<u>Outlook for February, 2013: "Five year highs!…"</u>

All the excess global Central Bank liquidity has propelled equity markets higher. As many of the popular market averages hit ***five year highs***, there appears to be ***a feeling of euphoria*** among market participants. The Oxford English dictionary defines the term "euphoria" as a noun where "a patient has a sense of well-being not based on reality". We do believe that this definition of euphoria is quite apt for where global financial markets find themselves currently.

On the economic front, our confluence of indicators suggests ***slight optimism***: The monthly labor report issued by the Bureau of Labor Statistics showed non-farm payrolls increased by 157,000 in January with an increase of 156,000 in November and December revisions. Private payrolls accounted for 166,000 while government cut back 9,000. The upward revisions to November and December were a surprise and boosted the monthly average for 2012 to 181,000 from 153,000 as previously reported.

In the Household Survey, a separate report, the unemployment rate actually increased marginally from 7.8% to 7.9%, partially reflecting an increase in the labor force. An alternative measure of what we believe to be "true" unemployment, commonly referred to as the ***U-6 measure***, was unchanged at ***14.4%.*** We will refrain from diving into the details of these reports, but at the rate we've seen for the past 2 years, we have a long way to go before "full" employment is achieved.

Now let's take a look at the sectors that produce jobs: Manufacturing has been a bellwether of the recovery and its strength is critical to sustaining this slow moving train. The regional surveys of manufacturing activity were decidedly negative for the month (with the exception of the Dallas Fed Survey); however, survey participants were optimistic over the next 6 months. On the national front, the popular and well respected ISM survey continued to show expansion in the sector at an accelerating rate (53.1 in January vs. 50.2 in December); new orders and employment provided the bulk of the increase.

Retail sales for December were encouraging as the m/m increase was 0.5%, up from 0.3% in November. It will be interesting to see how retail sales are impacted over the coming months as workers are hit with higher payroll taxes and the wealthy are dealt with a plethora of new taxes. Consumer confidence was notably down in January from 66.7 to 58.6, primarily reflecting Washington's antics surrounding the fiscal cliff and impending debt ceiling negotiations. Durable goods orders increased 4.6% m/m and the Leading Economic Indicators index (LEI) also showed growth (0.5%).

There's been much to say about the current ***"housing recovery".*** It's tough to ascertain whether this pickup in activity is sustainable, or just a blip that will fade quickly. Regardless, it is encouraging to see housing starts on positive ground and a boost to the economic recovery. We are also looking at auto sales in 2013 to provide a tailwind to the economy as the most recent data we've seen suggests the average age of the U.S. automobile fleet is now at 10.6 years.

The initial estimate of 4^{th} quarter GDP issued by the BEA showed contraction of -0.1% q/q - the first contraction since 2009. While the headline number is a bit alarming, the underlying fundamentals ease fears. Contributing to the downside was a sharp decrease in government spending (especially defense), lower exports, and slowing inventory investment. On the other hand, residential investment (housing) and consumer spending were up. Revisions in the coming months will be based on a more complete set of information and we do fully expect that the GDP report will likely be revised upwards.

If you happened to miss it, the ***Congressional Budget Office (CBO)*** released its annual projections of the budget and federal debt. The current fiscal year will produce a deficit of ***only $845 billion***, a modest decrease from the past four years of trillion plus deficits. Depending on which measure you use as the numerator, the federal debt is now somewhere between 73-104% of GDP (pubic and total debt respectively). It doesn't take a genius to know where we are headed if the politicians in Washington DC don't get serious. Expect tax increases and entitlement reform to take shape at some point later this decade. We'll leave you with one quick thought: The CBO's projection over the next 10 years shows government spending to total ***$47.2 trillion.***

Farther afield, Shinzo Abe, the new Prime Minister of Japan has continued to badger and cajole the Bank of Japan into "doing more" on the quantitative easing front. Indeed, the BoJ has finally succumbed to the temptation by throwing all caution to the winds and actually setting a ***target floor*** for consumer price inflation in that country. As one would expect, the Japanese Yen was quick to oblige weakening significantly against both the US Dollar and the Euro helping growth prospects for Japanese exporters.

The European Union leaders finally agreed to a ***"long term budget"*** for the next seven years which represents a 3.0% decline from current levels. The very fact that the negotiations occurred in a marathon session that lasted almost twenty four hours speaks to the ***intransigence that EU governance*** has become. This time around, the bone of contention was the agricultural subsidies that were railed against by British PM Cameron but defended passionately by French President Hollande.

There is no question in our mind that governments around the world – especially in countries that have made a significant social commitment to their populations – are bloated. From a governance standpoint, it is well nigh impossible to make the case that government and their operations are ***efficient.*** If anything, looking at governments in the US, Europe (that fiscal and monetary agglomeration) and Japan suggests that the size of governments remains ***inversely proportional*** to the level of efficiency.

We are afraid that many of the emerging markets like China, India and Brazil appear not to have learned much from the experiences of their developed cousins' governments and their efficiency (or lack thereof). Indeed, in many countries government employment is thought of as a sure way to propagate one's political party as well as a way to hand out political largesse. Nonetheless, it is ***quite disheartening*** to note that the size of government appears to be headed the wrong way the world over.

Now for some good news: ***Fourth Quarter earnings*** for the S&P500 have come in ***better than expected***. So far, 343 companies (=68.6%) in total have reported earnings for the quarter and of these 238 (=69.3%) have shown earnings gains, 8 (=2.5%) unchanged, while 97 (=28.2%) have seen a decline in earnings. Of the total 343 companies that have reported earnings so far, 275 are non-financial companies. The non-financial companies have reported a ***share-weighted gain in earnings of 4.1% (y/y)*** which is considerably better than the -0.6% (y/y) that third quarter earnings represented.

Our longer term ***worries*** about declining ***earnings momentum*** remain despite the recent good news: Consensus bottoms-up earnings forecasts for the S&P500 imply a ***gain of 14.4%*** for this year (2013) and a 10.8% gain for next year (2014). Looking further out, the compound annual growth rate for earnings going out to the end of 2015 is a mind-boggling 10.3% per year – suggesting a liberal use of ***rose colored glasses*** by analysts on Wall Street. We find these numbers will be hard to achieve particularly if the US economy only grows at an anemic 2.0 to 2.5% pace for the entire period.

Scattered reports of the "individual investor" finally moving monies from money market mutual funds and bond funds into equity mutual funds are all the rage. Many analysts are implying that this behavior by the ***"little guy"*** must be positive for equity markets going forward given the huge stash of cash that has remained on the sidelines for a number of years now. While we take the point that some investors might finally be coming out of their shell, we have a ***slightly different take*** on this phenomenon.

We have been around markets long enough to know that they typically move in the direction that they cause most pain (how is that for some healthy skepticism!). Indeed, more often than not, individual sentiment acts more as a ***contrarian indicator*** thus suggesting that we ought to ***"fade the move"*** rather than embrace it wholeheartedly. It also helps that media outlets are hyping the fact that markets are hitting five year highs.

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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