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Market Commentary
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Overview

What fiscal cliff? Both equity and fixed income markets performed well in 2012, led by mid caps, international developed equities, and emerging market equities which all topped the S&P 500's impressive 16% total return. As was the case heading into 2012, we enter 2013 barraged with conflicting signals, and a continued divergence between the economy and the market. The last minute fiscal cliff deal sparked a relief rally to start off the year with one of the strongest first day performances on record. Here are a few of the highlights from the fiscal cliff negotiations:

- Bush era tax cuts were permanently extended for all Americans, with the exception of individuals earning above $400,000 and couples earning above $450,000. The highest tax rate increased from 34% to 39.6% and the top tax rate on dividends and capital gains was raised to 20% (23.8% with the surcharge for the Affordable Care Act)
- Long term unemployment benefits were extended for one year
- Social Security was restated back to 6.2% from 4.2% for all levels of income
- Automatic spending cuts were delayed by two months

While much of this seems good for the markets, we are not out of the woods yet. If a deal is not made within the first two months of the year, it is expected that the debt limit will be reached and the spending cuts will go into effect leading to a possible recessionary environment. Additionally, certain topics, including the extension of long term unemployment benefits will be brought back into negotiations at year's end. While the economy grew in 2012, it did not grow as quickly as would have been expected based on the returns that equities had in 2012. Unemployment continues to improve, albeit at a slow pace, ending the year at 7.8%. Overall, the fiscal cliff could result in an approximate 1.5% drag on GDP in 2013 and we will likely run into further volatility as the debt ceiling limit is approached. We continue to hold a defensive posture in our portfolios, but we were able to capture much of the market upside in 2012.

Domestic Equity

Domestic equities performed very well for the first three quarters of 2012 with the S&P 500 ending the year up 16% despite returning -0.38% for the fourth quarter and lagging EAFE by 1.32% for the year. Continued quantitative efforts by the Fed, strong retail sales, expanding manufacturing and record corporate profits helped fuel the markets and contributed to the above average market returns. It should be pointed out though that year-over-year earnings growth for the S&P 500 turned negative in the third quarter for the first time in three years and manufacturing has shown some signs of weakness as of late. Despite the positive performance of equities over the last year, $130 billion came out of domestic equity mutual funds signaling a lack of confidence in the equity markets. In fact, since the start of 2007, domestic equity mutual funds have had $584 billion in outflows. Value stocks slightly outperformed growth stocks due to a resurgence in the financial stocks that were up significantly in the second part of the year. Large caps moderately outperformed small caps by 0.11% and we expect this trend to continue whereas we anticipate high quality equities to outperform lower quality small caps since they have more consistent earnings and dividend yields.

International Equity

Despite the fact that many European countries are in a recession that will likely continue for the foreseeable future, international markets rallied in the second half of year, as confidence rose that the Eurozone debt problems were being effectively handled. The European Central Bank (ECB), joined the US Federal Reserve and the Bank of Japan in injecting massive quantities of money into the financial system. Despite the Eurozone's resiliency, we believe emerging market and frontier market allocations are better positioned than international developed equities to outperform in 2013. These countries have younger populations, lower levels of debt, and higher anticipated growth rates than most developed nations.

Fixed Income

The Federal Reserve recently announced its latest stimulus plan, a program of buying $40 billion worth of mortgage-backed securities each month until it sees substantial improvement in both the jobs market and inflation. The Fed's commitment to keeping rates low until unemployment reaches 6.5% should continue to positively impact bond markets. We continue to favor corporate bonds over government bonds due to their prospective low default risks, relatively high yields, and high levels of cash on the corporate balance sheet, which equates to stronger corporate health. Within the high yield market, debt defaults are below their historical norms at 1.1% versus 4.2% on average. This has caused spreads against treasuries to narrow significantly, meaning investors are getting less compensation, compared to treasuries, for the risk being taken. We have had a philosophical shift when it comes to international fixed income by fully shifting our tactical allocation within international fixed income from an original mixture of both emerging and international developed fixed income to solely emerging market debt. Emerging market bonds issued by nations with lower debt to GDP ratios not only offer attractive yield opportunities, but also the potential for price appreciation through rating upgrades and the possible emerging market currency appreciation. Overall, we are less enthusiastic about the bond market as a whole with yields at such low levels relative to the historical norm.

Alternatives

We have recently decreased our allocation to traditional fixed income in favor of alternatives to increase the overall diversification of our strategies away from stocks and bonds and further between our alternative investments. We have recently added the PIMCO Fundamental Total Return Fund, which seeks positive performance in a variety of market environments, with moderate volatility through the use of a long short fundamental equity strategy and a short duration fixed income strategy. In addition to the PIMCO fund, we continue to hold allocations to gold, managed futures, and master limited partnerships (MLPs) within the alternatives space. Gold performed strongly in 2012 returning 7.06% and acts as hedge against global financial instability due to the massive levels of debt of worldwide governments. Managed futures struggled last year in what was a trendless year in most major markets other than equities, but still offer valuable diversification benefits to the portfolios especially during times of extended downturns. MLPs, which engage in businesses mostly pertaining to the use of natural resources, such as petroleum and natural gas extraction and transportation continue to provide consistent and stable income to the portfolios as well as provide inflation protection, as increases in their distributions have historically outpaced the rate of inflation. As the Untied States becomes less dependant on foreign energy and more dependant our own commodities such natural gas, this should bode well for MLPs.

Real Estate

The once depressed housing market continues to signal a turnaround with housing starts up 21.6% and the median home price up 10.1% year over year in November. The improving housing market should help to drive GDP growth and acceleration in consumer spending, but there is still a lot of progress that needs to be made. Housing starts have come back and are up to 861,000 but are still far below the historic average of 1.4 million. Continued improvements in employment and credit availability will be the catalysts for a sustainable recovery in housing.

Conclusion

While the fiscal cliff has passed, we have continued concerns about the economy which is keeping us from unwinding the conservatively postured stance we have in our portfolios. With the debt ceiling approaching and the impending spending cuts associated with it and the start of earnings season, we continue to take a conservative approach until signals on the long term direction of the economy are more clear. In addition, while it has not been on the forefront of the news as of late, there are still concerns surrounding the European debt issues that make us hesitant to state that there are clear skies ahead. We anticipate 2013 to be somewhat similar to the last two years, where regardless of market performance, there will be the continuous risk of increased volatility at any moment coupled with slow growth prospects in developed nations across the globe.