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February 2013 Commentary

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The Economy

The U.S.

Addressing the House and Senate in the final week of February, Federal Reserve Chairman Ben Bernanke reported mixed progress on the U.S. economy. Bernanke noted that "we are gaining some traction" in residential housing, automobiles and other durable goods. He also defended the Fed's continued stimulative monetary policy, including near-zero short term interest rates and ongoing quantitative easing. Due to a persistently weak job market and a lack of wage growth, the U.S. consumer's health is in question.

The stock market and risky assets in general have rallied through much of 2013 on the expectation that the Fed will keep monetary policy exceptionally loose. "Helicopter Ben," as he is known somewhat pejoratively, has done much for the recent rise in riskier asset prices. Investors continue to reach for more risk as the returns on high quality, conservative assets remain low.

The backstop of the Fed has been likened to a bazooka, or perhaps more fittingly, a machine gun. Anglo-French writer Hillaire Belloc chronicled the British army fighting in 19th century Africa with newly invented machine guns—a technology that their foes did not share. In his poem *The Modern Traveller*, Belloc wrote:

> *Whatever happens we have got*
> *The Maxim Gun, and they have not.*

While outmanned three or four to one, the British army scored a series of crushing victories in Rhodesia with the help of machine guns. It sometimes feels that the U.S. economy, in spite of itself, has been spurred on by the Fed's display of overwhelming, machine-gun like firepower. As the saying goes, "don't fight the Fed." The markets certainly haven't.

The private sector continues to gain strength. While Washington's proposed budget cuts will make government spending a net detractor to future GDP growth, American business has picked up some of the slack. Over the past two years, private sector growth in the U.S. has averaged around 3%. The business climate is improving in spite of the political nonsense witnessed over the past few years.

The health of the U.S. consumer remains in doubt and this uncertainty directly impacts a sustained recovery. Responsible for over two-thirds of economic activity in the U.S., consumer spending is the lifeblood of economic growth in our country. According to a recent report by the Commerce Department, consumer spending rose in January by 0.2%. Concurrently, consumer income dropped 4%, the largest decline since

1993. Though much of this drop had to do with accelerated profit taking ahead of the fiscal cliff, the net effect was to reduce the household saving rate to its lowest level since 2007. With wage growth at very low levels, the average household is saving less in order to consume more. A tapped out consumer is a concern on many levels.

The World

Lest we forget the European fiscal crisis, the Italian election at the end of February brought a new round of market-moving headlines. Former Italian Prime Minister Silvio Berlusconi and his party finished surprisingly close to winner Pier Lugui Bersani, forcing a potential political compromise that will result in less fiscal austerity. Italian bond market yields jumped on the election news.

We learned in February that real GDP contracted for the third consecutive quarter in Japan and the fifth consecutive quarter in the Eurozone. While we are well familiar with recession like conditions in Italy, Spain and Portugal, it was Germany that surprised to the downside in the fourth quarter of 2012. The German economy shrank by 0.6% to end the year.

There is a silver lining to the slowdowns in both Germany and Japan. Forward looking indicators hint at a rebound in economic activity in both countries for 2013. Economists expect positive GDP growth numbers this year in the Eurozone and in Japan, a potential boost to companies in the MSCI EAFE Index. Forecasted economic growth for Germany in 2013 is quite strong. While encouraging, Germany's strength may serve to highlight the divide with the weak Eurozone periphery.

Recently, CBS's *60 Minutes* featured a story on Chinese real estate. The story highlighted the potential real estate bubble in China, as many new developments in urban areas have become "ghost towns." There are massive tracts of uninhabited homes and commercial developments, reflecting an overbuilding through the past decade. Much of the overbuild was spurred by negative real rates for Chinese investors in savings accounts and other liquid instruments—one of the only ways to grow money in real terms has been to invest in real estate.

The bursting of a Chinese real estate bubble could have a detrimental impact on emerging markets and global GDP growth. The ramifications of a significant downturn could be political as well. China's new leader, Xi Jinping, assumed office in November 2012. The leadership transition could turn volatile with an economic shock. Chinese political unrest has largely been quelled over the past two decades by phenomenal growth in their economy.

The Markets: Mostly Positive

February continued the trend of positive results in the U.S. stock market. For the month, the S&P 500 rose by 1.36%. The broad U.S. index was up 6.61% for the first two months of 2013, a fast start on the back of a very good 2012. While there were ups and downs over the course of the month, stocks rallied into the end of February.

