Can Stocks Stay "In The Zone"?

The stock market has been on an impressive run since the end of last year when Congress narrowly avoided the tax portion of the fiscal cliff. The rally has been significant with both the Dow Jones Industrial Average (Dow) and S&P 500 surpassing their all-time highs in March. Their previous highs were set in October 2007, over five years ago. After the strong performance of the equity markets in 2012 and in the first quarter of 2013, many wonder whether stocks can maintain their run or if these new highs will bring worries that the markets have come too far, too fast.

In our opinion, the rally has been healthy because two factors have converged to create a sweet spot for stocks in recent months: improved economic momentum and a resilient consumer.

ECONOMIC MOMENTUM

Before 2013 began, expectations for the U.S. economy were muted at best. Consensus estimates were for gross domestic product (GDP) growth to be around 1.8 percent for the year. The historic average for GDP growth is 3.25 percent per year. Given the fiscal policy headwinds and lower economic forecasts, the bar was set rather low as it relates to expectations for the first quarter of 2013. Fortunately, most of the economic data so far has been coming in better than expected. Housing, the labor market, and manufacturing are all surprising to the upside.

The housing market recovery picked up steam in the final three months of 2012 with prices rising at an annual rate of 7.3 percent, according to S&P Case-Shiller. The home price increase marked the third straight quarter of year-over-year gains and represented the biggest annual increase since the second quarter of 2006, near the height of the housing boom.

The number of new homes sold in January jumped more than 15 percent from December and nearly 30 percent from a year earlier. There is only a 4.1-month supply of new homes available for sale on the market, the tightest supply since the bubble days of 2005. The improvement in the housing market is driven by many factors, including near record-low mortgage rates, a drop in the number of home foreclosures, the tight supply of both new and previously owned homes available for sale, and an improvement in the overall economy, including a lower unemployment rate. These factors are combining to bring buyers scared to buy during the housing downturn back into the market. The housing numbers are impressive, but we must also keep in mind they are coming off a really low base. The percentage growth rate is not sustainable, but the direction is clearly a healthy sign.

The labor market continues to show its resiliancy. U.S. employers added 236,000 to non-farm payroll jobs in February, up from 119,000 in January. This was the best payroll growth since 247,000 jobs were added last November and the second best month for job growth in the past 12 months. The unemployment rate dropped to 7.7 percent from 7.9 percent in January with 12 million people still looking for work. That is the lowest unemployment rate since December 2008, when the rate was 7.3 percent. However, it is not hard to find disappointing data in the same report. January job growth was revised down sharply, from 157,000 to 119,000 jobs and the unemployment rate fell in large part because the labor force shrank by 130,000 workers. Labor-force participation has never recovered from the recession, suggesting either that large numbers of workers have retired early, or have simply given up trying to find jobs.

The U.S. economy has added 5.7 million jobs since the labor market bottomed in February 2010. However, non-farm employment is still three million jobs lower than before the start of the recession in December 2007, making this the slowest labor-market recovery since World War II.

A final positive from the latest jobs report is that the government sector cut 10,000 jobs in February, and those numbers could rise later this year as the effects of the sequester related budget cuts take effect. This is further evidence of the private sector fueling the growth in jobs.

Manufacturing also has been a source of momemtum for 2013. Industrial production grew 0.7 percent in February surpassing expectations of 0.4 percent. Industrial capacity utilization, a measure of how fully firms are using their resources, rose to 79.6 percent in February. This was the highest average since March 2008 when it was 80.1 percent.

Another encouraging report was the February 2013 ISM Manufacturing Survey. This survey showed PMI (Purchasing Managers Index) increased by 1.1 percentage points to 54.2 percent and is in expansion (a reading above 50 percent) for the third month in a row. This is the fifth time in nine months manufacturing PMI has been in expansion and the highest manufacturing PMI since June 2011.

