Market Insight - Monthly Newsletter

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Last month's market trends and forward-looking commentary.

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Market Insight
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Four Months of Gains in a Row

U.S. equities recorded their fourth consecutive monthly gain in 2013 and joined an elite group of post-WWII years that have started out with positive returns in each of the first four months. There have only been 14 (out of 67) post-WWII years that have started out this strongly and 100% of these years delivered positive returns that averaged 20.97% — well in excess of the post-WWII average annual gain of 8.1% (price-only). For the remainder of the year (May through December), these years delivered an additional average gain of 9.6% with positive returns in 93% of the cases and only one negative May-through-December return (1971) that totaled 2.6%. Therefore, the strong start to 2013 is encouraging from a historic analog perspective since there is no precedent for the start of a severe bear market after such a strong start to the year. However, each of those years had intra-year drawdowns that averaged 8.9% compared to the S&P 500's relatively mild 3.8% correction thus far in 2013, so more volatility may be in store (more on this later).

Asset Class Performance

	Apr.	2013
Real Estate – DJ-Wilshire REIT	6.8%	14.2%
U.S. Equities – S&P 500 Index	1.9%	12.7%
Global Equities - MSCI All World Index	3.2%	11.3%
Developed Foreign Equities – MSCI EAFE Index	5.3%	10.8%
Bonds – Merrill Lynch High Yield	1.9%	4.8%
U.S. Dollar – DXY Index	(1.5)%	2.5%
Bonds – Barclays U.S. Aggregate Bond Index	1.0%	0.9%
Emerging Market Equity Index – MSCI Emerging Mkt Index	0.8%	(0.8)%
Commodities – RJ Commodities Price Index	(3.0)%	(2.5)%
Gold - Front Month Future	(7.7)%	(12.2)%

2013 continues to have a U.S.-centric performance profile as U.S. REITs and the S&P 500 have been among the strongest performers. That said, the MSCI Developed Foreign EAFE Index outdistanced the S&P 500 in April by gaining 5.3% and is now up 10.8% year-to-date. The EAFE's strong performance in April was underpinned by an 11.8% gain in Japan's Nikkei Index and a 4.3% gain in the Euro Stoxx 50 Index (Europe's leading blue chip index of 50 stocks from 12 eurozone countries). Gold and commodities fell for the month and remain 12.2% and 2.5% lower year-to-date, respectively, while bonds continue to underperform most equity categories as the Barclay's U.S. Aggregate Bond Index has gained only 0.9% thus far in 2013.

Economic Cross-Currents Surface in April

The last three years have seen encouraging economic signs fade as each year progressed, producing late-spring corrections consistent with the old "sell in May" adage. Economic data released in April suggests that the economy may have, once again, hit a speed bump as a slew of reports came in worse than expected. Durable goods orders in March dropped to their lowest level in seven months and the initial reading on first quarter U.S. GDP (+2.5%) came in well below economists' expectations. However, in early May, the downward trajectory in economic news brightened as the U.S. Labor Department reported that 165,000 jobs were added in April, above consensus expectations 140,000, and March's disappointing jobs report was revised upward to 138,000 from only 88,000 originally estimated.

One of our key indicators is the Citigroup Economic Surprise Index, which measures the pace at which economic data is coming in above or below consensus expectations. A reading above zero suggests that economic data has been coming in above consensus expectations over a rolling three-month window. This index dropped into negative territory coincident (or just ahead of) each of the S&P 500's corrections over the past three years. The disappointing economic news during April caused it once again to fall below zero at mid-month although, as of this writing, it has moved back into positive territory with positive April employment news. The index provides an objective and quantitative measure of economic news (as opposed to expectations) that seems to have explanatory power regarding market performance. We will be watching this key indicator closely going forward.

While corporate earnings and revenue growth are also slowing, the market was able to digest the first-quarter earnings season that has included some high-profile disappointments and negative guidance. As of May 3, 59% of all companies reporting had beaten earnings estimates for the quarter and 52% had beaten revenue estimates, according to data compiled by Bespoke Investment Group. Both beat rates are below average for the current bull market. It is noteworthy, however, that a much higher 73% of companies in the S&P 500 had exceeded first-quarter earnings estimates (as of April 26), according to data from Ned Davis Research, indicating that large U.S. companies are increasingly using their strong balance sheets to repurchase shares and boost bottom-line results.

