Investment Review | First Quarter 2013

IN THIS ISSUE

Detailed commentary on the First Quarter of 2013 along with insight and outlook from Market Street's investment team

OVERVIEW & STRATEGY

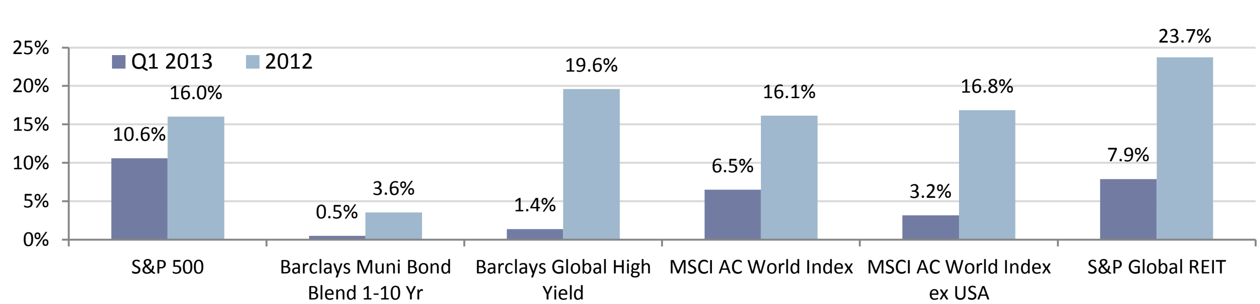
Robert White
Investment Manager

Global asset prices maintained their rally into 2013 with support from continued massive central bank liquidity. Markets rose in the face of both the European debt crisis and the sustained economic growth fears in China. Despite talk of a low return environment and a lost decade for equities, the U.S. stock market has now provided an annualized return of almost 22% over the last four years, and almost 10% annualized return over the last decade!

While U.S. stocks continue to hit record highs, more recently defensive stocks have performed best, as opposed to more cyclical stocks which often act as leading indicators of economic growth. This provides us with some pause for thought as to whether market participants feel that future economic growth may disappoint.

High yielding assets have also continued to rally, despite repeated warnings that prices have reached levels that do not reflect the diminishing strength of the global economy. High yield bonds returned around 1.4% during the quarter, while global REITs were up 7.9%. Master Limited Partnerships, high yield vehicles that provide exposure to U.S. energy infrastructure, had a fantastic first quarter with a gain of over 20%. Overall, Market Street clients enjoyed these positive returns with diversified Moderate Growth and Growth portfolios earning about 4% to 5% for the quarter.

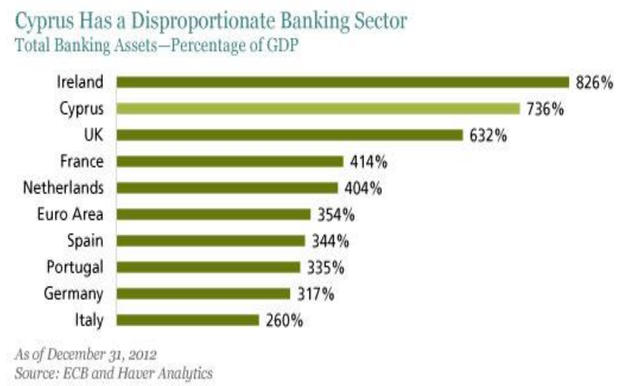
Chart 1: General Market Returns



With all manner of asset prices continuing to rise, we are left wondering why we cannot fully share in this happiness. There are a myriad of reasons for our reticence to wholeheartedly embrace the booming equity and debt markets, many of which have been written about in previous editions of our Investment Review (U.S. Fiscal position, European debt, China's economy, the eventual withdrawal of global central bank liquidity and the list goes on).

