OVERVIEW

Economic Analysis and Market Review — Q1—2013

- Sequester's problems yet to be realized
- Cyprus is just the beginning
- US stock market has more room to run

The first quarter of 2013 began with Sequester and ended with Cypress and, in between, our so-called recovery kept chugging along. Both of these events gave the global equity markets a shake, not much more. But neither has not yet run full course...it's still early. I'm sure we'll see more of their effects in the months to come.

First, there's the sequester. The federal government has agreed to reduce spending by $1.2 trillion over the next 9 years, which amounts to $109 billion a year or $12 billion a month. Sequestration was supposed to begin January 1, 2013 but a deal on the fiscal cliff put it off until March 1. Now that it's running, where will the spending cuts come from? Half will come from defense and the other half from domestic spending, all in equal amounts. Every program will be treated equally: the most important programs are treated no differently than the least. (And we elect the people that make these ridiculous decisions. I guess it's true that the least common thing about common sense is that it's common.) The concern reasonable people have is that the economy is in recovery mode, but a very weak recovery at best and drastic cuts in spending at this time will have a negative impact on the economy. Macroeconomic Advisors calculates that the GDP will decline about 0.7% in 2013, the Congressional Budget Office (CBO) estimates a decline of 0.8%. When GDP is only expected to grow 2%, then 0.7% or 0.8% is a significant head wind. Whatever the damage, the cuts are already impacting air traffic as 149 small regional airports will close their towers, TSA will cut their employee rolls so lines at airports will only get longer. The FDA will begin making cuts and federally funded research will be slashed. All 50 states will feel the pinch. In California for example, the forecast is for a loss of 1200 teachers and 8200 Head Start openings, 49,000 HIV tests and a lot more.

But budget cuts like these don't solve the real problems in our system, namely entitlements. There are no structural reforms for Medicare or Social Security in the legislation. Until these issues are dealt with in an efficient and reasonable fashion, there will be blood.

Then there is Cyprus. Cyprus is one of the smallest members of the European Union with a GDP of only $23 Billion (by comparison, Greece, another small European economy, has a GDP of $299 Billion). Serious problems in the Cypriot financial sector became apparent in 2011 as the Greek fiscal crisis and the European debt crisis deepened. Roughly 45% of Cyprus' economy is in the financial sector and two of its biggest banks are among the largest holders of Greek bonds. The Cypriot economy contracted in 2012 following the write-down of Greek bonds. A liquidity squeeze is choking the financial sector and the real economy as many global investors are not certain the Cypriot economy can weather the EU crisis. Cyprus has asked for a bailout from the European Central Bank (ECB), the International Monetary Fund and the European Commission in the amount of $5.8 billion. This is a small sum and one that the ECB could easily handle. The problem is in the "fix". Deposits under 100,000 will be protected but amounts over that aren't. Laiki Bank, Cyprus's second-largest bank, will be closed. Its 4.2 billion in deposits over 100,000 will be placed in a "bad bank" — meaning they could be wiped out entirely. Those with smaller deposits at Laiki will see their accounts transferred to the largest bank, the Bank of Cyprus. Large depositors will certainly lose about 30% of their money and possibly up to 60%. Therein lies the problem as I see it. If I were a wealthy investor in Europe, I would begin to get all my money out of European banks. If they can "bailout" a country in the EU(there are five that have asked for a bailout) by confiscating deposits, no country in the EU is safe from a similar fix. My money would be moved very quickly to a safer, more investor friendly haven like the U.S., Hong Kong or Singapore. We'll see if this develops. Watch for large withdrawals from Spanish, Portuguese and Italian banks.

The Eurozone is the global economy's weakest link among developed economies. Fortunately, the ECB is currently run by Mario Draghi, one of the smartest and politically able central bankers in Europe, but his task is a daunting one and his success is not assured.

With Europe such as it is, the US economy keeps plodding along. Data continue to show signs of improvement: jobs are opening up and corporate profits have made steady gains to all-time highs: in the 4th quarter, S&P 500 companies reported earnings growth of 4.2%, compared to analysts' estimates of 2.6%. The National Association of Realtors reported that existing home sales increased 0.8% to an annual rate of 4.98 million units last month, the highest level since 2009 and banks are again strong. In fact, Jamie Dimon, CEO of JPMorgan Chase, recently stated that banks will soon have too much capital! Confirming the recovery, the Institute for Supply Management's data shows business activity at 56.9%, new orders index at 58.2% and the employment index at 57.2%. Anything over 50% is a positive.

In response to the above data and to considerable Federal Reserve stimulus ($85 billion injected each month) the equity markets are hitting multi-year highs. This is what happens when you have low inflation, the lowest interest rates in over 60 years and a very accommodative Fed. As a result, money is pouring into the stock market. In January, equity mutual funds, which cater to retail investors, gained almost $38 billion of new money, the highest amount in nine years. In March, the Dow Jones recorded the longest winning streak since 1960.

Is another "bubble" in the making? Probably not. By several methodologies, the stock market has room to grow. Using the Dividend Discount Model, the companies that make up the Dow Jones Average indicate an approximate 8% upside for the index. Looking at P/E ratios, (a company's price is in relation to its earnings per share), at current interest rates and levels of inflation, a P/E ratio of 21 would be appropriate. The level today is 17. Using the Fed model, which compares a stock's earnings yield (E/P) to a long-term, risk-free bond rate, stocks look more attractive than bonds. The earnings yield on stocks is currently 6.5% vs. the yield on the 10-year Treasury at 2%. As long as interest rates stay low, the stock earnings yield will remain attractive. The 30-year Treasury is currently at 3% which would indicate that interest rates are expected to remain low for a long time.

So, is there a bubble? I would say that we are seeing multi-year highs in the stock market but not in the valuation metrics. If you're like many that have been invested in the bond markets and you're looking to get into equities, just look for countries with an accommodative central bank like the U.S., Japan, or perhaps even Russia.

Market Indexes
First Quarter, 2013

INDEX	Q1'13	YTD	3 YEAR RET.	10 YEAR RET.
S&P 500	10.61%	10.61%	12.67%	8.53%
Russell 2000	12.39%	12.39%	13.45%	11.52%
Europe, Aust., Far East	5.13%	5.13%	5.00%	9.69%
Barclays Agg. Bond	-0.12%	-0.12%	5.52%	5.02%
Dow Jones Real Estate	7.04%	7.05%	16.93%	12.10%

- The S&P 500 is an index of large, well-established companies
- The Russell 2000 is an index of 2000 small companies
- The Europe, Australasia, Far East Index (EAFE) is an index of developed countries around the world
- Barclays Aggregate Bond Index is an index composed of investment grade bonds
- Wilshire Real Estate Index is an index of commercial real estate properties