felt a gain of 6-7% would have been reasonable, yet their returns more than doubled that. Prior to last year, earnings have been the driver behind equity performance. Earnings growth has been more rapid than stock appreciation, as the Equity Risk Premium (ERP) increased and Price/Earnings (P/E) ratios declined. 2012 was the first year since the crisis that prices outpaced earnings growth, as the ERP came down and P/E's expanded. UBS estimates the sources of stock market performance for the year were:

P/E	+8%
Earnings	+6%
Dividends	+2%
	+16%

Stocks ended the year at what we would consider the upper end of the fair value. They are not expensive, but nor are they cheap. 2012 earnings for the S&P 500 should end at close to $100, about where we have been expecting for the better part of the year. As we enter the New Year, input costs are not under upward pressure. Labor, raw materials, and capital all have abundant excess capacity, so those costs may not be a problem yet. As a result, aggregate profits could show some modest growth, in line with the pace of the economy. We could well have another year like 2012, where the world continues to look a little better, the ERP declines further and P/E's gravitate toward the more normal 15x that they historically have reached. To us that means equity returns in the 6% area are reasonable. This could also mean a further decline in equity correlation. Performance in the recent past has been driven by global macro events, which has caused stock valuations to be tightly correlated, and volatility to be high. The level of correlation declined last year as the ERP declined, but it remains well above average. If we see a further reduction in the ERP, the correlation should decline further. This, of course, would be good for stocks, as they would become more influenced by company specific news rather than global headlines. Since we look for businesses that have sound economics and are reasonably priced, we would applaud this circumstance.

Fixed Income Review and Outlook

Fixed income securities produced another year of good returns. While investors in 2011 were subject to sporadic cycles of "risk-on, risk-off" mentality, they enjoyed a more steady "risk-on" environment, interrupted only by infrequent periods of risk aversion in 2012. Overall, the Barclays Aggregate Bond Index generated a 0.21% return in the fourth quarter, bringing the total for the year to 4.22%.

Treasuries lagged the market with a 1.99% return for the year. Looking at Treasury yields at the end of 2011 until the end of 2012, an investor might reasonably assume that the market was dull. However, during the year, ten year yields traded in an almost 100 basis point range, touching a post World War II low of 1.38% in late July. The thirty year or long bond yields touched a low of 2.45% in July and a high of 3.47% in March. A buyer of the long bond at the highest yield in March would have realized a 20% return when the bond hit its low yield in July.

We believe Treasury rates have hit their lows and will rise in 2013. However, the drivers of interest rates don't point toward a fast move upward. As noted above, GDP growth is tepid. Wage growth, a key component in inflation expectations, is restrained. Productivity is growing, while the change in unit labor costs has been negative for 18 of the last 20 quarters. That is not the kind of environment where a worker can demand higher wages. With an unemployment rate close to 8%, that worker is not likely to try. Inflation at the pump and at the grocery store is not translating into the higher inflation expectations that put pressure on interest rates.

Federal Reserve actions have, so far, been successful in their efforts to drive long term interest rates lower. These efforts continue. With the Maturity Extension Program or Operation Twist set to expire at the end of December 2012, the Fed at its December meeting announced a new program to purchase longer term Treasuries at an initial pace of $45 billion per month or about $540 billion this year. Last year, the Treasury Department issued about $240 billion of ten year notes and $170 billion thirty year bonds. 2013 issuance is expected to be similar. With the new program, the Fed has essentially committed to take out most if not all of the supply of longer maturity Treasuries in 2013. This puts the Fed in competition with other buyers of long duration assets, such as pension plans and life insurance companies who have liabilities that extend out for decades.

While we believe the Fed's policies will ultimately stoke inflation expectations, we are not convinced it will be this year's problem. The Federal Reserve members recognize the danger of letting expectations get away from them and have addressed this to some degree. At their December meeting, they reaffirmed their commitment to keep the Fed Funds target low, but 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. If growth surprises to the upside, the markets should be able to anticipate the move rather than be surprised as they were in 1994. This could lead to more orderly rise in interest rates.