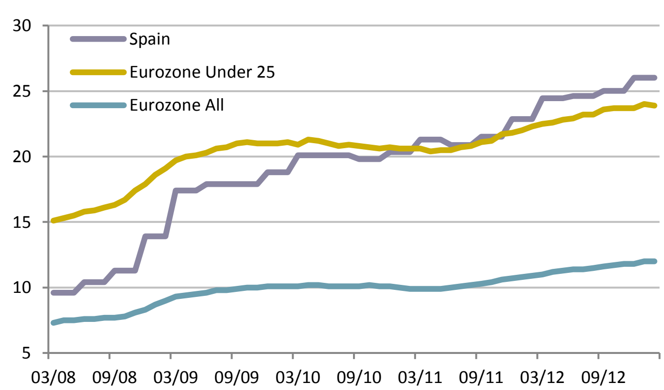
Recent events in Cyprus have reminded us of the continued crisis in the Eurozone. While Cyprus is just a tiny island off the coast of Syria with an economy representing only 0.2% of Eurozone GDP, its banking system was disproportionality large (Chart 2). Unfortunately, much of its deposit base was invested in Greece, resulting in a leveraged exposure to the Greek crisis. Cypriot politicians rightly voted down proposals by European leaders to expropriate the deposits of small depositors, an action that would have made a mockery of the European depositor protection scheme for balances under €100,000. European leaders may have viewed it fortuitously that it was largely foreign depositors, primarily Russian, who lost up to 100% of their balances in the two Cypriot banks. Such depositors were initially attracted by lax Cypriot banking regulations. However, many 'everyday' people were also caught, including those who were buying or selling a house with the funds on deposit overnight awaiting the final contract. This event has created future uncertainty for those undertaking financial transactions in other peripheral nations such as Italy, Spain and Portugal. By attempting to circumvent the European depositor protection scheme, European leaders initially demonstrated a poor handling of this crisis. Unfortunately, it is likely that with elections later this year in Germany, strong solutions that cost the German taxpayer money will continue to prove politically difficult.

Chart 2



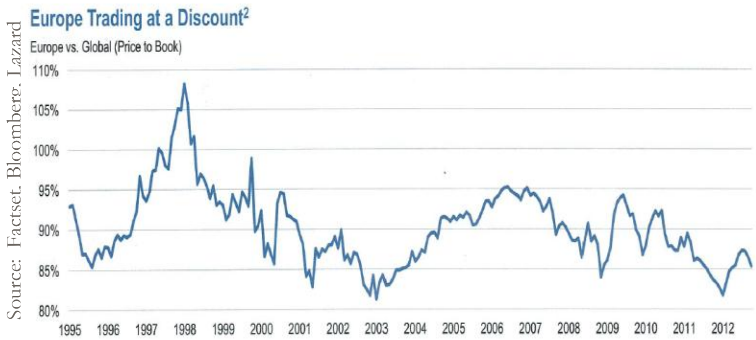
Furthermore, across the European Union business conditions have continued to deteriorate, even in the relatively austere German economy. The rate of economic contraction has generally increased, with Greece, France, Spain and Italy all in significant contraction. Manufacturing production has also continued to decline and new orders across the Eurozone have fallen for 22 successive months. Unemployment among the Euro nations has hit a record 19 million people, representing 12% of the workforce, while the youth unemployment rate (under 25s) is at 24%. Disappointedly, unemployment has increased over the last year in both the Eurozone overall and in many individual nations. Amid attempts at austerity, Spanish unemployment has increased from 24% to 26%, while youth unemployment is at a staggering 56%. However remote it may still seem at the moment, such conditions surely suggest the possibility of civil unrest.

Chart 3: Eurozone Unemployment Rates %



Source: Bloomberg

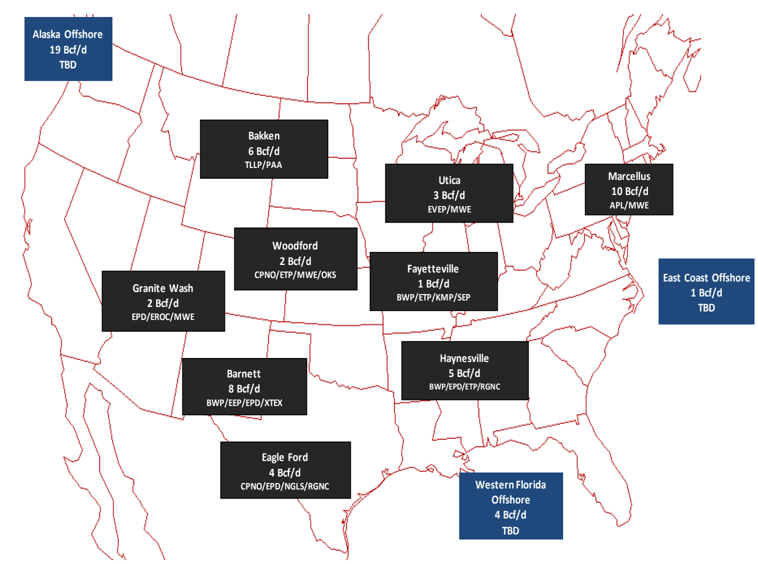
Chart 4



Yet, one must also acknowledge that there have been vast structural improvements in the peripheral markets which will result in increased productivity and competitiveness. The long-term future certainly looks brighter, and with stock valuations still attractive in Europe (Chart 4), the opportunity exists for those willing to take on headline risk and volatility over the next few years.

