# Capital Market Review & Outlook

*January, 2013*

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LIFE THE WAY YOU PLANNED IT.

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# Executive Summary

**2012 Capital Market Returns**

Contrary to the expectations of many investors, 2012 was a year in which risk-taking was rewarded. Real estate returned 17.8% during 2012 (as measured by a REIT index) and was the best performing asset class for the third year running. Other asset class returns included U.S. stocks at 16.4%, U.S. bonds at 4.2%, and cash at 0.1%. Only commodities produced a negative return of -1.1%

Despite all the uncertainty surrounding the European debt crisis, the developed international stock return of 17.3% outperformed U.S. stocks. The emerging market stock return of 15.2% underperformed the U.S. market. Here in the U.S., the mid-cap stock return of 17.3% exceeded the large and small company return of 16.4% and 16.3%, respectively. In addition, the value stock return of 17.6% exceeded the growth stock return of 15.2%.

Riskier assets also performed better within the bond market. The emerging market bond return of 17.4% was followed by the high yield bond market return of 15.8%. As concerns receded about state and local budgets, municipal bonds rallied returning 6.8% for the year. Overall, the investment grade U.S. bond market returned 4.2%.

**Economic Conditions**

We believe 2013 will be "much of the same" -- gradual improvement in various economic measures. Economic indicators such as Gross Domestic Product, National Activity Index, and Retail Sales, have all been growing at their ten-year average rate. Real disposable personal income has also been modestly growing. The unemployment rate is declining at a painfully slow pace.

On the more positive side, auto sales, housing starts, and home prices are improving. Inflation is benign. Consumers have largely repaired their balance sheets as household debt as a percent of disposable income is near 20 year lows. The employment outlook could be better, but is not terrible. Nearly 5 years after the financial crisis, we would prefer to see a more robust jobs picture.

The housing market is an additional potential bright spot. Housing starts, sales, and prices all seem to be improving. While it still may be too early to forecast a housing recovery, there are at least indications of one. A stronger housing market generally has many additional follow-on benefits to the broader economy.

In sum, the post-financial crisis environment continues to generate weak economic growth. Global central banks have actively promoted risk-taking by keeping interest rates low in an attempt to boost housing, equities, and eventually economic growth. We do not foresee major policy changes to these strategies in 2013. We believe economic growth may improve from recent levels, but will still be slower than desired.

**Stock Market**

We believe the U.S. stock market is near fair valuation. That does not mean there is not some potential for further appreciation, but we would expect it to be much more modest than 2012.

Emerging market stocks may offer investors more long-term opportunity as their economic conditions appear somewhat brighter and valuations have declined. Developed international stocks are still a question mark, as we have not heard the last of the European debt crisis. From a valuation

**Stock Market (continued)**

perspective, developed international appears attractive, but European economic conditions are weak with no signs of major improvement.

The S&P 500 earnings yield less the 10 year treasury yield is at extremely attractive levels. However, this is misleading due to the government's interference in the treasury markets (keeping short- and intermediate-term interest rates below the rate of inflation). As soon as interest rates begin to rise, this indicator will recede from its current levels. Nevertheless, compared to interest rates, there are many stocks which offer dividend yields greater than current interest rates. Making interest rates unattractive is part of the "risk on" strategy of the FED and other global central banks.

After 2012's performance, we are seeing a renewed interest in the stock market. The bull/bear sentiment spread is approaching its one standard deviation highs and the percent of investors becoming bullish has rebounded sharply. In addition, there are indications that 2013 money flows into stocks and stock funds have been particularly strong. Lastly, volatility has significantly declined and is approaching 10-year lows.

All of these factors give us pause for a continued strong stock market rebound. The market simply has a way of doing the opposite of what people expect. Remember one of Warrant Buffett's sayings, "be greedy when people are fearful and fearful when people are greedy". It appears to us that people are becoming greedier.

**Bond Market**

Bonds and bond investors have essentially been in a 30 year bull market as interest rates have declined from the high teens to their current levels. Over the next few years (wish we knew exactly when), we expect this to change and bond investors will enter a long-term bond bear market — one with rising interest rates. At that time, a generation of bond investors will learn that yes, in fact, bond returns can be negative.

For 2013, unless there is some sort of unexpected and substantial economic weakness, we do not see further declines in treasury interest rates. As it stands today, most short- and intermediate-term investors are losing money to inflation. In other words, when their bonds mature, these investors will not be able to purchase the same amount of bread and eggs that they once did. Losing money to inflation is not a healthy condition. While we do not expect major interest rate declines, we likewise do not expect major increases. However, should the economy surprise to the upside, a modest rise in interest rates would be a reasonable expectation.

Many income-starved investors are seeking riskier bond-like investments, such as emerging market debt, high yield bonds, and preferred stock. While this is understandable, these types of investments tend to be more correlated to stocks than bonds. As such, these investors may be taking unanticipated risks that have not yet surfaced (due to strong stock market performance). Bond investors employing this strategy need to be nimble should signs of economic weakness occur.

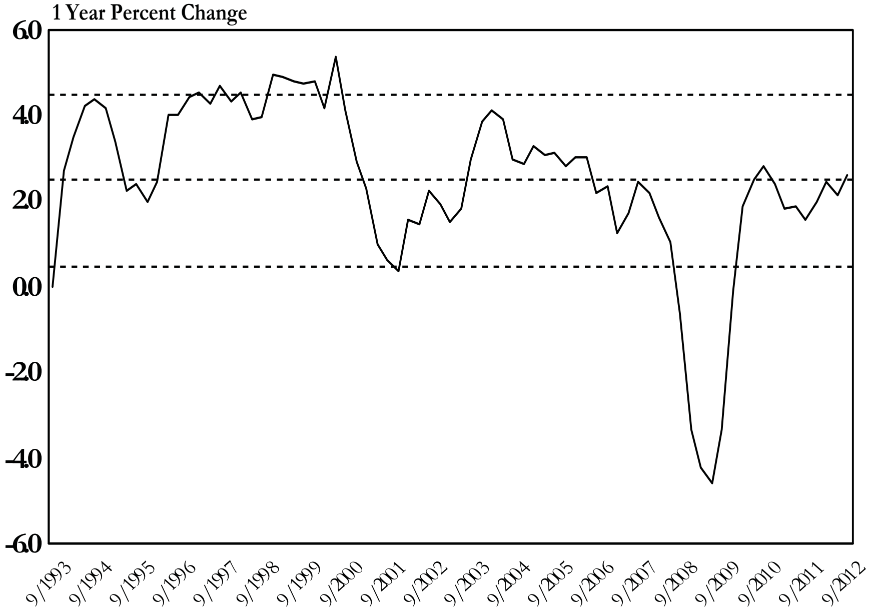
The absolute yield level of high yield bonds is at multi-year lows. However, the spread (difference between high yield and treasury bond yields), is just below its ten-year average. So, on a relative basis, they do not appear extremely expensive, however, we believe the "easy money" has already been made.

# Asset Class Returns

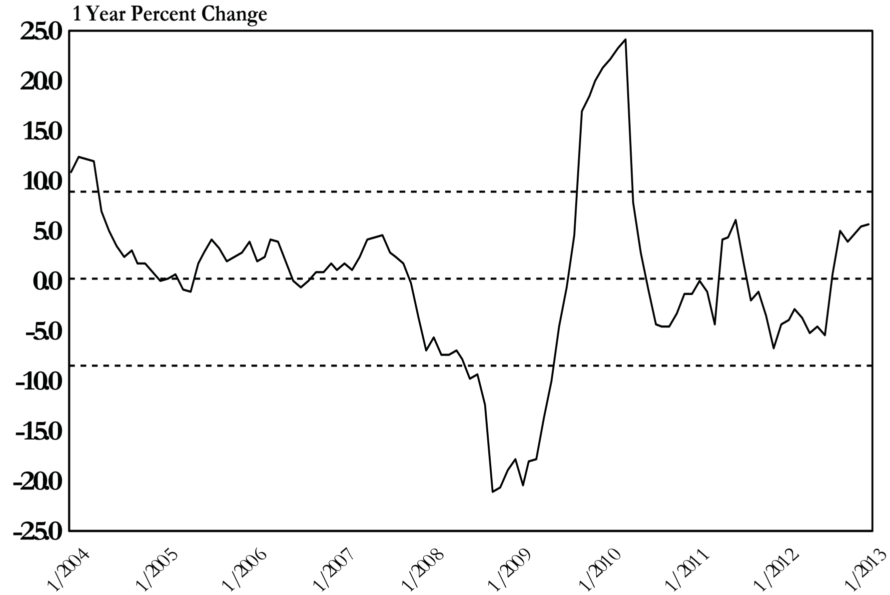
| | | | | | Annualized Returns | |
|---|---|---|---|---|---|---|
| **2008** | **2009** | **2010** | **2011** | **2012** | **3 Year** | **5 Year** |
| U.S. Bond 5.2% | Convertible 49.1% | Real Estate 28.5% | Real Estate 8.7% | Real Estate 17.8% | Real Estate 18.0% | U.S. Bond 5.9% |
| Cash 1.5% | Real Estate 28.6% | U.S. Stock 16.9% | U.S. Bond 7.8% | U.S. Stock 16.4% | U.S. Stock 11.2% | Real Estate 5.6% |
| Inflation -2.0% | U.S. Stock 28.3% | Commodity 16.8% | Inflation 2.2% | Convertible 15.0% | Convertible 8.4% | Convertible 4.1% |
| Commodity -35.6% | Commodity 18.9% | Convertible 16.8% | U.S. Stock 1.0% | U.S. Bond 4.2% | U.S. Bond 6.2% | U.S. Stock 2.0% |
| Convertible -35.7% | U.S. Bond 5.9% | U.S. Bond 6.5% | Cash 0.1% | Inflation 1.6% | Inflation 2.2% | Inflation 1.5% |
| U.S. Stock -37.3% | Inflation 3.0% | Inflation 2.9% | Convertible -5.2% | Cash 0.1% | Cash 0.1% | Cash 0.4% |
| Real Estate -38.0% | Cash 0.2% | Cash 0.1% | Commodity -13.3% | Commodity -1.1% | Commodity 0.1% | Commodity -5.2% |

