<u>Outlook for April, 2013: "Drag Racing to a Non-existent finish line!"</u>

With the Bank of Japan fully joining the ***Quantitative Easing party*** it is quite obvious that equity markets the world over are rejoicing some more this month. The visual of all three major Central Banks as cars (the US Federal Reserve, the European Central Bank and the Bank of Japan) racing down a drag strip, throttle fully open, to a non-existent finish line is an ***enduring*** (not endearing, mind you!) and scary one.

On the economic front, data released recently has been a ***bit perplexing***: Beginning with the employment situation, the report was dismal, to say the least. The Bureau of Labor Statistics reported that nonfarm payroll employment increased by a mere 88k in March, the slowest monthly gain since June of 2012. With expectations hovering around 200k, the equity market responded in a negative fashion. Net revisions for January and February were +61k in total. Among sectors, professional and business services (+51k, adding 533k over the past 12 months), health care (+23k), and construction (+18k, adding 169k jobs over the past 6 months) were the ones of note. Government at all levels shed a total of 7k jobs while the retail sector contracted by 24k.

From the Household Survey, the widely followed ***unemployment rate fell*** from 7.7% to 7.6%. This drop was as a result of almost 500k people dropping out of the labor force and they were therefore not counted in the survey. This is not how we want the unemployment rate to decline. The granular details of the report were generally unchanged from the prior month: 11.7 million people are unemployed, 4.6 million are considered long-term unemployed, and 7.6 million are working part-time despite wanting a full-time job. A more robust unemployment figure, ***the U-6 measure***, was down notably from 14.3% to 13.8%.

We focus on employment data because it is a reasonable indication of the current state of economic affairs. Companies have been in the process of creating leaner workforces since the start of the Great Recession. Operating and profit margins have reaped the benefits of such cost cutting along with the stock market. However, there reaches a point when cost cutting is no longer an option and growth must come from increased sales and/or innovation. But we also need the help of legislators to give businesses the opportunity to succeed and compete in a ***highly integrated global economy***.

GDP was revised up slightly to 0.4% (previously 0.1%), representing q/q annualized growth in the 4th quarter of 2012. The modest revision reflected stronger growth from nonresidential fixed investment and exports. As a result, real GDP was up 2.2% in 2012, slightly higher than 1.8% in 2011. Corporate profits are still increasing with year on year growth of 13.3% in 2012, a slight deceleration from the 17.9% growth experienced in 2011.

Regional surveys of business activity came in positive for the most part with new orders and employment showing mixed signals. Likewise, the PMI and ISM manufacturing surveys both reported readings above 50, indicating that expansion is still underway, despite slight declines in their overall metrics. In the non-manufacturing sector, the ISM survey reported a ***deceleration in growth***, but growth nonetheless. Positive momentum has been reflected in the consumer sentiment survey with the index at elevated levels seen only four times since the start of the recession.

A central banker will never admit to this, but when one launches a pre-emptive strike on the ***external value*** of their own currency with the intention of weakening it substantially (by euphemistically calling it quantitative easing), it is well nigh hard for other central banks (especially those of developing nations) to stand idly by. This is the reason why there are cries of ***"currency wars"*** from emerging market quarters in response to what the Bank of Japan, the European Central Bank and the Federal Reserve have been up to.

In a race at such break neck speed, as it inevitably happens on a slick surface, one of the drivers could well lose control. There is no question in our mind that what the three central bankers want (to weaken each of their currencies against the other two's) is essentially unattainable – for after all, this is not ***Lake Woebegon*** (the mythical town in Garrison Keillor's "A Prairie Home Companion"). At Lake Woebegon, "all the women are strong, all the men are good looking, and all the children are above average".

In other words, since a currency exchange rate is a ***relative price***, it is mathematically impossible for both currencies in a pair to weaken against each other – even using fancy new math! While the weakening of the Yen appears to have met with ***tacit approval*** from the other G-8 Central Bankers - allowing the Bank of Japan to launch its quantitative easing program - the real improvement in Japan will occur only if the weakening Yen is followed up with real policy reforms and steps.

Japan has long suffered from an economic malaise brought on by severe deflation and a bursting of dual bubbles in property as well as financial assets (primarily Japanese equities). In addition, the nation also has a chronic ***declining labor force*** exacerbated by a birth/death ratio that has been decidedly negative now for the past five years or so. Japan does have an opportunity to consolidate the gains if they ensure that real reforms take place – especially if they were to significantly increase investment spending and open up their moribund retail and wholesale distribution systems.

There is no question that the recent advent of QE in Japan has propelled all kinds of ***"yield" instruments higher.*** Recent reports in the financial press suggesting that some Japanese REIT companies (that in turn invest in US REITs) are now paying very high yields to their investors as a result of paying out unrealized capital gains are a little worrying. While we believe US REIT valuations are still reasonable, this is something we will continue to watch with a wary eye.

In Europe, it appears that after the crisis in Cyprus (which was handled very poorly by European authorities), it is now ***Slovenia's turn***. While finance ministers as well as the European Central Bank have taken pains to suggest that the haircut by depositors of insured deposits in Cyprus was a unique (and special) case, fears that such a fracas could well be repeated in Italy or Spain in the future are quite legitimate. The authorities have clearly removed what little sanctity there existed for ***private property*** in Europe.

News from the United Kingdom that Lady Margaret Thatcher has passed away had us reflecting on her legacy: The ***Iron Lady***, clearly put her country on a path to greater growth making it the envy of the western world along with her special relationship with President Ronald Reagan. Her battle with the coal mining unions in Britain and eventual triumph of conservative principles certainly helped put her on the map and secured her place in history.

The ***US earnings season for 1Q2013*** is in a nascent stage: With a mere 35 companies having reported earnings so far, it s still way too early to draw any significant conclusions. However, it appears that the early results are quite encouraging, with ex-financial members of the S&P500 index reporting a share-weighted gain of around 6.0% (year-on-year). We still think that the bottoms-up consensus is probably too optimistic as far as operating earnings are concerned and there is some scope for disappointment, as a result.

Valuation mutiples are, however, still reasonable: If anything, the past fifteen years (yes, a fairly arbitrary period) have witnessed a median valuation multiple of around 16.6 times prospective earnings. With the current multiple stuck around the 14 times range, it is entirely possible that we could see some ***expansion in mutiples***. However, we would caution that such an expansion in mutiples is unlikely to be sustained until such time as market participants believe that much of the uncertainty surrounding policy (monetary, fiscal and regulatory) has been resolved.

Market volatility has ***continued to decline*** recently: Indeed, the ***daily average standard deviation*** of the S&P500 Index over the past 90 days (a measure of volatility) has dropped to the 0.62% area. This means that theoretically, the S&P500 index has a chance of either going up or down by that figure on any single day, based on the past 90 days' history. To put this in perspective, this same measure (90D average daily stddev) was well ***north of 4.0%*** in Oct 2008! We continue to view this lack of volatility as more ***cyclical rather than strategic***, implying that volatility could well rear its ugly head again in the not too distant future!

In ***summary***, financial markets continue to be propelled higher by the sea of excess central bank liquidity – with the Federal Reserve, the European Central Bank and the Bank of Japan now joining the fray. There is no question in our mind that activist policies by central banks are ***unlikely to end well*** in the longer term. Our abiding faith in a ***fully diversified portfolio*** - that has a balanced approach to both risk and return - as the main way to attain favorable investment outcomes over the long haul remains steadfast.

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