By contrast, the U.S. economy appears to be the polar opposite, with a falling unemployment rate, a recovering housing market and a growing economy. Despite political indecision, Sequestration appears to be a non-event (apart for those government workers on furlough), with a limited effect on unemployment and economic growth. Moreover, fights over the Federal Budget have again been delayed with a Continuing Resolution that allows the Government to continue to function through the end of September. The housing market appears to be recovering, with new construction creating a circular cycle of job creation. And, while the State of Michigan has installed an emergency manager to bring fiscal discipline to the city of Detroit, state finances are generally improving, with personal income tax receipts rising in 39 states.

Chart 5: Substantial Reserve Potential



Source: Harvest Fund Advisors

Fueling America's future is the energy renaissance, with a foreseeable energy independence that is less constrained by geopolitical issues. Beyond serving as a direct boost to employment, a cheap energy source acts as a magnet to all those companies that had previously moved manufacturing overseas. The shale gas boom is creating jobs and enhancing economic growth across the nation from Pennsylvania to North Dakota. Independent research group ISI likens the U.S. energy and manufacturing resurgence to the build-out of many emerging market economies. This is evidenced in states like North Dakota, where population growth is three times the national average, with an enviable unemployment rate of just 3.2%. The state has a $1.2 billion budget surplus and modern infrastructure is being built-out with new schools, hotels, airports, roads and railways.

While our own energy source may mean the U.S. has less reason to place its military in the Middle East, global geopolitical risks continue to be of concern. Conflicts that potentially affect investment markets are spread across the globe, Syria and Israel in the Middle East, Pakistan on the Indian Subcontinent, and North Korea in the Far East where an inexperienced leader's saber-rattling has the potential to evolve into a much more dangerous situation.

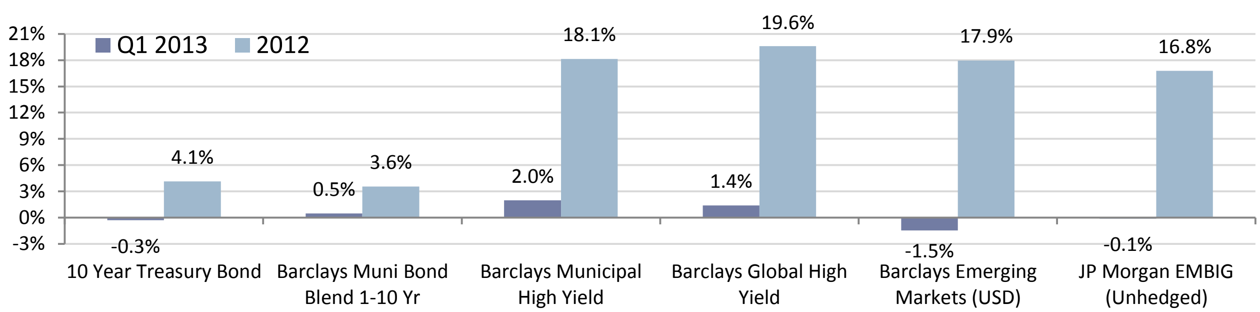
Although risks do remain, it appears that the known 'tail risks' that could lead to a financial meltdown or recession have been considerably reduced. Asset prices are likely to continue to be supported by global central bank liquidity, although we do not yet know the long-term effects of their actions. As we mentioned in our year-end review, Market Street has slowly been adding to risk assets. This rebalancing continued through the first quarter, with a reduction in high yield and hedged assets funding additional exposure to international equities and energy infrastructure. Looking forward, we can still expect some bumps along the way; however, we will continue to reposition portfolios to take advantage of the relative attractiveness of certain asset class opportunities.

FIXED INCOME

Despite the rallying stock market, there has been little sign of a 'Great Rotation' out of bonds. Mutual fund inflows during the first quarter totaled over $66 billion as investors continued to add to both taxable and tax-exempt bonds. Bond markets continued to reward those seeking higher yields and accepting higher risks, escaping from a Federal Funds Rate that remained at just 0.25%. U.S. Government debt suffered minor losses for the second successive quarter, with the benchmark 10-year Government bond losing 0.3%, while the more volatile 30-year Treasury lost 3.1% during the quarter.