# Economic Conditions

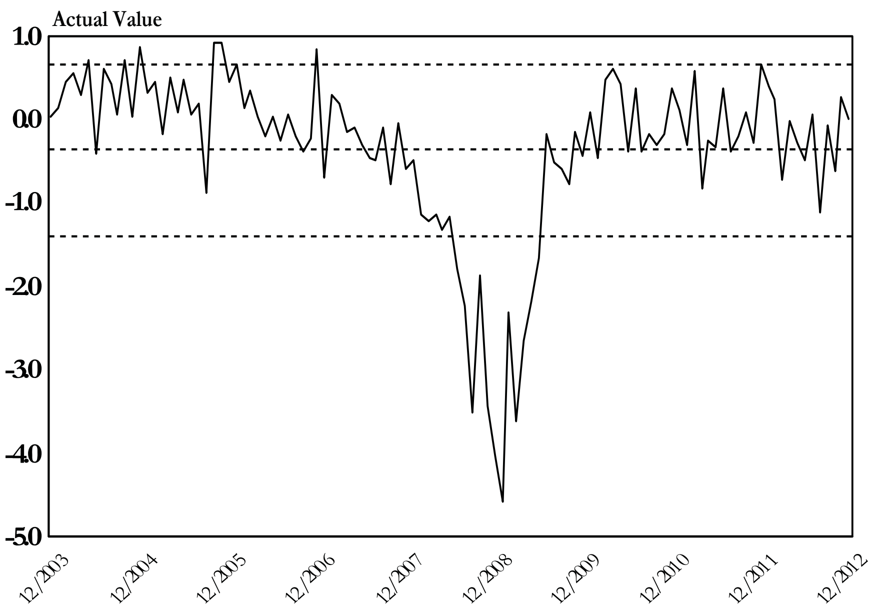
**Gross Domestic Product**



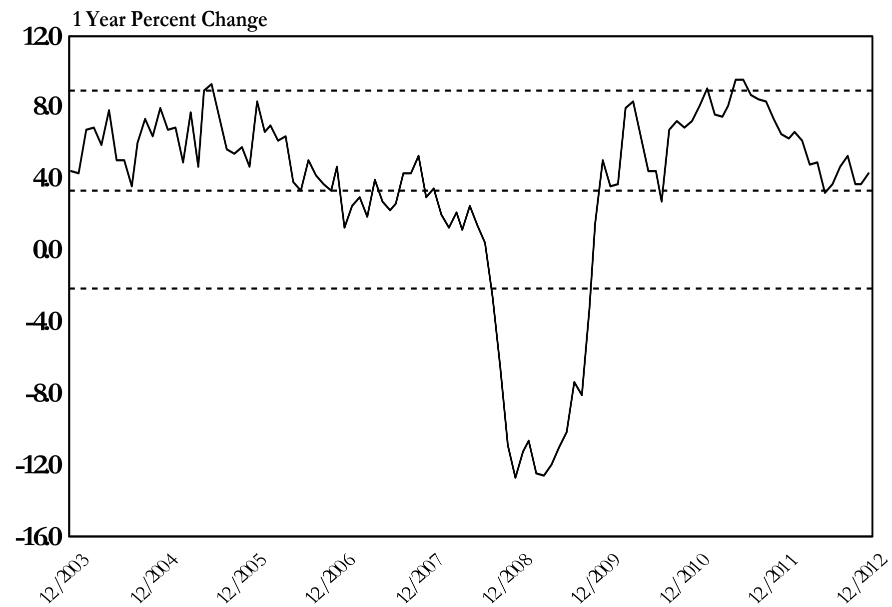

**ECRI Weekly Leading Index**



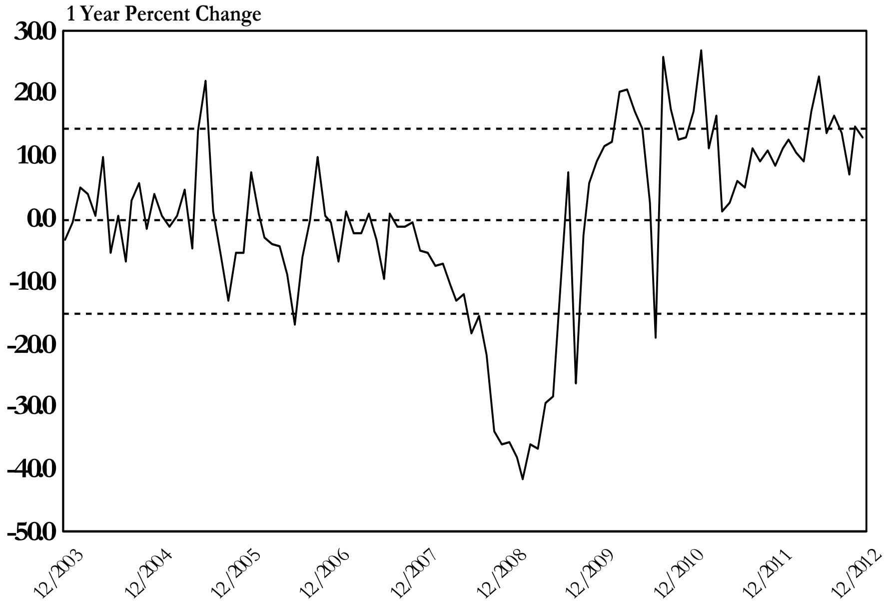

**Chicago Fed: National Activity Index**



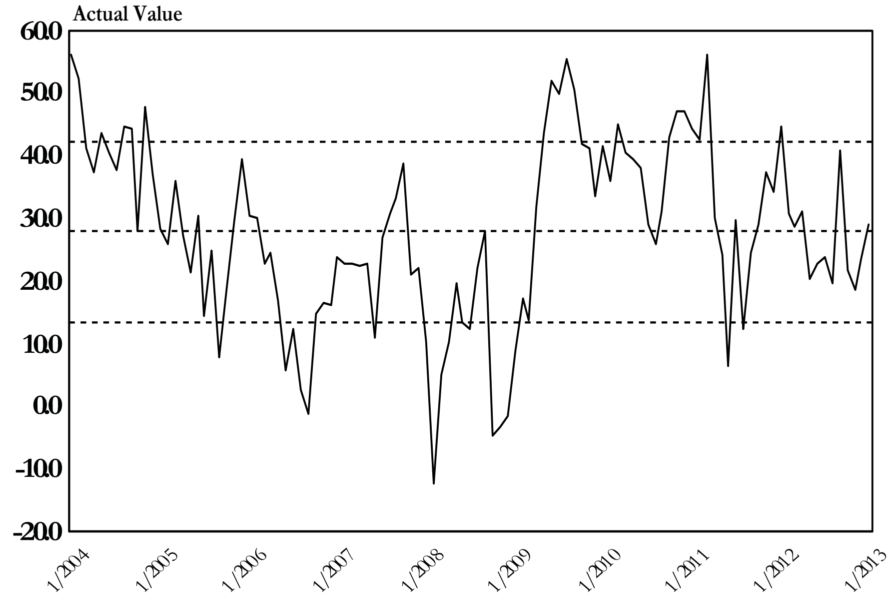

**Retail Sales**



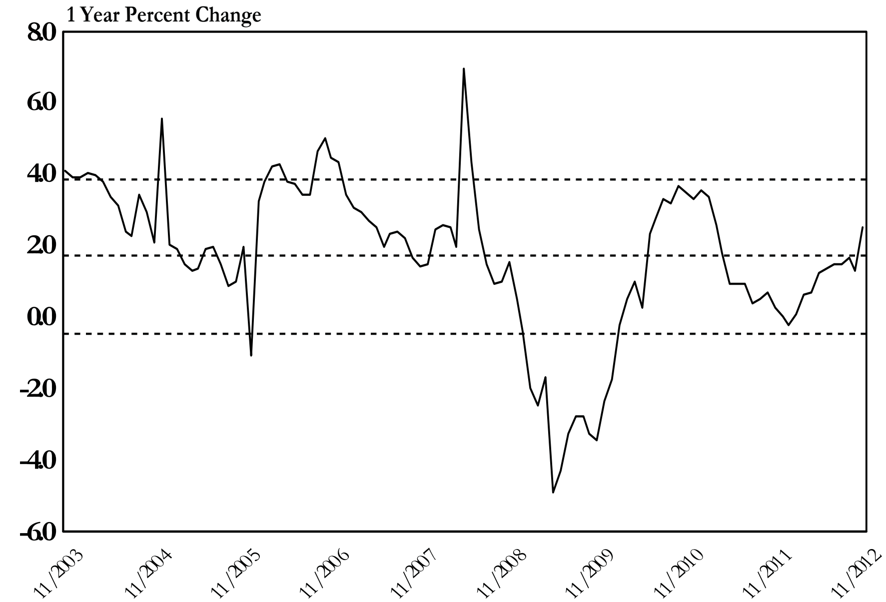
Auto and Light Truck Sales



