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ECONOMIC UPDATE - - THE GREAT ROTATION

As the global macroeconomic fears of the past few years fade, investors are shifting their attention to micro considerations, including corporate profits and profit margins, interest rates, and inflation expectations to guide their capital allocation. For most market savants, obsessing over the likelihood of a "double dip" recession in the US, the imminent collapse of the EU and the feared impending crash in the Chinese economy has given way to the more mundane task of parsing metrics more commonly used to measure the attractiveness of various asset classes. Investors' muted reactions to the recent Washington debt ceiling theatrics seem to signal a welcome back-to-basics mentality.

When viewed within the context of an economy locked in a slow growth rut, incoming economic data has been relatively encouraging. Industrial production rose 0.3% month-over-month in December; housing starts increased to a 954,000 multiyear high annualized rate last month; mortgage applications for home purchases rose 12.9% week-over-week in December; US retail sales climbed 0.5% month-over-month in December; and, initial jobless claims fell sharply last week to 335,000, the lowest reading in four years. Abroad, recent data show China reaccelerating, Europe improving marginally, and we sense reduced immediate tensions in the Middle East. In the US, fiscal crises have been put off by more can-kicking, with further procrastination likely.

In our view, these economic data suggest the US economy remains on track to expand at a 2.0% to 2.5% rate this year. In fact, if recent developments warrant a change in our outlook, we would be inclined to *raise* our expectations for GDP growth to the upper-end of this range as private sector demand late last year was stronger than expected, some potentially severe fiscal hits have been avoided, and financial conditions globally have improved more than anticipated. Taken together, these factors point to a stronger overall economy at the outset of 2013 than we expected last November.

POLICY CONSIDERATIONS

The near-term challenges of dealing with the debt ceiling, the sequester and spending authority for the balance of 2013 are likely to be overcome, though the process is certain to be a messy one, and achieved only through a series of minor deals, delaying the overarching entitlement spending decisions which must eventually be taken. Reports suggest Republicans want to postpone the most pressing debt ceiling issue until May and focus instead on the debate over spending discipline. The White House has agreed to the delay. Looking ahead, the drag from policy changes this year are likely to amount to a hit to GDP of only about 1.0%. Should Congress find a way to achieve entitlement repair, the impact would be felt only gradually and would not significantly change the growth outlook for 2013.

Given the unacceptably high unemployment rate, which is expected to persist well into next year, and with inflation running below 2.0%, monetary policy is expected to remain highly accommodative for an extended period as the Fed has indicated. While we believe inflation has probably bottomed for this economic cycle, unless we see a much stronger resurgence in global growth, high unemployment and excess capacity in most industries do not suggest price pressures will distract the Fed from its primary focus on unemployment. Short term interest rates set by the Fed are, therefore, likely to remain largely unchanged through 2013 and into 2014. On the other hand, open market interest rates, driven by investor’s expectations for future growth and inflation, could drift higher as market participants begin to demand higher yields to discount an improving jobs market and diminishing downside economic risks. It is entirely possible that yields on the 10 year US Treasury, currently 1.83% could exceed 2.25% later this year.

OUTLOOK

Sources of economic strength early this year are likely to be business inventory rebuilding following the disruptions of tropical storm Sandy, a continued rebound in housing where a shortage of new and existing homes on the market has developed, growing retail sales, and rising employment and hours worked. Also worth noting, personal wealth probably grew 8.0% or almost $5 trillion last year. That has likely offset the jolt to confidence from policy uncertainty and higher taxes. While the latter will likely curb spending in the first half of the year, the broader financial backdrop suggests that much of the initial tax impact will be absorbed by a temporarily lower household savings rate.