Municipal bonds outperformed U.S. Government bonds during the first quarter, with the Barclay's Municipal Bond Index (1-10 years) returning 0.5%, while the broader Barclay's Municipal Aggregate Index gained 0.3%. Despite continued headline risks, including the emergency takeover of Detroit by the State of Michigan, municipal debt remains supported by investor demand for the relatively attractive yields. The high yield municipal debt market, as represented by the Barclay's Capital Municipal High Yield Index, performed well, up 2.0%, as investors continued to be forced into higher risk assets as a result of the Federal Reserve's accommodative polices.

Chart 6: Fixed Income Returns



The corporate bond market provided a positive return during the first quarter, with spreads relative to Treasuries continuing to narrow. Despite increased warnings about stretched valuations, investors continued to demand lower-rated corporate bonds, with B-rated and CCC-rated 'junk' bonds providing the greatest performance, up 2.8% and 5.8%, respectively. Structured products such as Mortgage Backed Securities and Asset Backed Securities were largely flat over the quarter, despite massive support from the Federal Reserve's purchases that currently account for around 50% of the monthly gross issuance of all mortgage-backed securities.

Emerging market debt weakened during the quarter with the Barclay's Emerging Market Debt Index losing 1.5%, while the local currency Barclay's Emerging Local Debt Index was broadly unchanged.

Despite relatively attractive yields, U.S. dollar denominated emerging market debt was negatively impacted by the change in the U.S. Treasury market yield curve, while local currency debt suffered from the strength in the U.S. dollar during the first quarter.

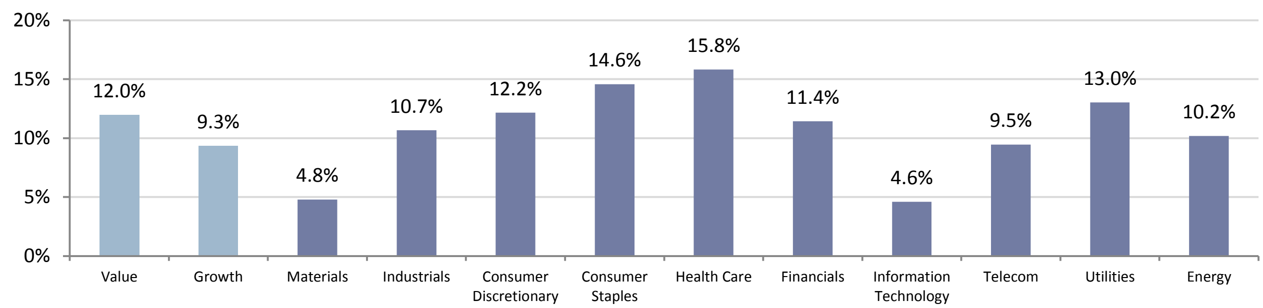
EQUITIES

Anastasia Smith
Investment Analyst

Global equity markets provided solid first quarter returns of more than 6%, led by the U.S. market which rallied 11% on continued strong economic data. Investors seemed to be sanguine about the lack of any immediate action to surmount spending and budgetary issues. Within the U.S. equity market, returns were differentiated by style, market capitalization, and sector. Mid-cap companies did slightly better than small and micro-cap stocks, while all outperformed large-cap stocks by nearly 2%. Within each market capitalization segment, value stocks again outperformed growth stocks, as investor demand for both yield and defensive characteristics continued. Value stocks have now outperformed growth stocks by more than 8% over the last 12 months.

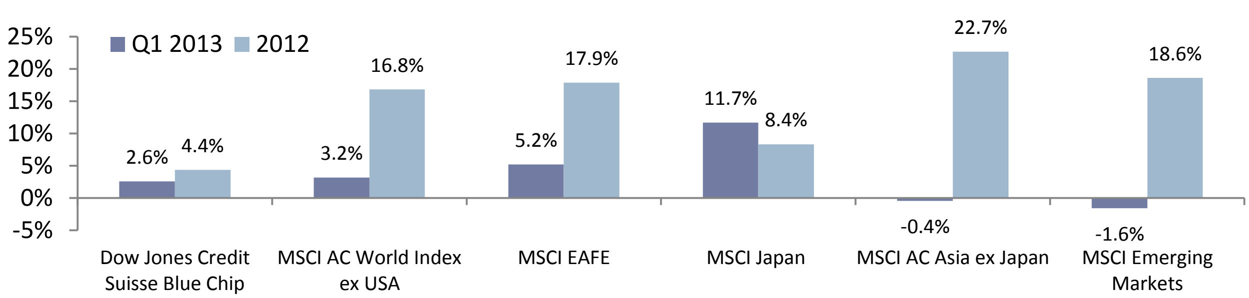
Within the S&P 500, sector returns varied by as much as 10%, with the more defensive Health Care, Industrial and Consumer Staple sectors performing best, up 15.8% and 14.6%, respectively, while the more economically cyclical 'growth' sectors such as Information Technology and Materials both returned less than 5%.

