

Financial Markets Perspective

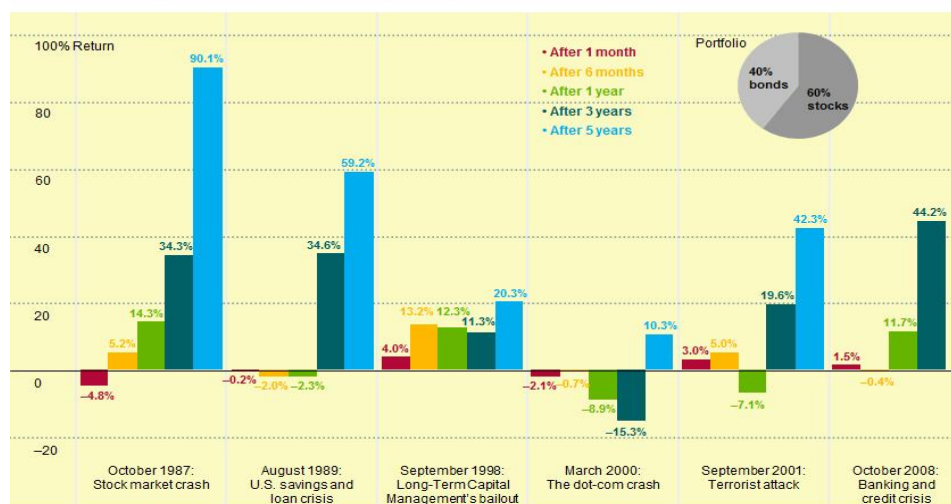
April 2013

THE UPSIDE OF STABILITY

The U.S. stock market grew by more than 10% during the first quarter of 2013 – much like the beginning of last year and several other past years. To put this gain in historical perspective, since 1926 there have been 15 first quarters with a gain of more than 10%. The past also tells us that of those 15 first quarter gains, 13 experienced a full-year gain. More importantly was that the major market averages surged beyond the record levels set in 2007 -- over five years ago when we experienced the greatest financial crisis since the Great Depression.

Few investors anticipated this surge in stocks and many professionals had forecast “gloom and doom” as a result of spending cuts and tax increases emanating from the year-end agreement to escape the "fiscal cliff." One of these bears is David Stockman, the past Office of Management and Budget director and author of the newly published book: “The Great Deformation: The Corruption of Capitalism in America.” In an Easter Sunday piece in the New York Times editorial he said: "Over the last 13 years, the stock market has twice crashed and touched off a recession: American households lost \$5 trillion in the 2000 dot-com bust and more than \$7 trillion in the 2007 housing crash. Sooner or later — within a few years, I predict — this latest Wall Street bubble, inflated by an egregious flood of phony money from the Federal Reserve rather than real economic gains, will explode, too." From our standpoint, the market rallies of 2003-2007 and then from 2009 to 2013 recovered those losses for investors who had a long-term perspective. This fact is illustrated in the following exhibit from Morningstar.

U.S. Market Recovery After Financial Crises
 Cumulative return of balanced portfolio after various events



The “bears” also see a downturn that is predicated on the fact that the market went up too far too fast -- so a decline is inevitable. Other more pessimistic soothsayers are expecting the Fed's low interest rate bubble to burst and a surge of inflation and soaring interest rates are forecast to be right around the corner. Such dire events are not in our forecast for the foreseeable future.

Stock markets, both domestically and abroad, are benefitting from a shift to stability from the uncertainty in economic policy that has dominated markets since 2008. Typically, the stock market flourishes during times of certainty and is frenetic when not. This stability did not come all at once but the stock market gains beginning in November of 2011 were characterized by a shift toward certainty in both monetary and fiscal policy. In the short-run, bouts of uncertainty are likely to emerge causing some near term mayhem in financial markets. As we pointed out in our "Speed Bumps and Potholes" Financial Markets Perspective in the first quarter of 2011, the likelihood of these events occurring was high.

The primary source of instability in 2011 was uncertainty surrounding the existence of the European Union as more than one of the weaker countries was on the brink of declaring bankruptcy. As stock markets around the world plunged in response to this perceived collapse, the European Central Bank assumed a role similar to that of the Federal Reserve by stepping in to support the financing operations of the individual member countries. The bank has the ability to do this because it has the power to create Euros and to purchase an unlimited amount of individual country debt. The announcement of these policies triggered a powerful global stock market rally that reversed the almost 20% decline in stocks.

In the U.S., the Federal Reserve's steadfast commitment to low interest rates via QE or quantitative easing (the commitment to buy government securities to keep interest rates low and stimulate loans) kept a steady hand on one side of the economic equation--monetary policy. As the end of last year approached, stock market volatility became a function of political and fiscal uncertainty--the stark differences between political dogma and the implications of these philosophies on the economy. Moreover, uncertainty over the "fiscal cliff" and the diverse outcomes of letting the Bush tax cuts expire, extending them indefinitely or any other solution in between upset investors.

As inaction characterized the approaching year-end deadline, investors began to prepare for the worst and many stock prices reflected this uncertainty. For example, dividend paying stocks began to lose their luster as investors feared a rise in the maximum tax rate on those dividends (going from 15% to the highest personal income tax rate of 39.6%). However, last year closed on a positive note as the Federal Reserve increased the certainty of monetary policy as it committed to an indefinite period of low interest rates bounded by a 6.5% unemployment target and an acceptable level of inflation.

