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January 2013 Commentary

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The Economy

The U.S.

The economy sputters along here in the U.S., though at times offering brief glimpses of hope. Economic data were again mixed for the month, though the economy is generally heading in the right direction. We have now settled into winter time here in Colorado, as January brought us cold weather and short days. Like the ephemeral January sun that gives us just a hint of warmth and encouragement, so too do the latest economic reports give us some belief in better days ahead. Poet John Updike describes the nature of this daylight in his poem, *January*:

The days are short,
The sun a spark
Hung thin between
The dark and dark…

Domestic financial conditions eased in January, reflected by a 5.2% rally in U.S. equities and record low nominal yields on investment grade corporate bonds and high yield bonds. Between the Fed's latest round of quantitative easing and greater investor confidence, a rally in risk assets is unsurprising.

Though generally dismissed by the markets, the bad 2012 fourth quarter GDP number released in late January should give economists pause. The U.S. economy contracted by 0.1% over the last three months of 2012. In the last fifty years, only once (1977) has there been a new, quarterly GDP contraction that hasn't signaled the start of a new recession. While we are not likely to enter a recession imminently, economic contraction is certainly less than ideal.

Much of the fourth quarter GDP number can be attributed to a slowdown in government spending coupled with worse than expected inventory growth. Encouragingly, the private sector of the economy continues to grow. Consumer spending and business investment held steady at year end, in spite of the fiscal cliff and regulatory worries from Washington.

The housing market continues to strengthen into 2013 and drive economic growth. Housing prices are on the rise in nearly every major market in the country, according to the Case Shiller Index. Residential investment is typically one of the major drivers of growth as the economy recovers from a recession. Since the real estate collapse in 2008, residential investment has not just been absent from our recovery—it has been a significant detriment. The housing market is finally contributing to a healthier economy.

Lending activity in the U.S. has picked up over the past year. One of the key drivers to a potential U.S. recovery will be the availability of loans to small businesses. Heretofore, credit has been in short supply for all but the largest companies and institutions. M2 money supply grew by 12.3% in the fourth quarter, an encouraging sign that Main Street is finally catching up with Wall Street.

The U.S. economy grew 2.2% in 2012—simply not high enough to address the myriad problems that we still face. Our slow growth path puts us in a precarious position. Any number of possible exogenous factors (conflict in the Middle East, Greek fiscal troubles, a weaker China) in 2013 could derail this growth. Still, we are on track for a decent economy in 2013.

The World

Conditions have eased in the Eurozone and worries of systemic failure are now largely forgotten. At one point last summer, the odds of a Greek exit from the Euro were very high. ECB President Draghi's now famous comments on defending the Euro, and the subsequent ECB announcement of a sovereign bond buying program, have calmed the markets.

While recession has gripped Europe for much of 2012, a potential turnaround is in sight. Much of the very necessary reforms and austerity measures across the continent have already taken place. Fiscal spending for many European countries should actually be more accommodative in 2013 and 2014.

While Japan's stock market has enjoyed recent gains, the underlying economy is still very weak. Japan has been struggling against low growth and deflation since the 1990s. At the end of January, the Japanese government and the Bank of Japan issued a joint statement on their new efforts to boost the economy. They have targeted inflation at 2% going forward through additional fiscal and monetary stimuli. The new accommodative measures are an imperfect solution to Japan's many structural problems, but they could help steer their economy in the right direction.

China's GDP growth gained in the fourth quarter to an annual rate of 7.9%, reflecting the stimulative measures of the Chinese government from earlier in 2012. While China's economy is not likely to boom in the foreseeable future, its incremental growth appears to be steady and sustainable. An increase in private sector business as a bigger percentage of GDP is both necessary and welcome. A stable China is an important pillar to global economic health in 2013.

The Markets: A Fast Start in 2013

January began the New Year right where we left off in 2012, registering big gains for nearly all risk-based asset classes. The S&P 500 rose 5.18% for the month, the best start for the U.S. stock market since 1997. Retail investors have begun putting money back into equities. January fund flows into equity mutual funds were extremely strong.