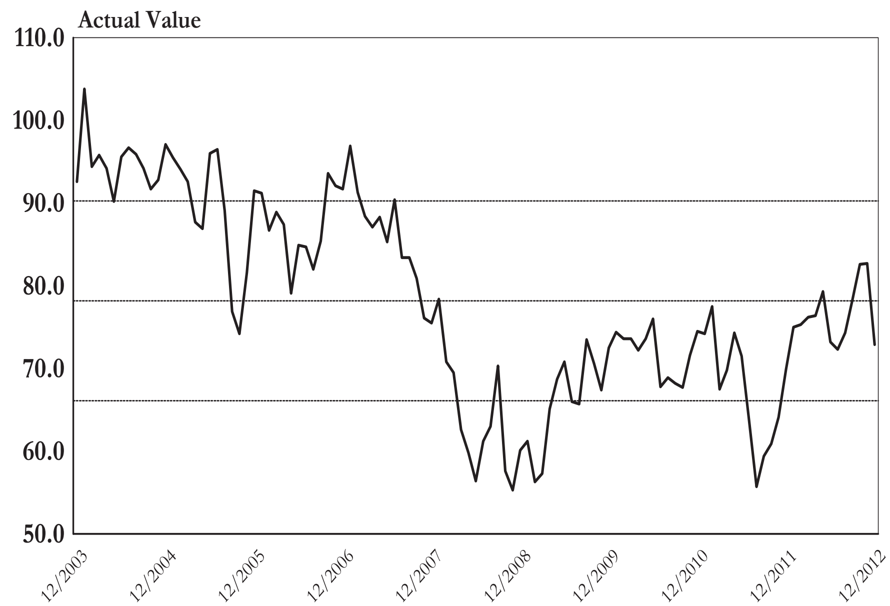

Phili Fed: General Activity - 6 Months Ahead (Diffusion)




Real Disposable Personal Income

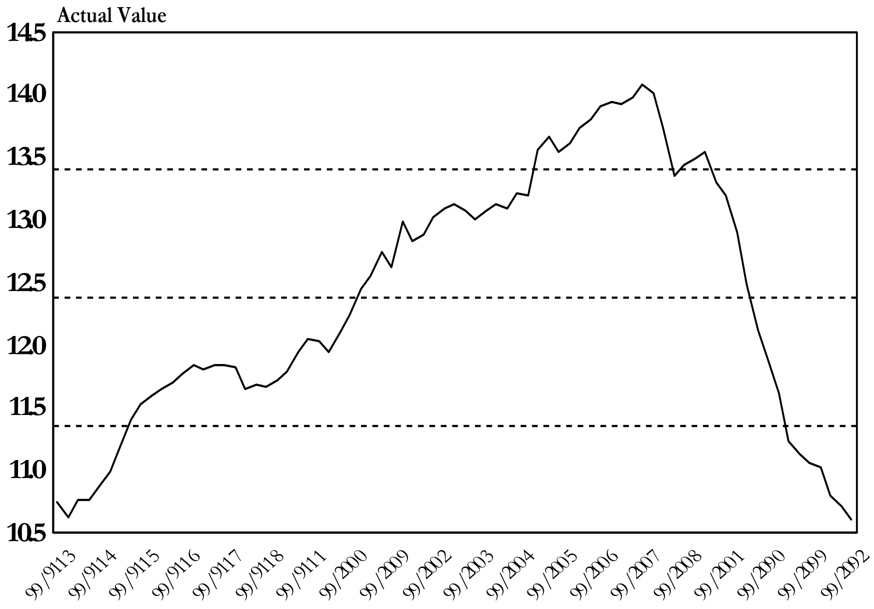



Consumer Sentiment

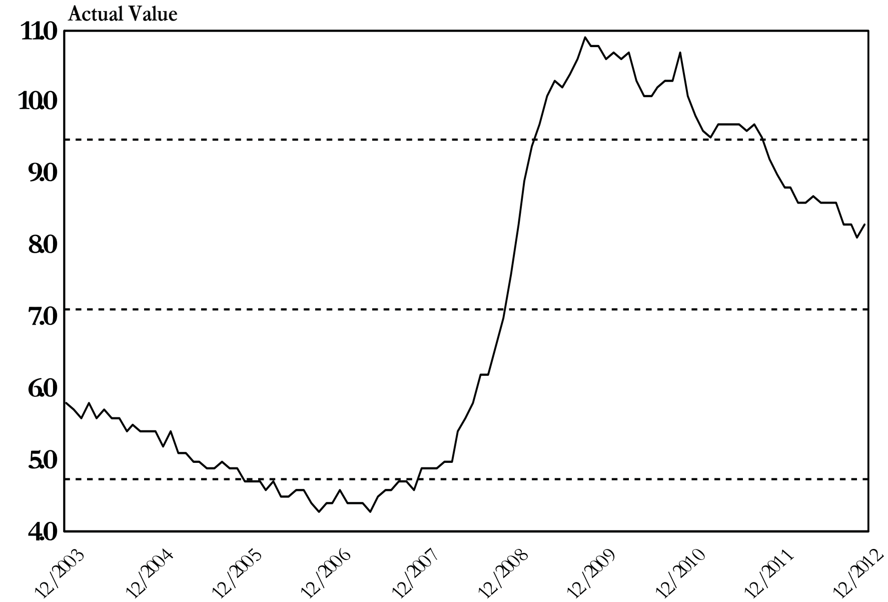


## Economic Conditions (continued)

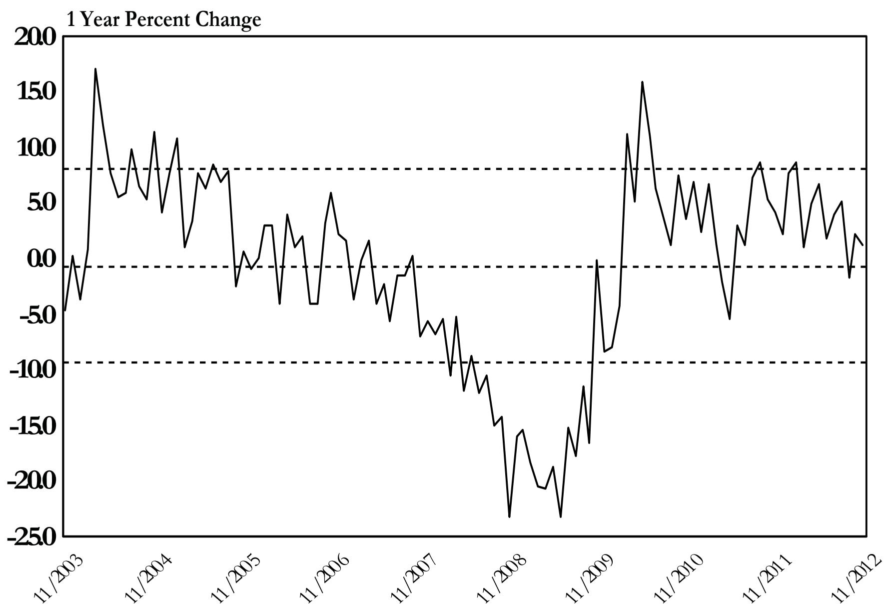
**Household Debt As Percent Of Disp. Income**



