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Market Commentary
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Overview

Domestic Equity markets continued to test new highs in the face of a sluggish economy and ongoing issues in debt markets across the globe. Where markets go from here depends on whether a real improvement in economic conditions and growth is driving the rally or if it is a result of cost cutting by reducing labor costs and general asset inflation caused by easy Fed policies. The question remains whether or not the consumer can keep the US economy afloat with minimal wage growth and a declining savings rate (implying consumers are spending more of their savings and may not have as much to spend in the future). While the unemployment number has fallen (now 7.6% from a high of 10%), declining corporate profits coupled with limited revenue growth could lead to a decline in equities. We still have debt issues in Europe that could resurface at any moment, evidenced by the Cyprus fiasco, which almost lost the European musical chairs game. For the time being, however, the music continues. Over the last few years we've seen equity markets start the year off strongly, followed by a slow patch typically in the second or third quarter, with a late rally to finish the year, specifically within international equities. This does not mean we expect this year to exactly mirror the last few, but it does raise concerns about the near term prospects for equities after such a significant run up year to date. We continue to be defensively postured, as growth is still weak and debt markets have swelled across developed markets.

Domestic Equities

Despite fears regarding the impact of the payroll tax cut, the sequester that kicked in on March 1st, and the looming debt ceiling situation, US equity markets have been on a largely uninterrupted run in the first quarter, posting gains each month. In late March, the S&P 500 hit a new high, erasing all losses since the previous market high in 2007, returning more than 10% for the quarter. January US diversified equity fund flows were $14.1 billion, breaking a 20 month streak of outflows and posting their highest level since December 2006. February flows to equity funds were also positive at $2.4 billion, leading to speculation as to whether or not the much anticipated "great rotation," in which investors seeking higher returns in the current low interest rate environment will move from bonds to stocks en masse, has begun. Stocks aren't as cheap on a valuation basis as they were several months ago but valuations are still well below their credit crisis peaks. The current S&P 500 price-to-earnings ratio, which measures how expensive stocks are relative to their earnings, is at 15.4. That's close to the long term average and is trending higher, but is still below its pre-recession value of 18. Small and mid caps slightly outperformed large caps. Mid caps posted essentially the same returns of small caps, but achieved this without the additional risks of small caps, potentially due to smaller companies' relative difficulty in accessing capital markets and lack of benefits from favorable regulation. We continue to position in mid caps as opposed to small caps as the market is not rewarding investors with higher return for the additional risk.

International Equities

International developed equity markets were mostly higher in the first quarter but significantly underperformed their US counterparts with the MSCI EAFE returning 4.38%. We are concerned about the situation in Europe and have reduced our exposure over the last several years in favor of emerging markets. The economic weakness in Europe persisted this quarter with bad macroeconomic data across the board including the failed elections in Italy, and culminating with the March bailout of the Cypriot banking system. The issue is that the problems in Europe may not be a typical business cycle recession but are structural in nature. That is, they may be due to the inherent difficulty of managing vastly different economies like Greece and Germany under the same monetary umbrella. The European Central Bank's 2012 declaration of intent to become the lender of last resort provided some support and hope to European markets but this now seems farfetched as it requires passing harsh austerity measures by majority votes that are increasingly difficult to come by. In the less developed economies, we've seen first quarter underperformance in emerging market equities with the MSCI Emerging Market index down 1.92% over concerns about slowing economic expansion and falling resource prices. However, we still believe that emerging and frontier markets are better positioned to outperform with improved credit, lower debt levels, better regulatory controls and fiscal policy than in the past, and higher anticipated growth rates. We see this most recent pullback as an opportunity and continue to be positioned in the space with a long term view.