Returning to housing for a moment, existing home sales reached the highest level in 5 years in December. Pending home sales are at the highest pace since the first-time home buyers' tax credit expired in 2010. Traffic of prospective buyers has climbed back to 2006 levels. Analysts point out that the improvement in the housing market may be forming a virtuous cycle where increases in demand are pushing up prices and, in turn, making new supply available. (Currently, there is only a 4.4 month supply of houses for sale on the market compared with over 11 months of supply two years ago.) However, the same circularity will likely limit the improvements as new supply prevents prices from rising too fast.

Leading Economic Indicators (LEI), which have been on a tear, will probably show another increase when released this week. High frequency, forward looking economic indicators such as Institute for Supply Management (ISM) manufacturing and services indices signal growth ahead. Financial market metrics, reliable leading indicators, are rising; stock prices, the price of crude oil and other commodities have been trending higher; yields on 10 and 30 year US Treasury bonds have risen since late last year; and, our firm's proprietary Economic Model continues to foreshadow economic expansion in the coming months, albeit at a moderate rate.

EQUITY INVESTMENT STRATEGY

As noted above, the more resilient pace of fourth quarter demand coupled with lawmakers' willingness to postpone immediate fiscal reckoning, suggests a stronger outlook for US growth and corporate profits than appears to be the consensus view. We now expect S&P 500 earnings per share to rise to $110.00 per share, up from $103.00 estimated for 2012 and $97.82 reported in 2011. An unprecedented volume of expected share repurchases will provide an underpinning to our estimate of 2013 S&P earnings. With the S&P Index currently trading at 1485, US common stocks remain very attractively priced at 13.5 times 2013 earnings, well below the mean multiple of 15 times of the past 20 years.

It is also interesting to note that the S&P 500 Index is currently 5.1% below its all-time high of October 2007. Profits of this benchmark index are forecast to exceed $1 trillion this year, 31% more than when this gauge peaked 5 years ago. Even if the price-earnings ratio, now 9.8% below the six decade mean, does not expand, the S&P 500 is poised to recover fully from the financial crisis that began almost six years ago. In short, US companies are generating more income than ever, setting the stage for the S&P to exceed its prior peak sometime in the next year. Other measures of stock market valuation we monitor confirm the continued statistical cheapness of stocks, particularly when compared with the near zero yields available from short term obligations, and less than 1.5% yields available from investment-grade corporate bonds due in fewer than 5 years.

As to supply and demand for equities, only in the past month have investors begun to reallocate investments from money market funds and managed bond funds to equities. Net flows to US-based equity funds in the first two weeks of this year were $11.3 billion, the biggest two week inflow since April 2000. Including exchange traded equity funds (ETFs), the increase in equity preference tops $18 billion - - well over twice the flow to equivalent bond funds. Absent a major external shock, we believe that in response to increasing profits forecasts, investors who shunned the stock market following the 2008 - 2009 decline will reallocate their investments toward higher stock positions driving the stock market to new highs. This reversal in investor appetites for equities, now referred to as the "great rotation" by some analysts, is likely to persist for an extended period.

While the stock market is likely to remain volatile in the months ahead, core equity portfolios under our supervision remain fully invested. *Growth* shares are favored over *value* stocks. We continue to allocate about 15% of clients' equity investments to companies domiciled abroad in *developed* and *emerging* markets, with emphasis on the *emerging* markets where future GDP growth is expected to be greater than that achieved in the US or in *developed* markets. While 10% + stock market corrections are likely, we believe the risks of a short-term setback are outweighed by the potential for higher share valuations over time.

FIXED INCOME STRATEGY

We remain convinced a very cautious approach to fixed income investment is warranted. In our view, rates are likely to rise as economic conditions improve and investors demand higher yields from their bond investments to compensate them for likely higher future inflation. We have therefore, limited the maturities of bonds purchased in client accounts to two years or less. Bond durations in portfolios under our supervision approach 1.5, well below the benchmark. We continue to avoid US Treasury issues as they appear to be particularly overpriced due to Fed policy and global geopolitical risks. Changes in Fed membership and a sooner-than-expected pick-up in growth could trigger a reversal in Fed policy sooner than is currently priced into these obligations.

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