International indices rallied as well. The MSCI EAFE Index was up 5.27% in January. While difficulties remain in Europe, financial markets there have continued to rise on renewed optimism. Emerging market equities were also positive for the month, as the MSCI Emerging Markets Index gained 1.38%.

High quality bonds were down in January, as U.S. Treasury yields rose. Renewed confidence in a U.S. recovery has pushed the U.S. 10-year Treasury bond to 2%. The Barclays U.S. Aggregate Index declined by 0.70% for the month. Globally, the Barclays Global Aggregate Index fell 0.91% in January. High yield bonds continued to do well, extending the significant gains that they made in 2012. The high yield index was up 1.34% in January.

The Dow Jones UBS Commodity Index gained 2.4% in January. Energy led much of the gain in commodities for the month, as increased economic growth expectations and a weaker U.S. dollar contributed to gains in WTI and Brent crude oil.

Table of Returns

January 31, 2013

	Performance(%)				
Equities Index	1 Month	Year To Date	1 Year	3 Years	5 Years
S&P 500 Index	5.18	5.18	16.78	14.14	3.97
S&P MidCap 400	7.22	7.22	18.56	17.57	7.99
S&P SmallCap 600	5.78	5.78	15.45	17.57	7.40
MSCI EAFE (net) Index	5.27	5.27	17.25	6.94	-0.79
MSCI EM (net) Index	1.38	1.38	7.65	7.17	2.04
Fixed Income Index					
Barclays Aggregate Index	-0.70	-0.70	2.59	5.41	5.45
Barclays Global Aggregate	-0.91	-0.91	1.67	4.70	4.67
Barclays 1-10 Yr. Muni	0.23	0.23	2.71	4.62	4.72
CSFB Leveraged Loan	1.12	1.12	8.47	6.75	5.70
Barclays US Corp: High Yield	1.34	1.34	13.91	11.89	10.93
Other Index					
HFRI Fund of Funds Composite Index	N/A	N/A	N/A	N/A	N/A
Dow Jones-UBS Commodity Index	2.40	2.40	-1.13	3.43	-5.51
Wilshire US REIT Index	3.54	3.54	14.35	21.92	6.09
S&P Developed Property	3.18	3.18	23.76	17.15	2.84
LPX 50 TR	8.11	8.11	29.96	14.45	-2.87
Citigroup 3 Month T-Bill Index	0.01	0.01	0.10	0.09	0.38

Closing Thoughts

Stock markets worldwide have experienced enormous run-ups over the past fifteen months. Since October 2011, the S&P 500 has returned close to 40%. As is usually the case when the stock market goes up, investor confidence has improved as well. Retail investors are finally leaving the sidelines and investing in equities.

Equity inflows reached an all time record in January, as $77.4 billion went to equity mutual funds and exchange traded funds.

Based upon a variety of historical valuation measures, U.S. stocks are fairly valued at the present time. They aren't terribly cheap, but they aren't terribly expensive either. That said, the market will not continue to go up indefinitely and continuously. Rebalancing back to a strategic asset allocation at this time is prudent. As Mark Twain once noted: "Whenever you find yourself on the side of the majority, it is time to pause and reflect." Retail investors frequently have the dubious distinction of providing a contrary indicator to the direction of the stock market.

More positive economic data and corporate earnings reports are needed for a sustained rally in 2013. While we are cautiously optimistic about the improving state of the world, a well diversified portfolio remains the key to managing the inevitable hiccups that will come along the way. Should the markets continue to rise, we would again recommend portfolio rebalancing. Investors, even very good ones, tend to ignore the lessons of the past. Many Wall Street firms have bumped up their S&P 500 targets for the year in light of a great January. Shakespeare wrote in Othello about this very concept: "But men are men. Sometimes the best forget." Hopefully the lessons from the past 20 years of managing risk and maintaining diversification will not be easily forgotten.