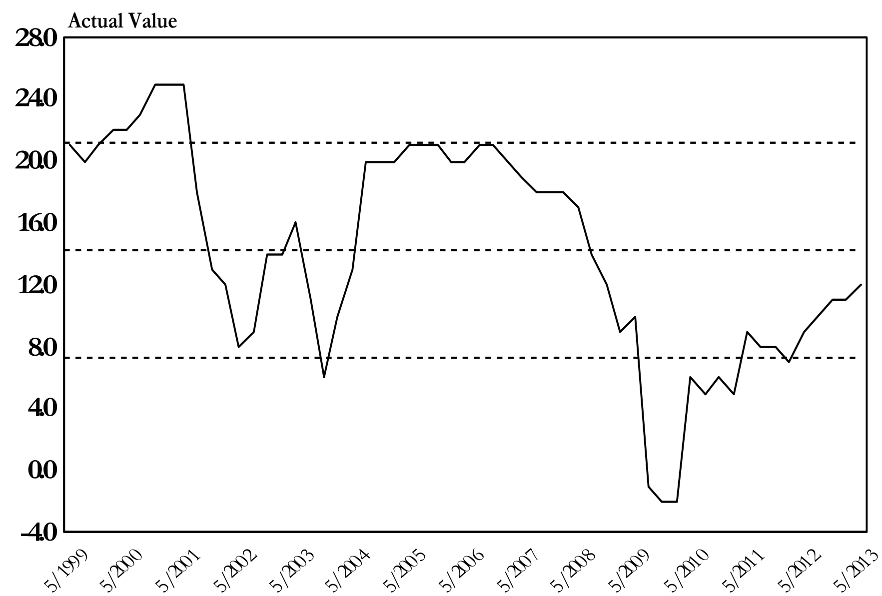

**Unemployment Rate**



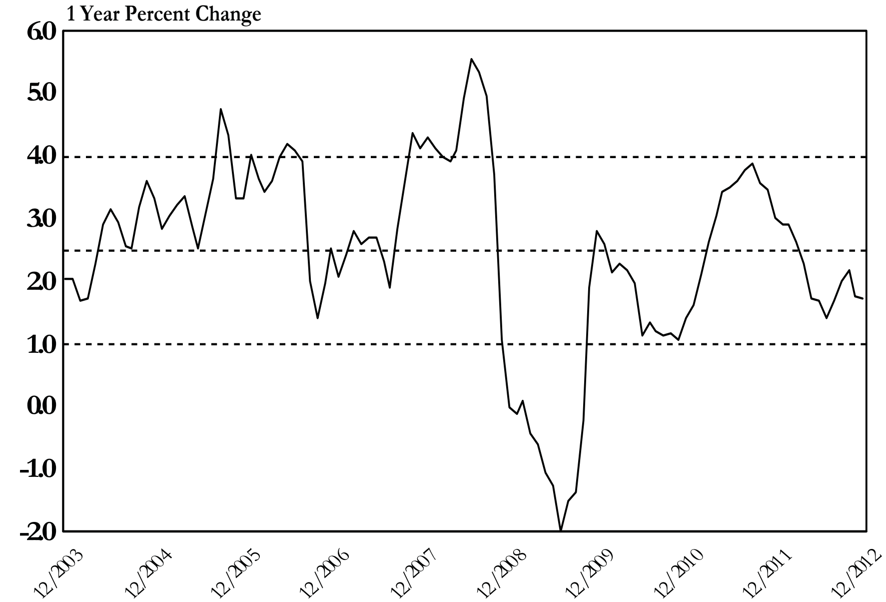

**Hires: Total Nonfarm**



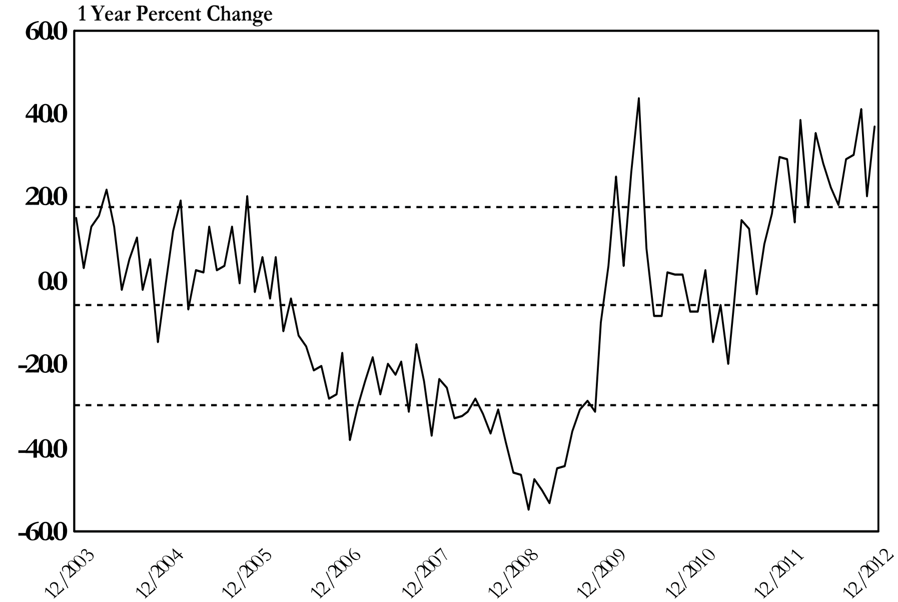

**Manpower Employment Outlook (Net % Hiring)**



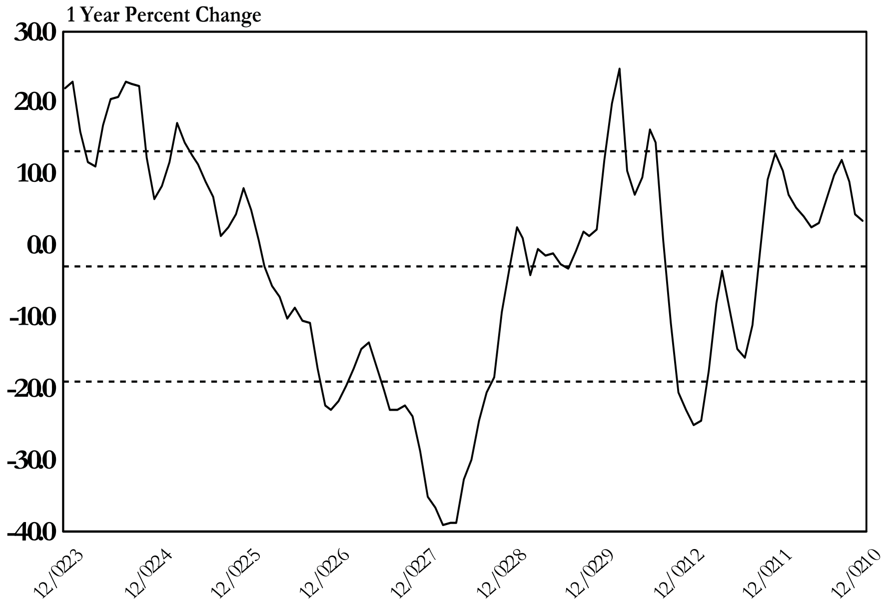
**Consumer Price Index**



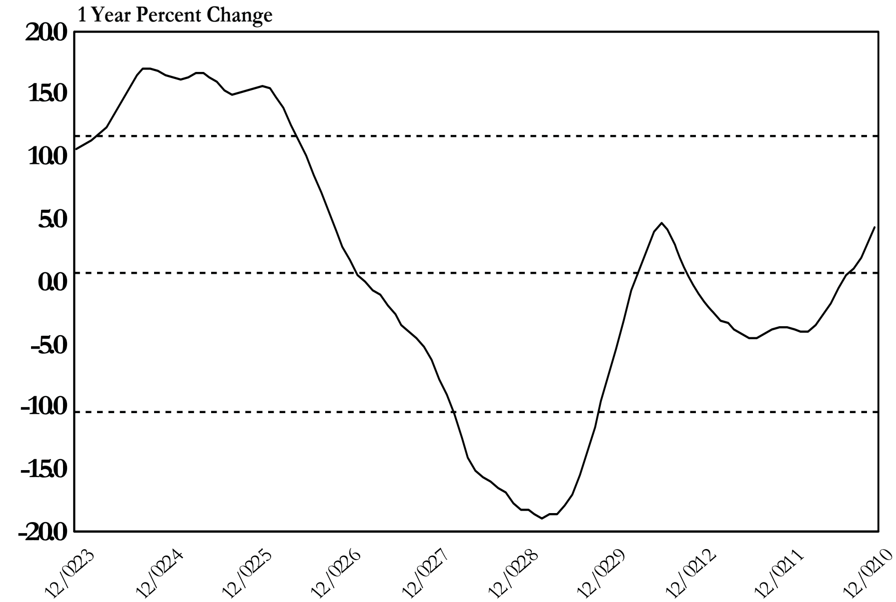

**Housing Starts**




**Case Schiller Sales In 20 Largest Markets**




**Case Schiller Home Price Index: 20 Largest Markets**

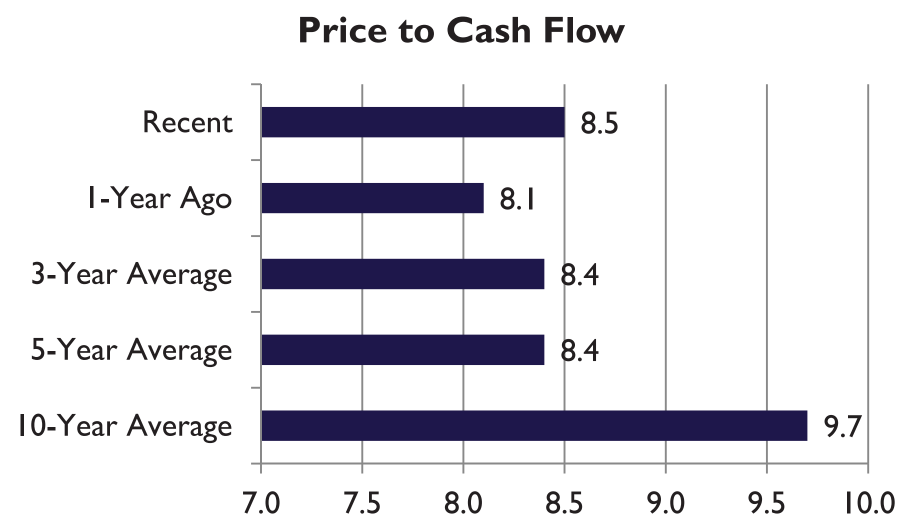


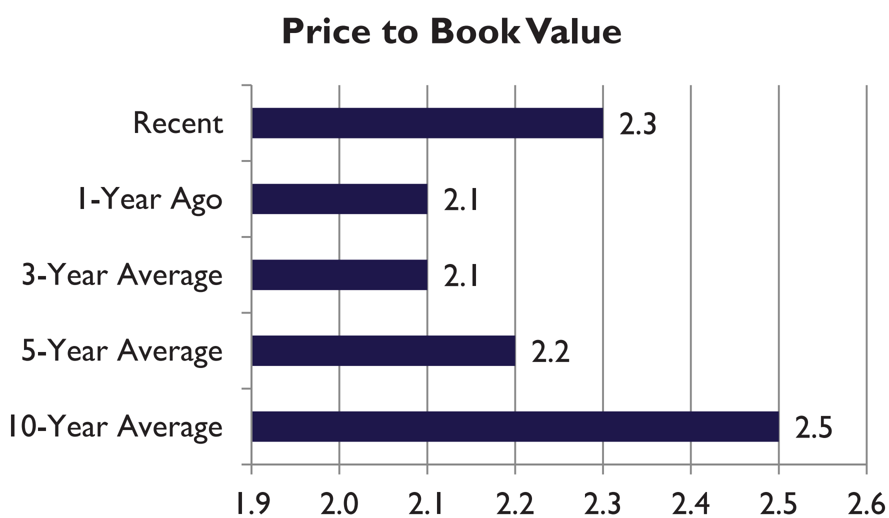
# Stock Market

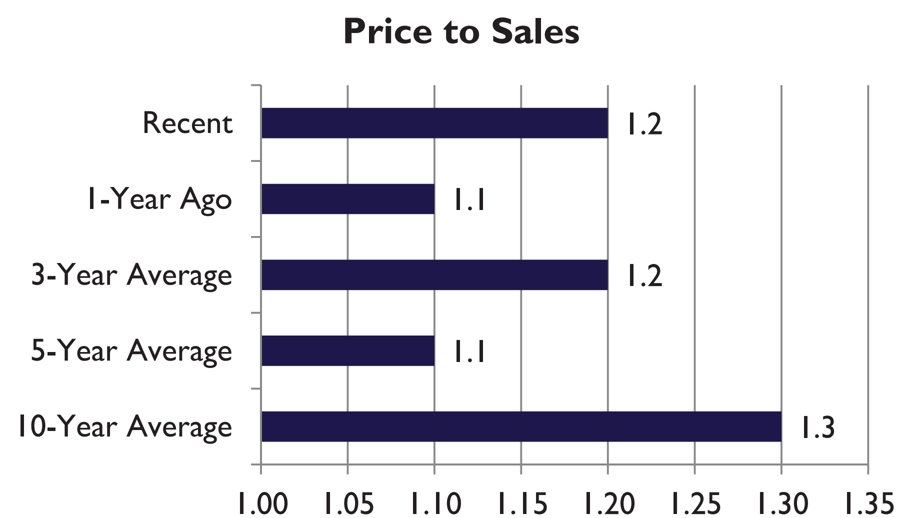
# Stock Market Returns By Company Size

| 2008 | 2009 | 2010 | 2011 | 2012 | Annualized Returns 3 Year | Annualized Returns 5 Year |
|---|---|---|---|---|---|---|
| Small -33.8% | Micro 45.2% | Micro 32.6% | Large 1.5% | Micro 23.4% | Micro 14.0% | Micro 3.9% |