International equity markets fell slightly in February. While equity returns were positive in the MSCI EAFE Index in local markets, a sharp drop in the Euro currency pushed the returns into negative territory in U.S.

dollar terms: the MSCI EAFE Index fell 0.95% for the month. Emerging markets were down for the month as well, registering a 1.26% loss.

Bonds had mixed results in February. The broad U.S. measure, the Barclays Aggregate Index, gained 0.5% for the month. Yields fell slightly after having experienced a run-up to begin the year. Credit rallied, as investment grade corporate rose 0.77% and high yield bonds rose 0.51%. Priced in U.S. dollars, international bond markets fared more poorly. The Barclays Global Aggregate Index fell 0.95% in February.

The Dow Jones UBS Commodity Index was down in February, declining by 4.09%. After a strong January, commodities corrected significantly. A stronger U.S. dollar and weaker demand for metals and agriculture led the correction. Curiously, gas prices remain high for the U.S. consumer. Limited refining capacity and a stubbornly high price of Brent crude has kept gas just below $4 for the national average.

Table of Returns

February 28, 2013

	Performance(%)				
Equities Index	1 Month	Year To Date	1 Year	3 Years	5 Years
S&P 500 Index	1.36	6.61	13.46	13.50	4.94
S&P MidCap 400	0.98	8.27	14.57	15.97	8.60
S&P SmallCap 600	1.41	7.27	14.65	16.47	8.37
MSCI EAFE (net) Index	-0.95	4.28	9.84	6.85	-1.26
MSCI Emerging Markets (Net)	-1.26	0.10	0.29	6.60	0.35
Fixed Income Index					
Barclays Aggregate Index	0.50	-0.20	3.12	5.45	5.52
Barclays Global Aggregate	-0.95	-1.85	0.77	4.35	4.13
Barclays 1-10 Yr. Muni	0.35	0.58	2.96	4.44	5.34
CSFB Leveraged Loan	0.39	1.51	8.09	6.78	6.30
Barclays US Corp: High Yield	0.51	1.86	11.83	12.01	11.34
Other Index					
HFRI Fund of Funds Composite Index	N/A	N/A	N/A	N/A	N/A
Dow Jones-UBS Commodity Index	-4.09	-1.79	-7.66	0.77	-8.44
Wilshire US REIT Index	N/A	N/A	N/A	N/A	N/A
S&P Developed Property	0.88	4.09	21.01	16.46	3.48
LPX 50 TR	3.36	11.74	27.06	15.24	-3.02
Citigroup 3 Month T-Bill Index	0.00	0.01	0.10	0.09	0.34

Closing Thoughts

U.S. stock market indices have reached near-record highs at the end of February. A combination of excess liquidity (provided by the aforementioned Fed Chairman Bernanke) and decent relative valuations have pushed stocks higher and higher. For stocks to continue their rise from here, more economic growth is needed. Luckily, U.S. leading indicators improved slightly at the beginning of 2013. If the economy is truly improving and better times are indeed ahead for Main Street, risk assets will likely share in the upside.

The current domestic energy boom is a tremendous windfall to the country. As a result of new "fracking" technology, our country has experienced a huge increase in natural gas and crude oil production. Once considered a laughable impossibility, the U.S. is rapidly closing its energy import gap. According to the

International Energy Agency, the U.S. will overtake Saudi Arabia by 2020 as the world's biggest oil producer—and become energy independent by 2030.

Energy independence has very positive implications and is a welcome turn of events. In spite of environmentalist efforts to block fracking, the U.S. now finds itself in a "win-win" situation with respect to economic growth and the environmental benefits of natural gas.

Compared to coal, the burning of natural gas results in approximately 45% less carbon emission per unit of energy. As a result of our new natural gas supply, the U.S. has reduced its carbon emissions by approximately 500 megatons of carbon dioxide per year, all the while providing an economic boost here at home. According to recent studies, this carbon reduction is equal to twice the total effect of the Kyoto Protocol for the rest of world. Once again, it appears that free markets and private technology have accomplished what decades of government regulation and bureaucracy could not—a cleaner planet at less cost to the economy.

On balance, there is both ample good news and bad news in the current investment outlook. A diversified portfolio that balances risk with return objectives remains the best way to navigate a very complex financial landscape.