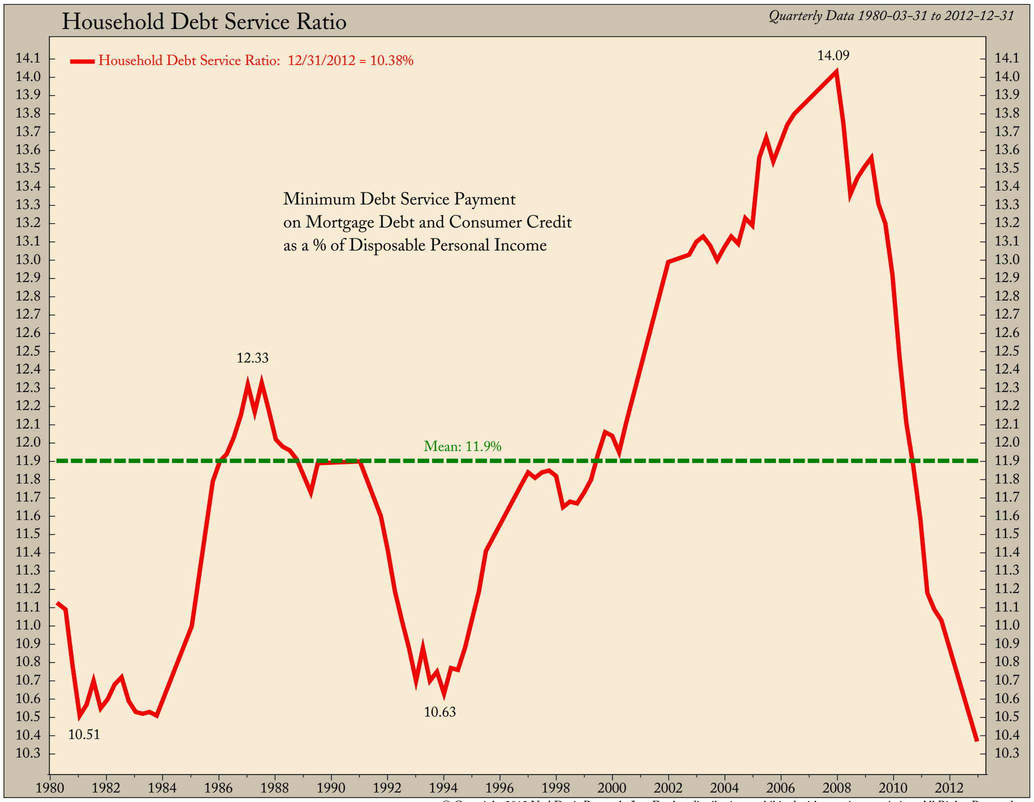
A RESILIENT CONSUMER

The biggest concern and likewise the biggest surprise thus far in 2013 has been the consumer who makes up the largest sector of the U.S. economy. In the past few years, consumer spending has been equal to more than 70 percent of GDP. Without a strong consumer, the economy will stagnate very quickly. We are concerned that the economy could weaken this year because of tax increases at a time when the unemployment rate is still high.

The income tax changes received much of the attention at the end of last year. However, the payroll tax rate increasing from 4.2 to 6.2 percent gave us just as much unease. This rise means an individual making $50,000 per year would have $1,000 less in disposable income to spend. However, retail sales figures have continued to be very strong, generally exceeding consensus expectations.

It appears we are experiencing the "wealth effect." Consumer spending has remained resilient this year despite slow income growth and higher taxes because consumers have seen the value of their home and investment portfolios increase. Equally important, households have increased savings and reduced their debts during the past few years. As a result, the percent of after-tax income necessary to service outstanding mortgages and consumer credit has dropped to its lowest level on record, going back to 1980. *(see chart on following page)*

Households can spend more of their after-tax income when they do not have to use as much of their income to service outstanding debts. History suggests that the current low debt-service burden is a significant positive for the U.S. economy. The last two times the debt-service ratio was near



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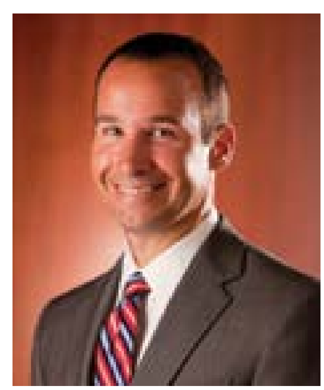
the current level (in the early 1980s and 1990s), the U.S. economy continued to grow for more than five years afterward. Deleveraging hurts the economy when it is taking place but typically sets the stage for healthier economic growth later. In our opinion, we could see the benefits of this deleveraging during the next few years. But, student loan debt and rising debt burdens from retirees are still a growing concern; and with current interest rates very low, we are unlikely to see rising interest rates as we did in the 80s and 90s.

As with any positive investing environment, things can change rather quickly. Investors and the markets have generally been ignoring much of what is happening in Washington. However, the sequestration related cuts can have a significant impact on the economy's growth (GDP) going forward. Housing will most likely level off and while the consumer has been very resilient, less disposable income from the payroll tax increase could impact spending.

Also keep in mind, in each of the past three years the stock market has peaked sometime in the spring (April 2010, May 2011, April 2012) and then proceeded to correct 10 percent or more over the summer. While the market may be due for a pullback over the near term, we recommend investors maintain a long-term view and evaluate the proper asset allocation mix given long-term goals and objectives.



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