| U.S. Stock -37.3% | Intl Small 43.2% | Small 26.9% | U.S. Stock 1.0% | Inlt Large 17.3% | Mid 13.2% | Mid 3.6% |
| Large -37.6% | Mid 40.5% | Mid 25.5% | Mid -1.5% | Mid 17.3% | Small 12.2% | Small 3.6% |
| Mid -41.5% | Inlt Large 31.8% | Intl Small 19.4% | Small -4.2% | Intl Small 16.9% | U.S. Stock 11.2% | U.S. Stock 2.0% |
| Inlt Large -43.4% | Large 28.4% | U.S. Stock 16.9% | Micro -9.4% | Large 16.4% | Large 11.1% | Large 1.9% |
| Micro -43.8% | U.S. Stock 28.3% | Large 16.1% | Inlt Large -12.1% | U.S. Stock 16.4% | Intl Small 4.6% | Intl Small -3.3% |
| Intl Small -48.4% | Small 27.2% | Inlt Large 7.8% | Intl Small -18.0% | Small 16.3% | Inlt Large 3.6% | Inlt Large -3.7% |

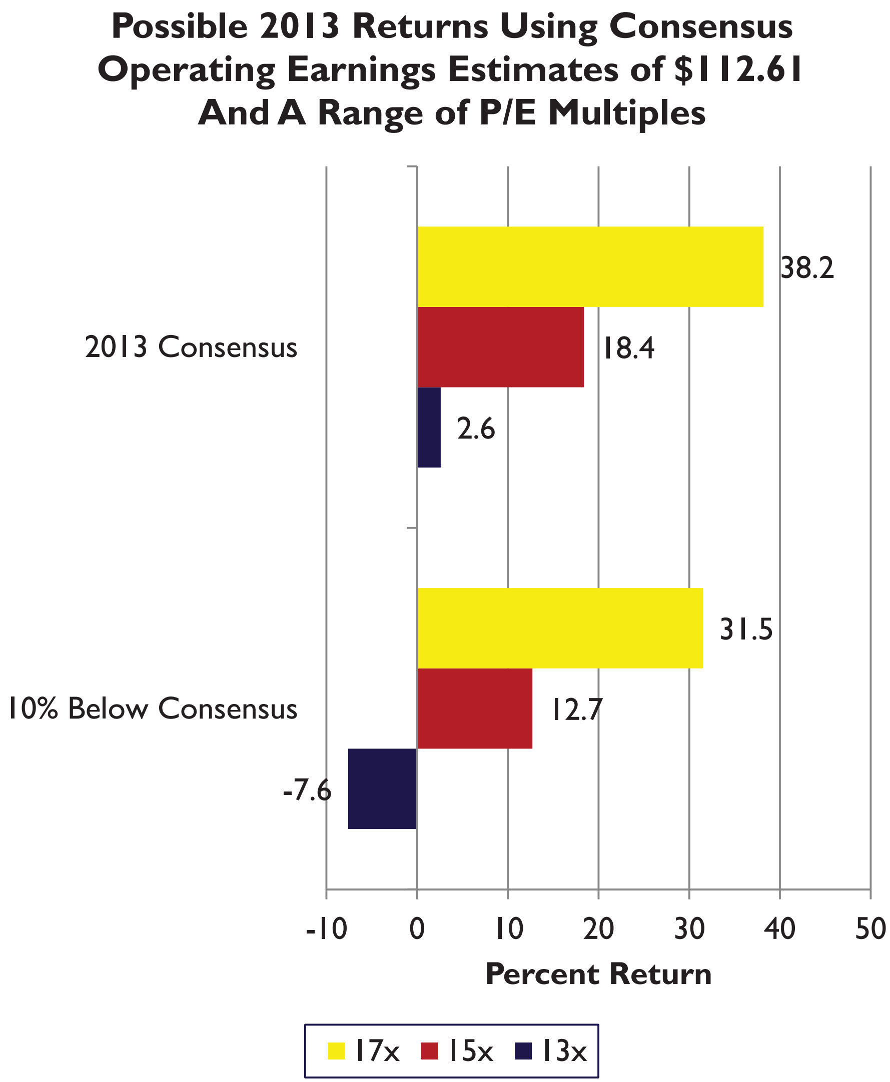
## Stock Valuation Measures: SP 500 Index

