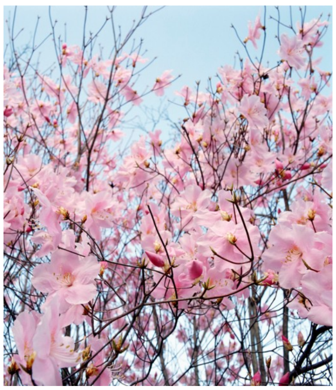
2013: A First Quarter Review

A quick summary of economies & markets for you.

Dear Client,

Wall Street's bulls figured stocks were ready for a breakout in 2013, and that is exactly what happened in the first quarter. The Dow finished March at 14,578.54, its highest close ever. The S&P 500 ended the quarter with a record close: 1,569.19. The S&P, Dow and Russell 2000 all gained 10% or more in the opening three months of the year. Bullish sentiment was backed up by impressive economic indicators – in real estate, in the manufacturing and service sectors, in consumer spending and retail sales. New anxieties in Europe and sluggish projections of global growth couldn't halt the rally. The quarter was flat-out spectacular for equities, from small caps to blue chips – in fact, it was the Dow's best first quarter since 1998[1]



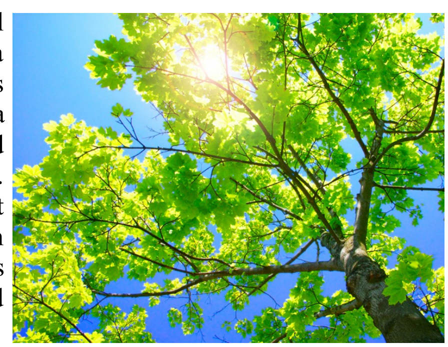
Domestic economic health. The Dow jumped nearly 2% on January 2 as President Obama signed a bill into law to avert the "fiscal cliff" – the combination of tax hikes and expiration of Bush-era tax cuts presumed to throw the economy into recession. While the legislation raised estate taxes, hiked the top tax bracket to 39.6% and ended the payroll tax holiday (resulting in a 2% reduction in take-home pay for each working American), it did preserve the Bush-era cuts for the bulk of taxpayers and extended numerous tax breaks and long-term jobless benefits.[2]

The unemployment rate – 7.8% at the end of 2012 – ticked up to 7.9% in January yet fell to 7.7% in February. Still, hiring was picking up. Non-farm payrolls added 236,000 workers in February, capping off a three-month stretch in which the employment ranks grew by an average of 191,000 jobs a month. From June-August 2012, the pace of hiring averaged only 135,000 jobs per month.[3,4]

Gasoline grew costlier – rising 35¢ in February alone – and that was a big influence in Q1 gains in consumer spending and retail sales. As the Commerce Department noted, personal spending rose 0.4% in January and 0.7% in February; personal wages recovered from a 3.7% plunge in January to advance 1.1% in February. (Household wages dropped in January partly because of a rush by corporations to issue dividends in December, ahead of the assumed fiscal cliff.) Consumer prices rose 1.6% in January, and 2.0% in February, according to the Bureau of Labor Statistics. Even so, retail sales rose in both months – 0.2% in January, 1.1% in February. February's gain was the largest in five months and brought the annualized gain to 4.6%, more than twice the rate of inflation.[5,6,7]

Results from America's two major consumer confidence polls varied notably. The Conference Board's monthly survey came in at 58.4 in January, 68.0 in February, and 59.7 in March; the University of Michigan's consumer sentiment survey went from 73.8 to 77.6 to 78.6 across the first three months of 2013.[8,9]

In late March, the Bureau of Economic Analysis made its last appraisal of Q4 GDP – just +0.4%. The recent boost in consumer spending hints at improved growth for Q1, as do the twin PMIs of the Institute for Supply Management. ISM's manufacturing index rose in each month of the quarter (it had contracted in November), hitting a high of 54.2 in February, but then 51.3 in March; its service sector PMI was at 56.0 in February, then 54.4 in March. In other business indicators, overall hard goods orders recovered from a 3.8% dip in January to increase 5.6% in February; producer prices rose 0.2% in January and 0.7% in February.[10,11,12,13]



As Congress and the White House could not arrive at a deal to postpone federal spending cuts scheduled for March 1, the last month of the quarter saw the start of a phase in which $85 billion would be trimmed from the budgets of federal agencies this year. The Pentagon faced a 13% cut, while non-defense programs stared at a 9% cut. Against expectations, Congress passed a stopgap budget bill that would keep the federal government funded until October 1 six days ahead of a deadline. As the quarter ended, Federal Reserve Chairman Ben Bernanke reaffirmed that interest rates would remain at historic lows until the economy showed more than "temporary improvement". There would be no near-term end for the Fed's quantitative easing effort, though the amount of its monthly bond purchases could vary in response to improvements in the unemployment rate.[14,15,16]

Global economic health. Like a campfire that had been inadequately doused, the financial crisis in Europe flared up anew. Cyprus needed a bailout by March, so the European Central Bank offered it €10 billion to rescue its banking system. The Cypriot parliament at first rejected the plan (which would have taxed bank accounts up to 10%), then accepted it with modifications. Adding to the drama, Italy's February national election resulted in a parliamentary stalemate which may not be resolved until July; at the end of March, Italian bond yields were again rising dangerously. Eurozone unemployment was 12.0% by the end of the quarter.[17,18,19]