The last minute agreement averting the fiscal cliff provided investors with additional confidence sending the Dow Jones Industrial Average up by more than 300 points or 2.35% in the first trading day of this year. This common measure of U.S. stocks never looked back and finished March with a powerful first quarter advance. The S&P 500 index, that many professional investors like us use as a benchmark, had a similar January 1, 2013 gain of 2.54% and finished the first quarter up by more than 10%.

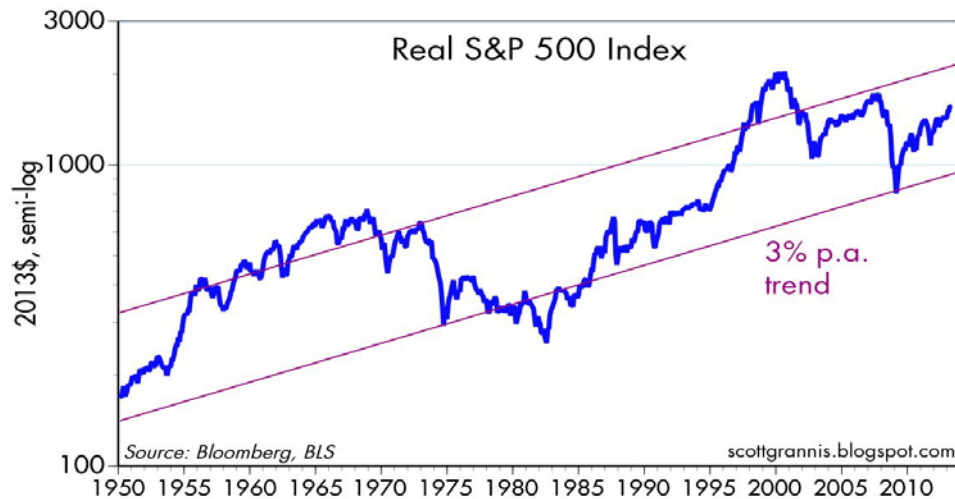
The strong stock market showing in the first quarter was in stark contrast to a weak bond market where investors had low levels of interest payments to augment their principal values. After a 30-year "rally" in bond prices where investors seemingly benefited from falling interest rates, there was little prospect of stock-equivalent returns. Further interest rate declines appeared unlikely and the prospects for a strong economy sending interest rates higher and bond prices lower strengthened.

Commodities also suffered in an environment of global malaise as rising output put downward pressure on oil prices. Natural gas prices finally rallied on the back of rising demand and a supply shortage. One of the measures of rising certainty about the future was the surprising collapse in gold prices. As long as the global economy continues to improve, the traditional safe-haven vehicle of holding gold will run out of gas. More notably, when comparing the charts of the S&P 500 index and gold as seen below, one can see the price divergence since last year. The perceived attractiveness of the yellow metal as a retirement plan asset has declined.



The rise in the stock market to new highs has underlying fundamental support. Corporate earnings have been the real backbone of a broad increase in stock prices. Moreover, dividend payouts are at all-time high. Scott Grannis provides us with some perspective about these fundamentals as it relates to the chart on the following page. "In inflation-adjusted terms, the S&P 500 index is still almost 25% below its 2000 all-time high. From a long-term perspective, the

chart suggests that current equity prices are about "average," having followed a 3% trend growth rate, which happens to be the average real growth rate of the U.S. economy. Moreover, corporate profits today are almost 200% above the levels of late 2000. By these metrics, stocks are not optimistically priced at all."



Financial commentators indicate concern about the loftiness of the stock market and they are either predicting a pullback in the near future or a prolonged downturn. Such a pullback or correction, as it is known, has characterized the markets both in 2011 and 2012. However, in both cases the declines were attributable to the ongoing crisis in Europe and debates over fiscal policy in the U.S. Uncertainty introduced into both the economy and financial markets was self-induced as demands for fiscal conservatism triggered the use of austerity measures to curtail government deficits that would result in slower economic activity.

CONCLUSION

Today, the future does not appear as uncertain as it has in the last two years. The weakness of the European economy remains in question as austerity measures continue to characterize policies in the largest member countries. The pain and suffering imposed upon the average citizen in the Eurozone is causing a powerful backlash against these policies forcing politicians to reconsider the value of tightening measures. Recently, the leaders in Brussels have been increasing pressure on governments to introduce more pro-growth policies. Unfortunately, economic reforms already adopted have not displayed their full effects due to implementation lags. While these reforms are a step in the right direction, members of the Eurozone have much more policy work to do. These reform efforts will continue to take time yet, on balance, the threat of a financial crisis in Europe has declined as a result of the European Central Bank's new role.

In the U.S., fiscal policy has shifted to neutral. President Obama's victory short-circuits Republican demands for austere budgets and massive budget cuts. The sequester is having marginal effects on the economy but is clearly affecting beneficiaries of government spending. While the President has put a damper on additional cuts in spending, Republicans have blunted plans for additional tax increases proposed by Democrats. This political gridlock that will last at least until the 2014 elections should provide a degree of certainty that major changes in fiscal policy are highly unlikely.

In the short run, stock market volatility will continue subject to the same uncertainties of a European economic crisis and further political decisions in this country regarding taxes and spending. While day-to-day economic statistics will vary, the trends remain in a positive direction and we expect to see a continuing economic recovery spurred by ongoing improvements in domestic energy production. In addition, the Federal Reserve remains committed to keep interest rates at record lows until the economy gets back on a growth path. Such policies will keep bond yields low and undermine investors' returns on these types of securities making stocks the vehicle of choice.

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