Chart 7: Q1 2013 S&P Style & Sector Returns



International equities underperformed U.S. markets in the first quarter by nearly 6%. Developed markets, as represented by the MSCI EAFE Index, gained 5.2% during the quarter. Within Europe, by the time that the Cypriot market was suspended on March 15th (it reopened April 2nd), its stock market had already lost 94% since the Greek crisis started in late 2009. The top performer in Europe was Greece with a gain of 14%, bringing its 12 month return from negative to flat. Among other peripheral European markets, Spain and Italy lost 6% and 10%, respectively, as investor concern grew over expectations of weak long-term growth. In the Pacific region, Japanese stocks rallied 11.7%, with stock prices benefiting from weakness in the Japanese Yen. Investor sentiment also gained on the approval of Haruhiko Kuroda, an advocate of looser monetary policy, as the Bank of Japan Governor.

Chart 8: Hedge Fund and International Returns



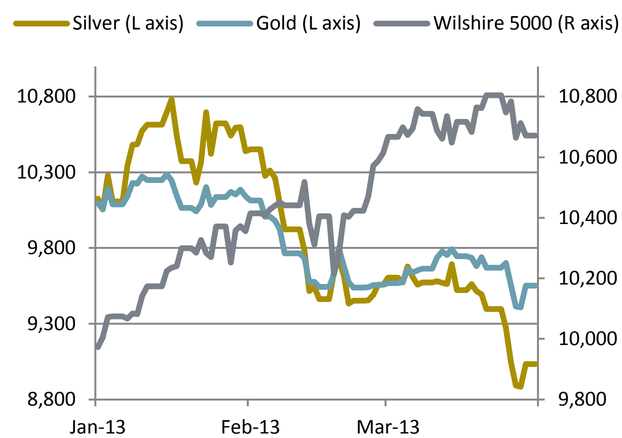
Emerging markets once again underperformed developed markets with a first quarter loss of 1.6%, and are now trailing developed markets by nearly 10% over the last 12 months. Regionally, Latin America posted a marginal positive return of 0.5% while most other regions were generally negative over the quarter. Among the individual countries, the Philippines market gained 18%. Sentiment there benefited from the nation's promotion to investment grade debt rating from Fitch Ratings, as well as the reported 6.8% growth in GDP during the fourth quarter of 2012. However, the Chinese market was disappointing with a loss of 4.5% in the first quarter after a 19% gain last year. Investors are increasingly fearful that Government actions to slow the property market bubble may actually cause a sell-off that would negatively impact economic growth.

Hedge fund returns continue to lag U.S. equity markets, a consequence of their lower net equity exposure. The Dow Jones Credit Suisse Blue Chip Index gained 2.6% during the quarter, and is now up 4.5% in the past 12 months. During the first quarter, it was the long/short equity and emerging market focused managers who performed best, while short-biased, market-neutral and global macro managers suffered negative returns.