China tried to ward off a real estate bubble during the quarter by levying a 20% capital gains tax on home sales. Its central bank set a growth target of 7.5% for 2013 and an inflation target of 3.5%. By March, Markit PMIs showed expanding manufacturing sectors in the PRC (51.6), Taiwan (51.2), South Korea (52.0), Vietnam (50.8), India (52.0) and Indonesia (51.3). Also notable: Japan's embrace of "Abenomics", the stimulus-driven economic policy of prime minister Shinzo Abe. Aimed at lifting Japan out of its current recession, it drove Japanese stocks significantly higher and gave business sentiment a shot in the arm.[20,21,22]

World markets. The Nikkei 225 had another amazing quarter, rising 19.27%. Other Q1 performances in the Asia Pacific region: Pakistan's KSE 100, +6.17%; Australia's ASX, +6.83%; the PSE Composite in Manila, +17.80%; Hang Seng, -1.58%; Sensex, -3.04%; Shanghai Composite, -1.43%. In the Americas, the Bovespa sank 7.55% on the quarter while the TSX Composite rose 2.55%; Argentina's MERVAL climbed 18.45%. In Europe, the FTSE 100 gained 8.71% in Q1, the DAX 2.40% and the CAC 40 2.48%; Ireland's ISEQ topped all indices in the region with a 16.53% Q1 advance. The MSCI Emerging Markets Index dropped 2.14% in Q1 2013; in contrast, the MSCI World Index rose 7.18%.[23,24]

Commodities markets. Metals prices were mixed on the COMEX for the first quarter. Gold fell 4.8%, copper 6.0%, and silver 6.3%; platinum advanced 2.1% and palladium rose 9.2%. The U.S. Dollar Index gained 8.1%. U.S. crude futures rebounded 5.7% in the quarter, while natural gas logged a 20.1% advance. Crop futures had it rough in Q1: sugar lost 9.5%, coffee 4.6%, cocoa 3.0%, corn 0.4%, soybeans 1.0% and wheat 11.6%.[25,26]

Real estate. The sector was plainly on the way back. In March, the National Association of Realtors noted that pace of existing home sales had improved 10.2% in the 12 months ending in February, with the median price up 11.6%; pending home sales were up 5.0% across 12 months as well. The Census Bureau said new home sales had risen 12.3% in that same period, and it also reported much more groundbreaking and considerably more projects in the pipeline: a 27.7% 12-month gain in housing starts, a 33.8% annualized gain in building permits. The latest edition of the S&P/ Case-Shiller Home Price Index (January) posted its largest annual rise since 2006 (8.1%) with 19 of 20 cities showing gains.[27,28,29,30]

Broadly speaking, mortgages grew more expensive in the quarter. In Freddie Mac's last 2012 Primary Mortgage Market Survey (December 27), the average interest rates for mortgage varieties were as follows: 30-year FRMs, 3.35%; 15-year FRMs, 2.65%; 5/1-year ARMs, 2.70%; 1-year ARMs, 2.56%. In the March 28 PMMS, the rates looked like this: 30-year FRMs, 3.57%; 15-year FRMs, 2.76%; 5/1-year ARMs, 2.68%; 1-year ARMs, 2.62%.[31,32]

Looking back … looking forward. As the final trading day of the first quarter ended on March 28, the Dow (14,578.54) and S&P 500 (1,569.19) eclipsed their all-time closing highs. They had a spectacular quarter, and so did the small caps. The Russell 2000 reached new heights, gaining 12.03% in Q1 and settling at 951.54 on March 28. The NASDAQ ended the quarter at 3,267.52. Some S&P 500 trivia for you: the broad U.S. benchmark wrapped up the quarter 132% above where it was on March 9, 2009 (the day it bottomed out in the last, dreadful bear market). In terms of total return, the index has set 33 records since April 2 of last year.[1,33]

% CHANGE	Q1 CHG	2012	1-YR CHG	10-YR AVG
DJIA	+11.25	+7.26	+11.06	+7.90
NASDAQ	+8.21	+15.91	+5.24	+13.86
S&P 500	+10.03	+13.41	+11.64	+8.17
REAL YIELD	3/28 RATE	1 YR AGO	5 YRS AGO	10 YRS AGO
10 YR TIPS	-0.64%	-0.11%	1.13%	2.09%

Sources: cnbc.com, bigcharts.com, treasury.gov - 3/28/13[1,34,35,36]

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.

These returns do not include dividends.

What is next for Wall Street? Will the "sell in May" philosophy encourage mere profit-taking, or will stocks descend more than bulls expect this spring? Some analysts see the market peaking in the near term as latecomers to the rally buy high and grow impatient or disappointed. Others cite steady inflows, arguing that we are not near the top and that stocks look supremely attractive compared to other asset classes. They also point to all the good news emerging in the U.S. economic data stream, the ongoing easing being practiced by central banks on three continents, and (fingers crossed) the lack of a wild card from overseas to upset the advance. Right now, confidence seems to be winning out over anxiety. We can only hope this trend will continue as the new quarter plays out.

We will offer a review of market performance and domestic and global economic developments from Q2 2013 in early July. Should you have any financial questions or concerns in the meantime, feel free to contact us at 425.455.6623.

Sincerely yours,
Larry (Lars) Knudsen & Dan Stober

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