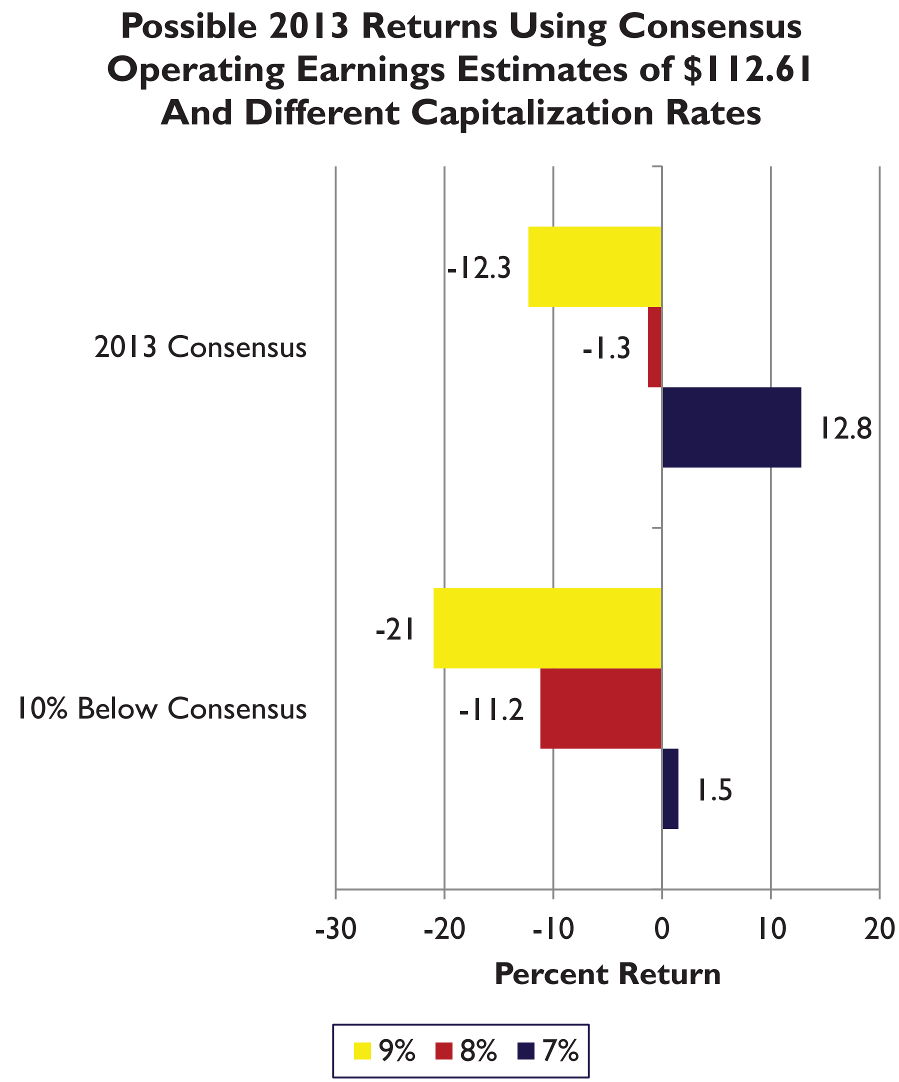



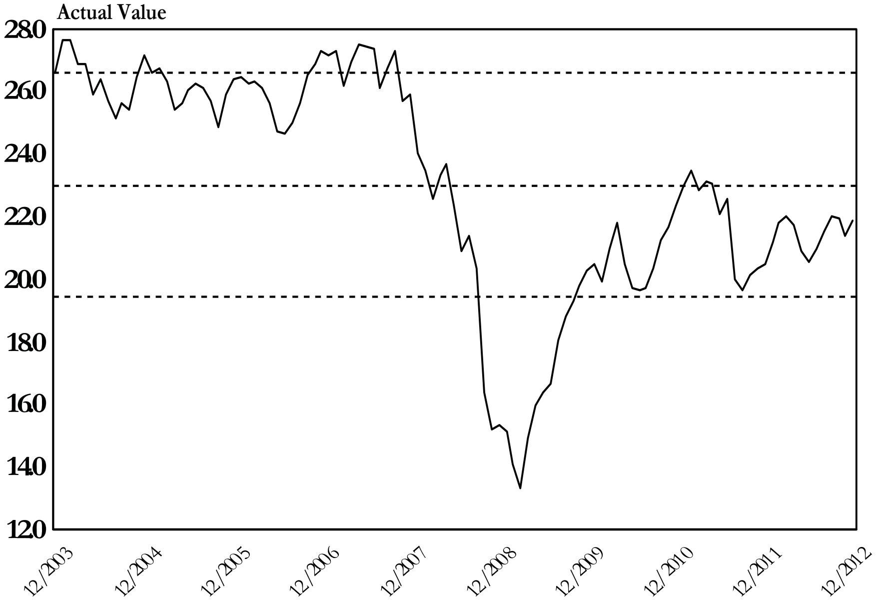
## Estimated 2013 Stock Returns Using Consensus Operating Earnings Estimates



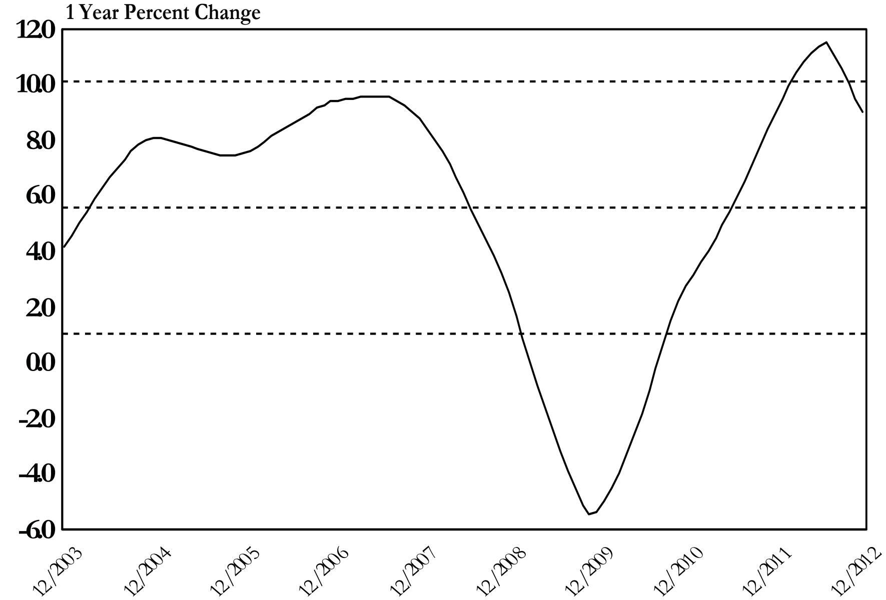



## Stock Market

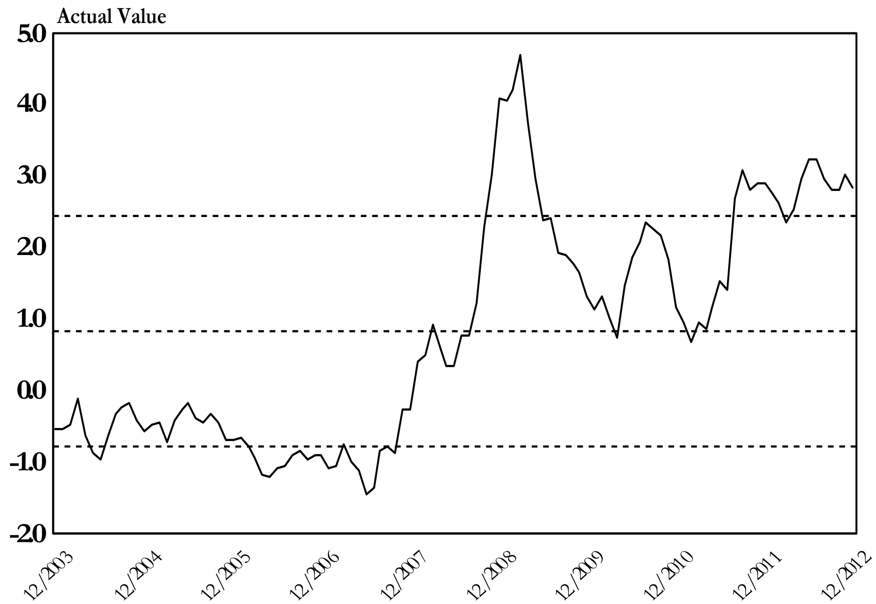
**S&P 500 PE Using 10 Year Average Earnings**