Fixed Income

At the March Fed meeting, the Federal Open Market Committee (FOMC) reiterated their commitment to keeping the Fed funds rate at near zero and maintained its path of Quantitative Easing. Specifically, it was noted that the current policy to buy additional mortgage-backed securities at a pace of $40 billion per month and more long-term Treasury securities at a pace of $45 billion per month would remain in place until the unemployment rate reaches 6.5%. Since the Fed began its quantitative easing efforts in

2008, the Federal balance sheet has more than tripled and has resulted in historically low yields for fixed income securities with the yield of the 10 year Treasury at a mere 1.86%. The low yielding environment has pushed investors to take on more risk in search for yield. Accordingly, more credit sensitive, higher yielding sectors including investment grade corporates, non-agency mortgage-backed securities, and high yield debt have outperformed government related debt in the first quarter. Despite the low yield environment in the US, domestic fixed income outperformed both international developed and emerging market debt in Q1 returning -0.18% (measured by the Barclays Aggregate), -3.36%, (measured by the Barclays Global Treasury ex-US Capped Index), and -2.30% (measured by JP Morgan EMBI Global Index) respectively. Renewed concerns over the European debt situation led to a sharp weakening of the Euro against the U.S. dollar and international developed bonds to underperform US bonds late in the quarter. Emerging market bonds also underperformed US bonds, but we continue to see benefits in the asset class despite any short term volatility. As many developed economies face lower growth prospects and high levels of debt, several emerging markets countries are expected to drive more growth in the global economy in the coming years, creating the potential for attractive returns on their bonds. We continue to be mindful of the potential risks in the market and maintain a relatively short duration in our fixed income portfolios to hedge against an unanticipated spike in inflation.

Alternatives

With future prospects for bonds looking less and less attractive, we continue to believe our alternative allocations will be relied on more and more to provide stability through diversification in our portfolios, and will be the Yin to equity's Yang. Although the mix between equities and fixed income, broadly defined, is typically the most important asset allocation decision, proper diversification requires that a portfolio be allocated among several distinct asset classes including alternative investments. We see increased risks in both stocks and bonds compared to a few years prior, and therefore have focused on diversifying our risk away from both of these asset classes through the use of alternatives. Master Limited Partnerships (MLPs) which engage in petroleum and natural gas extraction and transportation, significantly outpaced traditional equity markets returning nearly 19.74% for the quarter, after underperforming in 2012 due to concerns involving potentially significant tax increases. This asset class continues to hedge the risk of future inflation as well as add exposure to the natural gas boom that we expect could be a driver of the US economy for years to come. Gold has had a difficult year, primarily due to the dollar strengthening against other developed currencies, specifically the Euro. While many can point to the run up gold has already had and conclude that its run may be over, with the unprecedented amount of quantitative easing seen from our government and governments across the globe, we continue to expect gold to hedge our portfolios against most paper currencies and the inflation that will likely come from all of the government stimulus.

Real Estate

A bright spot in the US economy is the continued improvement of the residential real estate market. Housing starts have improved significantly, coming in at 900,000 on an annual basis. Home sales are also up with existing home sales up 10% versus a year ago and new home sales are up 29%. Although there have been improvements in the sector, it still remains more difficult than normal to buy a home. The Fed's loose monetary has resulted in record low mortgage rates, but home buyers continue to face very tight credit conditions. The concern is that first time buyers and buyers under 40 are making up a smaller share of the buyer market than in the past, while investors intending to rent out properties are making up a larger share. While there have been improvements in the real estate market, the recovery in the real estate market still has a long way to go.

Conclusion

Despite some areas of good news for equities, such as inflows and moderately improving US data, the balance of factors discussed in this commentary seem to paint a negative picture, which has frequently been the case in the recent past. Equity markets have consistently surprised us with their resilience in the face of bad news, aided significantly by Fed's unprecedented loose monetary policy and the much-discussed "Great Rotation" from bonds to stocks may be starting to gain some steam. As much as we may question the driving forces of this rally, the markets may be in an unshakeable uptrend over the near term. As such, we remain cautiously and opportunistically positioned in equity markets and continue to assert our investment philosophy that protecting against downside losses is essential to a portfolio and is worth potential sacrifice of upside. We see opportunities in emerging and frontier markets in particular that can add not just diversification but potential upside compared to troubled developed markets and maintain a portfolio of alternative investments that have the similar benefits.