Agencies outpaced Treasuries, returning 3.02% for the year, as bullet agency spreads over Treasuries declined steadily for much of the year. They now trade at levels such that a slight widening of spreads would cause agencies to underperform Treasuries. In a low volatility environment, we prefer to use callable agencies as a yield enhancing strategy. With short term rates being held artificially low by the Federal Reserve, investors in callable agencies are compensated for owning the bonds.

Investment grade corporate bonds provided an annual return of 9.82%, which was the second best annual return for corporate bonds over the last decade. BBB-rated securities and financials led the market higher as they returned 11.10% and 14.65% respectively. Low Treasury rates and extremely tight agency bullet spreads make high grade and high yield bonds attractive alternatives and have encouraged record issuance in 2012. Gross fixed rate Investment Grade issuance was $1.086 trillion, beating the previous record of $988 billion set in 2009. Expectations are for $1 trillion in new issues this year. Recently, it has become more common for corporations to issue debt to buy back stock or pay special dividends, thereby increasing balance sheet leverage. Barclays Capital reported that gross leverage reached 1.86x and net leverage 1.50x in the third quarter. These levels approach those last seen in early 2009. Approximately 60% of the companies Barclays sampled increased both total and new leverage in 2012. This trend toward re-levering the balance sheets has not had a material effect on the overall quality of the sector, but bears watching. We intend to remain overweight corporate bonds. Despite the uptick in leverage, corporate balance sheets remain strong. Funding needs are expected to be light, as new issue is more driven by a desire to lock in low absolute interest rates. The additional income provided by corporate bonds will be welcome once rates do start to move up, as the reinvestment will come at higher rates. In the meantime, investors are compensated by higher yields than are available in Agencies and Asset-Backed Securities.

Mortgage-Backed Securities (MBS) trailed the overall index for the year returning 2.59% in 2012. The strategy of buying lower coupon mortgages, essentially accepting more interest rate risk in lieu of extension risk, proved to be a winner in 2012, as mortgages with coupons of less than 4% returned 4%. Higher coupon MBS returned about half of that.

The Federal Reserve continues its efforts to stimulate the economy via mortgage purchases. At the end of the meeting in December, the Fed reaffirmed its intention to buy $40 billion of mortgages per month. Some estimates suggest that the Fed, by buying $480 billion per year, will purchases 5 times the expected net issuance of the mortgage market this year. In the face of investor demand for high quality assets with an attractive yield over Treasuries, the MBS should continue to be well supported in 2013.

Municipals outperformed the Barclay's Aggregate for the year with a 6.78% return. Municipals benefited from improving fundamentals in the form of increasing revenues and continuing investor appetite for yield. Where it is appropriate, we will add to our municipal holdings. We are concerned that, in the face of expected tax reform, municipal interest could become taxable or, at the very least, the tax exemption could be capped. The first outcome would likely result in existing bonds being grandfathered. New bonds would need to be issued at a higher rate to entice bond buyers and would compete directly with corporate bonds. The second option could be applied to existing bonds as it would be the individual's circumstances that determined the tax status of the income. Either outcome would likely lead to higher yields in the municipal market.

High yield bonds posted the best return since 2009 and second best return in the last ten years. Low default rates, easy access to the new issue market and investor demand for yield all contributed to the good showing in 2012. The factors that produced the strong returns for 2012 remain in place. However, the return on high yield has fallen to about 6% from a high of 8.35% in December 2011. The average price of a high yield bond now trades above par. Many of these bonds are callable at par and, as a result, opportunities for significant price appreciation are diminished

We remain cautiously optimistic on the bond market for the coming year. While we think Treasury rates will move higher, we expect the increase to be gradual as economic growth picks up later in the year. We like "spread product" in the form of corporates, mortgages and are eschewing bullet agencies currently.