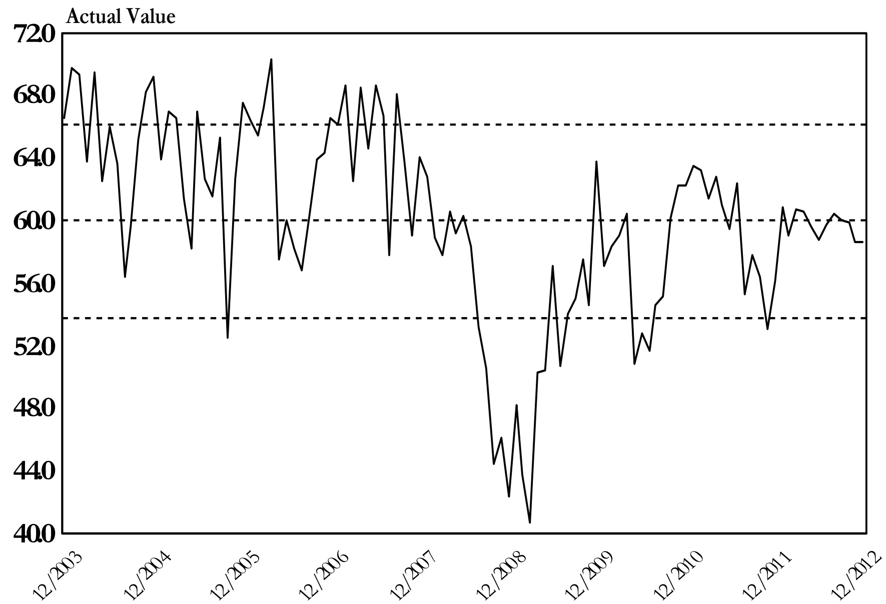

**SP500 10-Year Average Earnings**




**SP500 Earnings Yield(10-Yr. Avg Earnings) Less 10Yr. Yield**

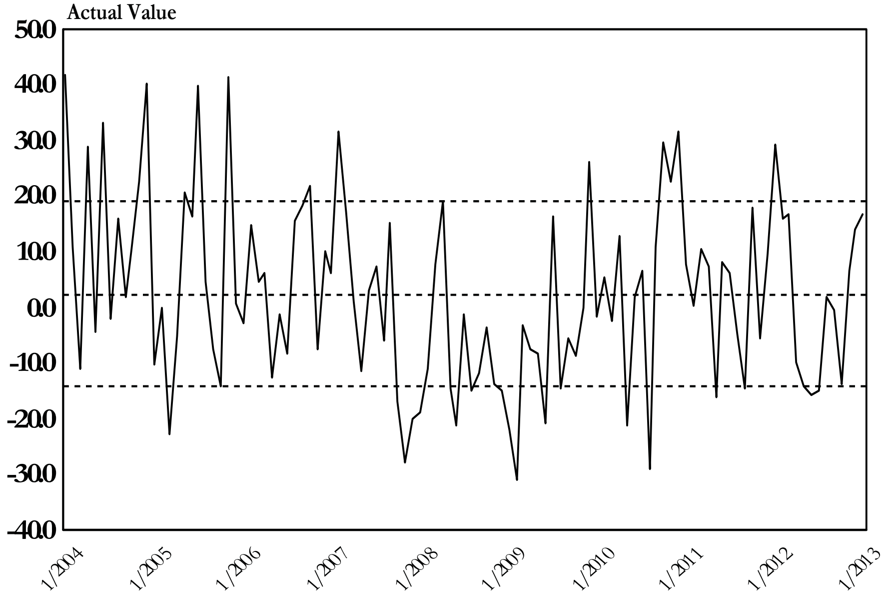



**AAII Survey: Stock Allocation**

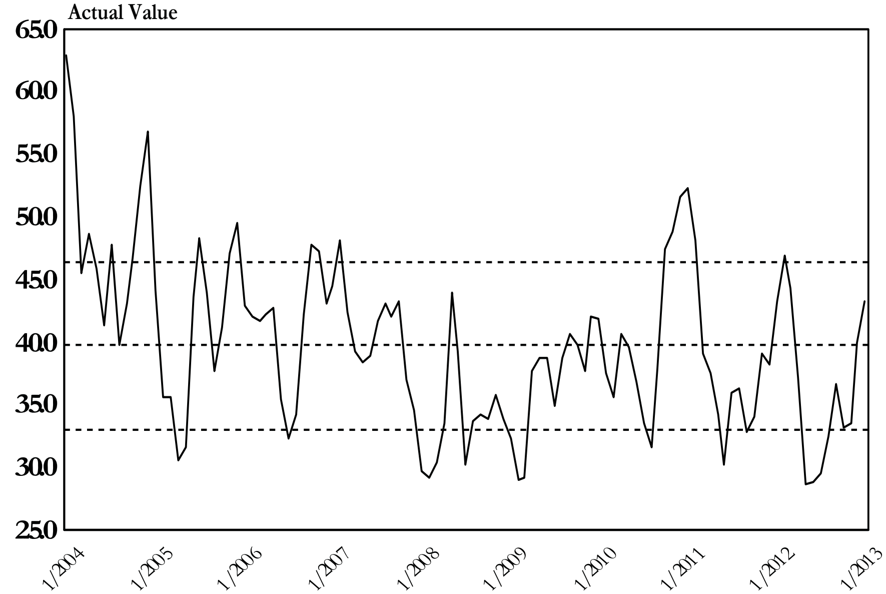


## Stock Market

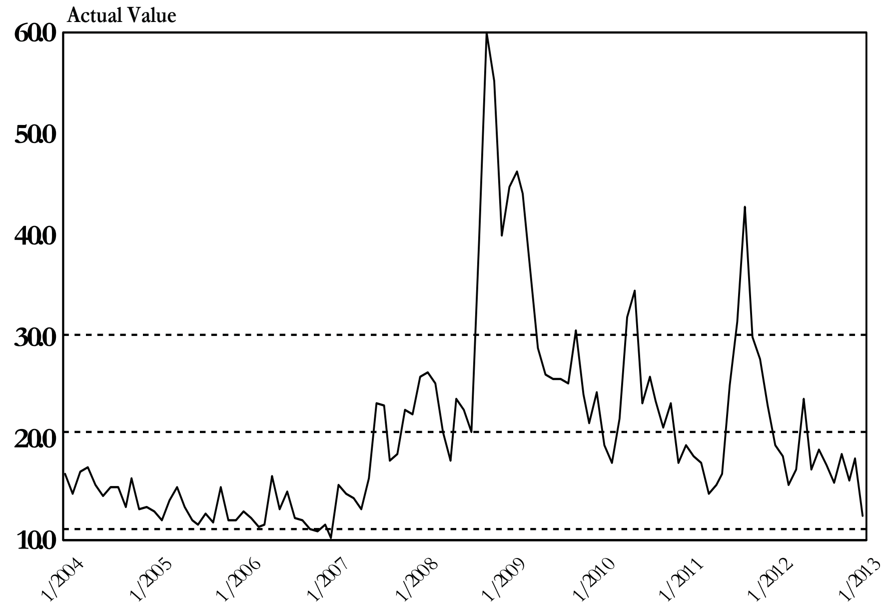
AAII Bull/Bear Investor Sentiment Spread