REAL ESTATE AND COMMODITIES

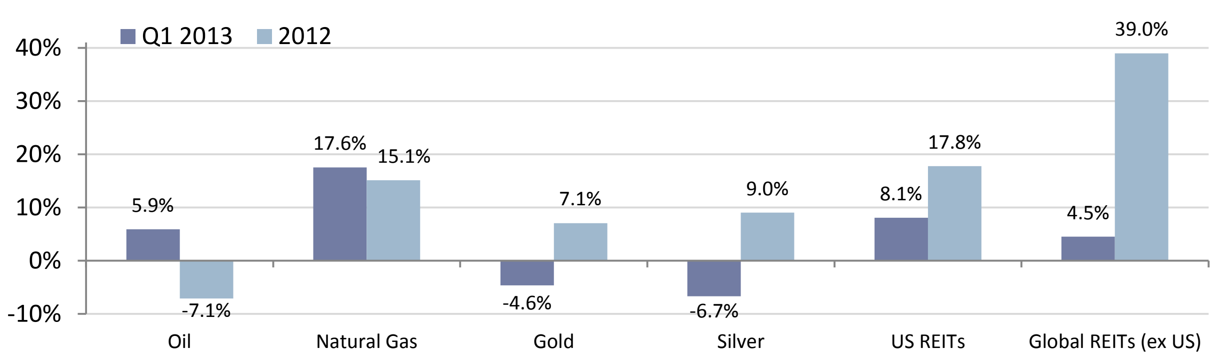
U.S. Crude oil prices rose 5.9% in the first quarter, reaching $97 per barrel, led in part by dollar strength as well as an improving economic outlook. Although this has translated to an increase in the average gas price, currently $3.63 per gallon, the average price is still nearly 30 cents below this time last year. After a gain of 15% in 2012, natural gas prices continued to rally in the first quarter, returning 17.6% and ending the quarter at just over $4 per British thermal unit. As the production of domestic natural gas increases, the U.S. Energy Information Administration forecasts that the nation will become a net exporter by 2022. Among the precious metals, Gold and silver both suffered a pullback over the quarter, falling 4.6% and 6.7%, respectively (Chart 9) due to a "risk on" market.

Chart 9: Gold & Silver versus the Wilshire 5000



Source: Morningstar-Growth of $10,000

Chart 10: Real Estate and Commodity Returns



Global REITs, as represented by the S&P BMI Global REIT Index, rallied 8.5% during the first quarter and have now returned 21% over the past year. During the quarter, global REIT returns were led by Japan with gains of 36.5%. Performance within the U.S. REIT market varied widely by sector, with Shopping Centers and Hotels returning 12% over the quarter, while Specialty REITs and Apartments posted modest losses. REIT investors continued to monitor multifamily construction, as a rising supply could negatively impact pricing power.

OUTLOOK

Michael Eisner
Chief Investment Officer

First quarter returns were excellent for investors. U.S. equity returns were some of the strongest we've seen in several quarters, and most markets (outside of Treasuries) participated nicely. However, we've seen this before, as 2010, 2011 and 2012 all started with similar strength, only to weaken considerably during the late spring and summer ("sell in May and go away"). Fortunately, strong rebounds in 2010 and 2012 contributed to double digit full year returns while 2011 saw very weak calendar year returns. The question though is, "is the current environment similar to a 2011 or 2010/2012 and how should we position portfolios?"

In our opinion, 2013 has many more positive policies in place than in 2011. In 2011, policies and economic data were not yet friendly to the markets. Certain foreign central banks were in a tightening mode, continued Federal Reserve quantitative easing was questionable, the European Central Bank liquidity "fire hose" had yet to be turned on, and U.S. housing had not turned up. Additionally, many national elections were just around the corner (in 2012) which hampered the political process. Fast forward to 2013, and policies and data are much more favorable. Unlimited quantitative easing is the game of the day (Federal Reserve, Bank of Japan, ECB – "ready to do whatever it takes"), the U.S. housing recovery is in full swing, facilities to manage the European debt crisis are in place and economic data, such as manufacturing, inflation and oil prices are reasonably positive. In our view, this all bodes well for a continued slow grind upward in the financial markets.

What could go wrong? The market has moved up quickly over a short period of time and could naturally pull back and consolidate. The Federal Reserve could reduce its quantitative easing program earlier than expected. Economic data could roll over. Inflation could perk up.

The European crisis could lead to widespread civil unrest. Many of these are valid themes, yet we do not believe any single item has the ability to create a full blown recession or bear market. Could they all occur at once? Sure, but we think it's highly unlikely. We would not be surprised to see a pickup in volatility as the market is forecasting a Goldilocks economy (the VIX, a measure of future volatility, is near record lows). This would definitely make the ride forward bumpier, but we still feel long term we would be headed in a positive direction.

Therefore, we are positioning portfolios for continued slow economic growth, but favorable long-term returns. Due to very low bond yields, we are underweight high quality fixed income (and cash) and overweight credit, international equities (more attractive than U.S. equity) and energy (discussed by Robert earlier in this review). We are just about at target weight for Hedged Assets, to help soften the blow if markets turn unfavorable over short periods of time.

Please visit our website, www.marketstreettrust.com. As always, feel free to contact us if you have any questions about the investment program or want to discuss Market Street's services.

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