Market Review and Outlook—April 3, 2013

What a Quarter! In the past quarter, US stocks returned over 10%, in just three months! While emerging-market stocks fell slightly, overall foreign stocks managed moderate gains, 3-4% for large foreign stocks, and 6-8% for smaller foreign stocks. Bonds largely had a flat quarter—only high yield bonds did quite well, returning close to 3%. The average Moderate Allocation fund (with close to 60% in stocks) returned almost 6% during the quarter. During the past quarter investors earned what is a average year's returns. I have said many times that stocks move ahead of the economy. It is reasonable to conclude that the 1st quarter of this year, and the stock market's rise during these three months, is predicting that the US economy will grow nicely for the rest of this year.

US Economic News The top headlines for the quarter were Congress' deal during New Years to sidestep the Fiscal Cliff and its inability to sidestep the Sequester. The Fiscal Cliff deal enabled our country to limit the drastic economic contraction that inaction would have produced, while still providing a better path to financial responsibility than we would otherwise have adopted. There were two surprises to the Sequester. First, it was not avoided. It was designed in August 2011 as an impossible path—social program reductions that Democrats couldn't stand coupled with defense program reductions that Republicans couldn't stand. And yet, both sides were ultimately willing to stomach the cuts, in order to avoid having to compromise with the other side. The second surprise is that, despite the economic drag both from the Fiscal Cliff deal (higher withholding taxes) and also from the start of the Sequester, the US economy is chugging along. This is largely due to the relatively modest size of the government within the US economy—it makes up 20% of the US economy, while consumers make up 70% (the last 10% is corporate spending). This is why the double-pronged slowdown in government spending during the past quarter was more than fully compensated by a fairly slight boost in consumer spending.

European News The news is not good in Europe. A year ago, analysts expected Europe to slow down a bit in 2012 and to be well on the road to recovery by 2013. Not even close! Dr. David Kelly, the chief strategist at JP Morgan, notes that Europe is no longer in a <u>fiscal crisis</u> (due to the herculean efforts of the European central banks), but is now in the midst of an <u>economic crisis</u>. The good news is that with our globalized economy, European companies are not restricted to only selling to (depressed) neighboring economies—they are able, and are successful, in selling to stronger economic regions, including the US, Asia, and Central and South America. Another important positive for investors is that European stocks are (understandably) cheap, with attractive dividend yields.

Bonds The returns from bonds were indeed disappointing in the past quarter. However, given the potential for bond-bubble-burst losses, <u>I am pleased to earn any positive returns from bonds now, and for a few years</u>.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.01%	+0.03%	+0.52%	+1.79%
Intermediate Term Bond	+0.30%	+5.64%	+6.18%	+5.97%	+4.96%
Intermediate Muni Bond	+0.32%	+4.52%	+5.37%	+5.09%	+4.01%
Large-Cap Stock	+10.40%	+12.98%	+10.84%	+4.80%	+8.12%
Mid-Cap Stock	+12.33%	+15.77%	+12.24%	+6.80%	+10.68%
Small-Cap Stock	+12.43%	+15.68%	+13.30%	+7.67%	+11.16%
Foreign Large-Cap Stock	+3.66%	+9.61%	+4.65%	-1.01%	+9.23%
Real Estate	+6.77%	+13.60%	+16.28%	+5.95%	+11.23%
Natural Resources	+2.57%	+0.38%	+3.70%	-1.54%	+12.67%
Science/Technology	+6.87%	+0.19%	+9.08%	+7.24%	+10.29%
Moderate Allocation	+5.68%	+9.22%	+8.39%	+4.78%	+7.19%

The data in this table comes from Morningstar and is as of December 31, 2012.
Information herein should not be construed by any consumer and/or prospective client as a solicitation to effect, or attempt to effect transactions in securities, or the rendering of personalized investment advice for compensation.