Globally, there is some evidence that the risk appetite in investor sentiment has returned in the eurozone after the recent banking crisis in Cyprus as European bond yields, including Italian and Spanish short-term borrowing costs, consistently fell throughout April to new record lows. Of note, after struggling for two months to form a government, Italy was finally able to form a coalition in both parliamentary chambers on April 29. New Premier Enrico Letta has promised reduced taxes and a strategy to revive growth, leading to some renewed optimism in European financial markets.

Perhaps the most important event for global financial markets occurred early in the month when the Bank of Japan took a page out of the Federal Reserve's 2008 playbook, unveiling an overwhelming stimulus measure in an attempt to shock the Japanese economy out of its deflationary slumber. In his first meeting as the Governor of the Bank of Japan, Haruhiko Kuroda topped heightened expectations with a bold monetary easing plan. Since taking power last fall, Prime Minister Shinzo Abe has embarked on a controversial policy

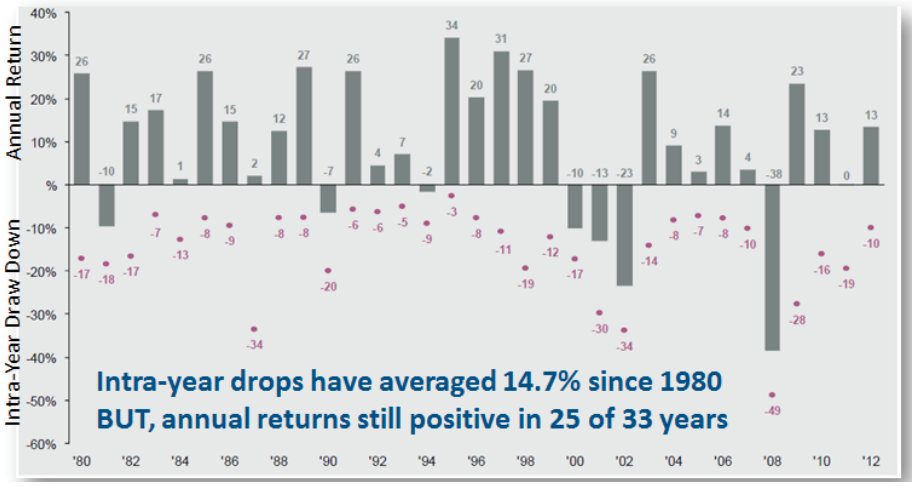
to devalue the yen at breakneck speed, thereby aiding Japanese exports and juicing asset prices including equities. Mr. Kuroda's announcement of a dramatic expansion to the monetary base caused the yen to plunge further against the dollar. As previously mentioned, Japan's Nikkei surged 12.2% on the month and is now up nearly 35% year-to-date. The bold monetary strategy is not without its risks, however. The deeply indebted nation runs the risk that buyers of Japanese bonds will ultimately demand higher coupons if inflation slowly creeps back into the system. Imported inflation courtesy of a weaker yen could also damage Japan's fragile economy.

In discussing the significant economic and market cross-currents experienced in April, it is worth mentioning the wild action in the price of gold. On April 15, the commodity suffered a historic slump, experiencing its biggest one-day decline in 30 years before recovering modestly to finish the week down 6%. With the world's leading central banks providing unprecedented backstops for risk assets (i.e., stocks), gold's safe-haven status appeared out of favor with investors. Adding to the selling pressure were recently subdued inflation readings and the breach of key technical support at $1,520 per oz. that has contained pullbacks over the past year-and-a-half.

Longer-term Outlook

As shown in the following chart, the S&P 500 has averaged a 14.7% intra-year correction since 1980, yet annual returns have still been positive in 25 out of 33 years. Even if the years with negative full-year performance are excluded, the average intra-year correction is still 12% since 1980. Our macro models are designed to help differentiate between severe bear market conditions and shorter-term concerns that are likely to prove temporary. The point of the chart is to illustrate that some intra-year turbulence is inevitable in investing and an excessive focus on shorter-term market gyrations can adversely impact longer-term investment objectives.

S&P 500 Intra-Year Declines vs. Calendar Year Return



Source: JP Morgan

Positively, to conclude on the theme of this newsletter, each post-WW II year that has started out this strongly (positive returns in Jan, Feb, Mar and Apr) went on to make higher highs in the following year.

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