Looking Forward We have conducted our monthly investment strategy meetings, and concluded that no strategic steps are warranted, that the pieces and proportions we identified earlier this year remain our best strategy at this time.

The top question is whether to over– or under-emphasize stocks versus bonds. This hasn't changed significantly. Stocks continue to appear undervalued and bonds overvalued. While investors have (FINALLY) begun to add more new dollars to stock mutual funds than bonds, the first time for consecutive net stock purchases since before the 2008-2009 crisis, bond yields are incredibly low and bond prices are therefore incredibly high. Historically, I have projected that annual bond total returns would range 4-6% over time. Given the current price levels, I expect bonds to come closer to 2-5% total return over the coming decade.

While US stock market levels are reaching new peak levels, the US economy is notably higher than it was in October 2007 (and early 2000) when US stock markets were at similar levels. This means that while we are setting price level records, we are not setting pricey level records—US stocks do not appear to be expensive. They seem to have quite a lot of room to grow. It is for this reason that we continue to place a slight preference for stocks at this time, setting clients' current stock allocation to 103% of long-term stock target levels (61.8% stocks for a portfolio with a 60% long-term target level). This excess comes from our clients' bonds, which we will therefore permit to stand at less than their long-term target levels.

Stocks We continue to use a 58/42 balance for US/foreign stocks. This remains more US-centric than the global stock market; however, this is more foreign-centric than the vast majority of US investors' portfolios. While foreign stock investing introduces more uncertainty than US stock investing, and while currently the European challenges prevent investors from enjoying a high comfort level with foreign investing, we believe that the much greater opportunities are available beyond the US borders, and the higher growth rate (especially in foreign developing countries) justify this stance.

We largely use contrarian and valuation-driven guidelines to set our more specific stock allocations. We currently have a bit of a large-cap stock emphasis, and a growth-stock emphasis. This directly results from current values and trailing performance of each subgroup.

Bonds For bonds, we are also changing nothing—we feel that the steps that we took earlier this year continue to provide the best balance of higher opportunity and lower risk. We continue to use a 70/30 balance of quality/opportunity bonds. Quality bonds are at a greater risk of the bond-bubble-burst, while opportunity bonds present a greater risk in the case of economic slowdowns. We feel that the 70/30 balance is the best compromise between these two diverging scenarios.

We continue to use a 30/30/10 balance of intermediate-term/short-term/inflation-protected bonds within our quality bonds. It still appears that higher interest rates are two-plus years out, and this justifies the hefty use of intermediate-term (largely corporate) bonds. However, if we are wrong, we are counting on the 30% short-term bond position to provide wonderful stability in even that case. The 10% inflation position establishes a base for when inflation eventually shows up with a vengeance, also likely more than two years out. It is critical to note that our inflation bond fund does NOT invest in TIPS, Treasury Inflation Protected Securities. I consider TIPS to be grossly overpriced, and I avoid them like the plague.

We are also using a blend for our opportunity bonds, with the most directed to 'multi-sector bonds.' These can be viewed as 'unconstrained,' funds which can invest in most any kind of bonds, and can change their allocations as the manager feels that the conditions warrant. The second largest subcategory of opportunity bonds is high-yield (junk) bonds. We have cut this back sharply in the past six months, due to our view that we have already earned the 'easy money' from junk bonds from 2009-2012. We have even cleaned up our junk bonds—we direct about half to higher-quality junk bonds (yes, there really are such things). Our last two subcategories are floating-rate bonds and foreign bonds. We boosted the floating-rate bonds when we reduced the high-yields. We believe that there is greater value here, and that if we are wrong and interest rates rise sooner rather than later, this subcategory should hold up quite well—thus they have both aggressive and conservative characteristics.

These are broad guidelines that we are using this month for our clients. They are a starting point, which is invariably adjusted for each client's specific situation. We feel, however, that sharing our current view can help investors identify where they agree and where they differ from us, and how they will use their convictions to modify their portfolios.