AAII Percent Bullish 8-Week Average




CBOE Volatility Index

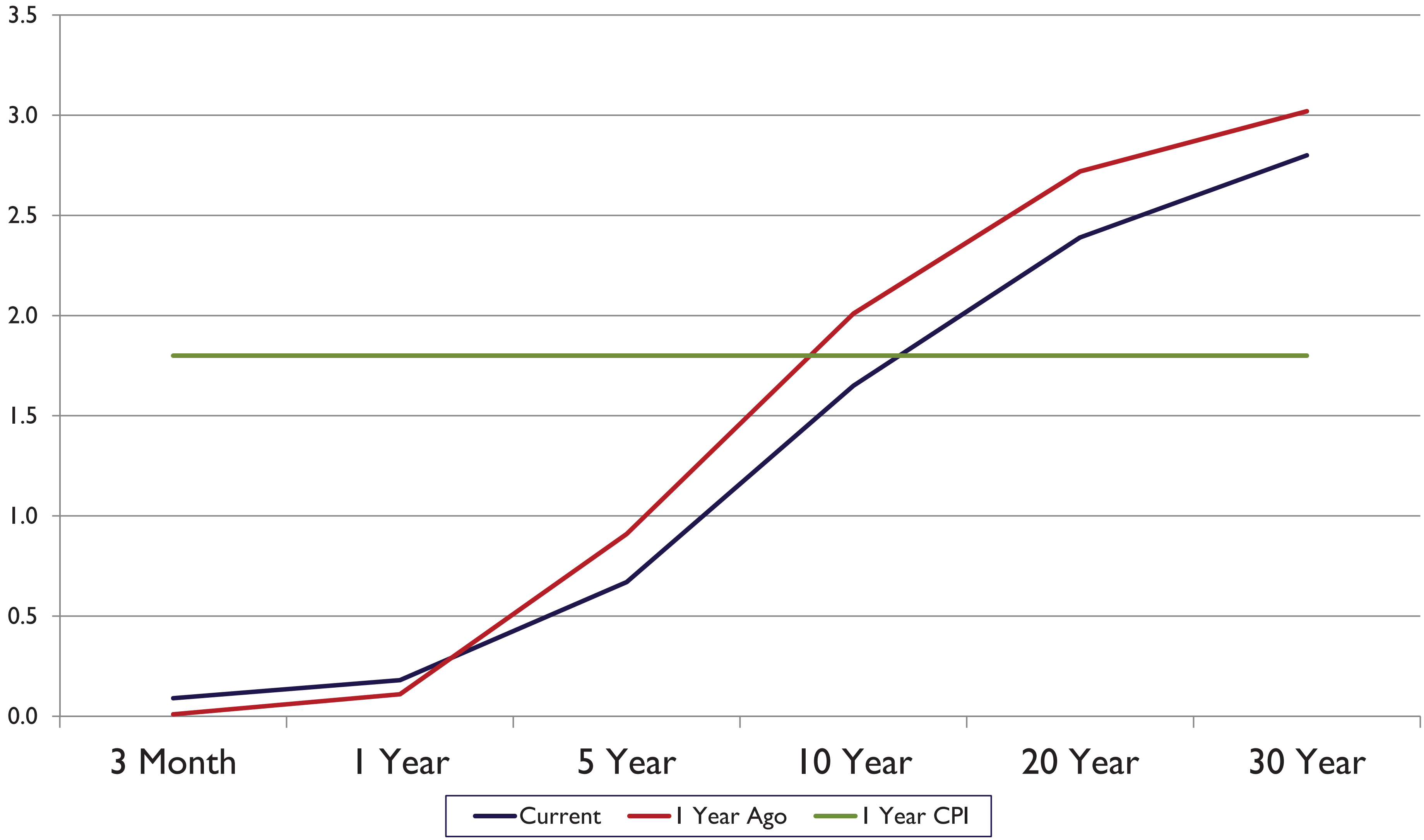


# Bond Market

# Broad Bond Market Returns

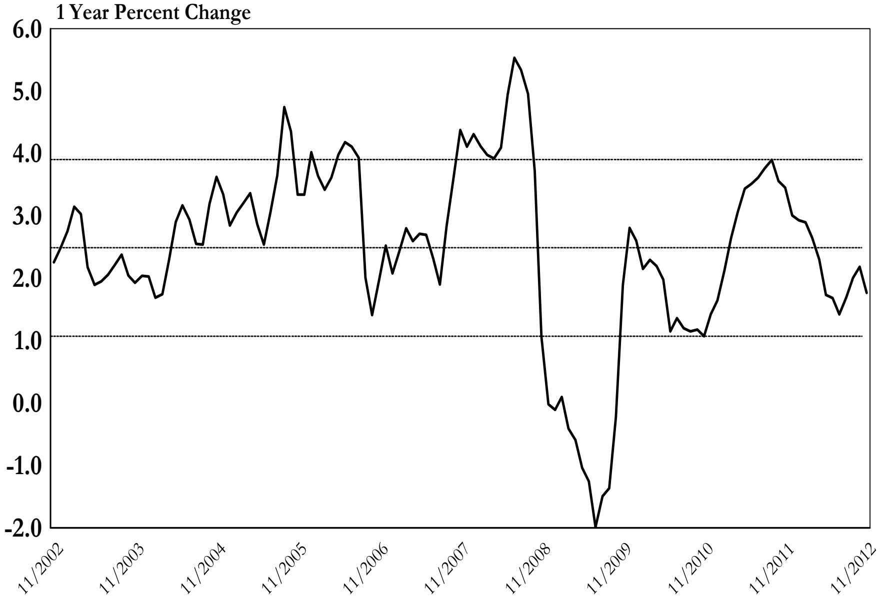
| 2008 | 2009 | 2010 | 2011 | 2012 | Annualized Returns: 3 Year | Annualized Returns: 5 Year |
|---|---|---|---|---|---|---|
| Intl Bond 11.4% | Emerging Market 29.8% | Emerging Market 12.2% | Inflation Protected 13.6% | Emerging Market 17.4% | Emerging Market 12.3% | Emerging Market 10.1% |
| U.S. Bond 5.2% | Muni 12.9% | Intl Bond 6.8% | Muni 10.7% | Inflation Protected 7.0% | Inflation Protected 8.9% | Inflation Protected 7.0% |
| Cash 1.5% | Inflation Protected 11.4% | U.S. Bond 6.5% | U.S. Bond 7.8% | Muni 6.8% | Muni 6.6% | U.S. Bond 5.9% |
| Inflation -2.0% | U.S. Bond 5.9% | Inflation Protected 6.3% | Emerging Market 7.3% | U.S. Bond 4.2% | U.S. Bond 6.2% | Muni 5.9% |
| Inflation Protected -2.4% | Intl Bond 3.9% | Inflation 2.9% | Intl Bond 5.9% | Inflation 1.6% | Intl Bond 4.5% | Intl Bond 5.7% |
| Muni -2.5% | Inflation 3.0% | Muni 2.4% | Inflation 2.2% | Intl Bond 0.8% | Inflation 2.2% | Inflation 1.5% |
| Emerging Market -12.0% | Cash 0.2% | Cash 0.1% | Cash 0.1% | Cash 0.1% | Cash 0.1% | Cash 0.4% |

## Treasury Yield Curve

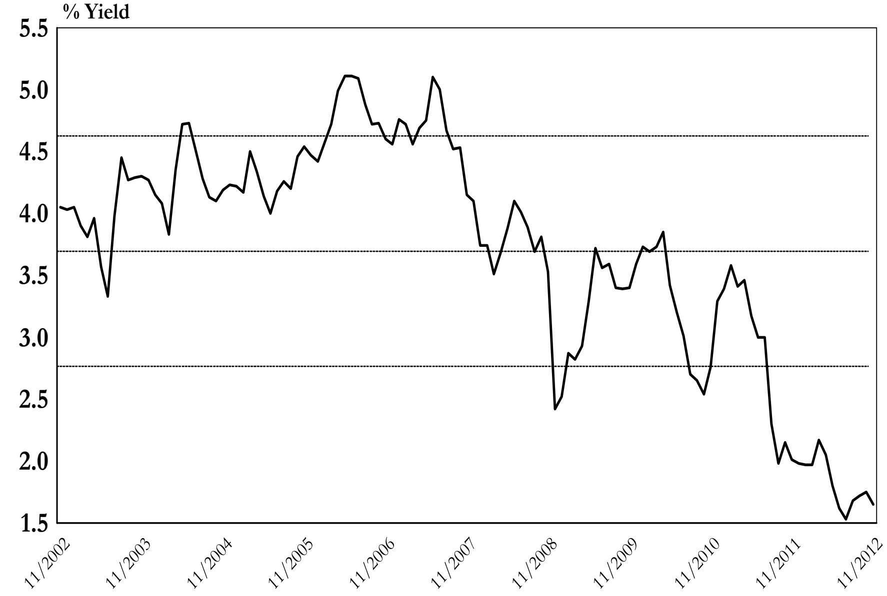


## Bond Market

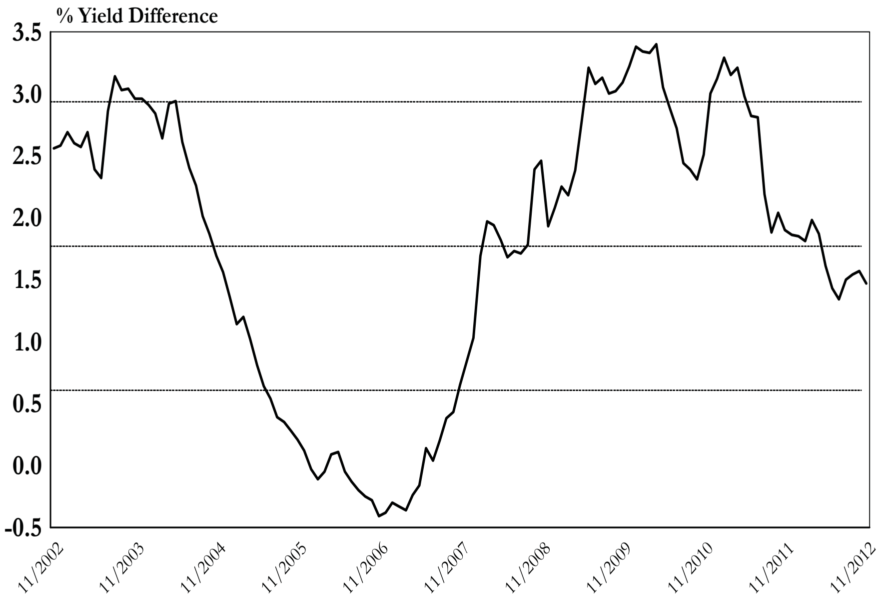
**Consumer Price Index**



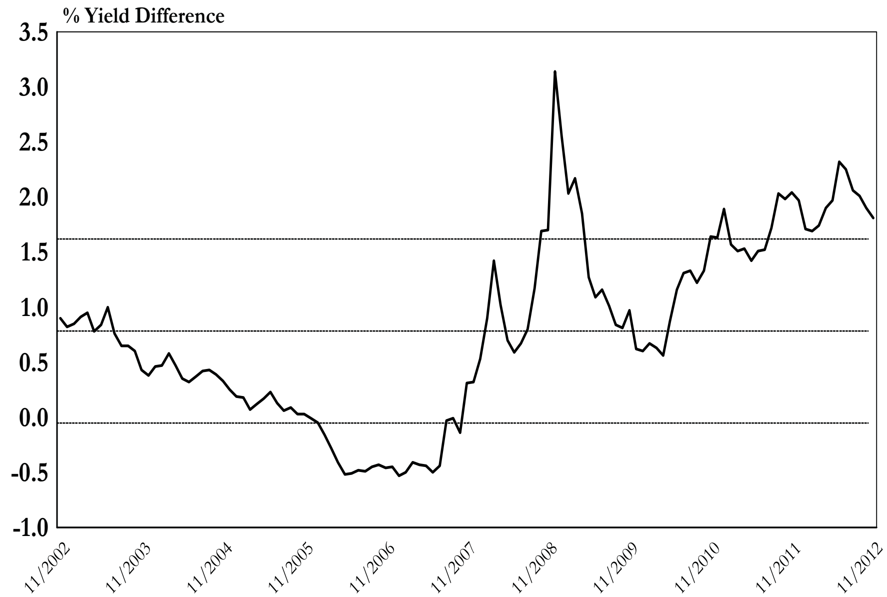

**10 Year Treasury**




**10 Year Treasury Less 1 Year Treasury**

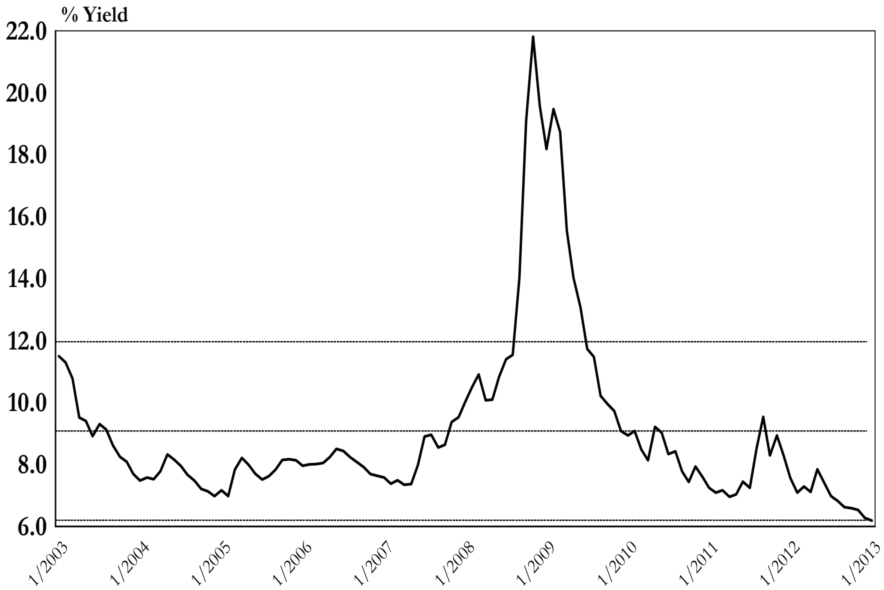



**Bond Buyer 20-Bond Municipal Bond Index Less 10 Year Treasury**

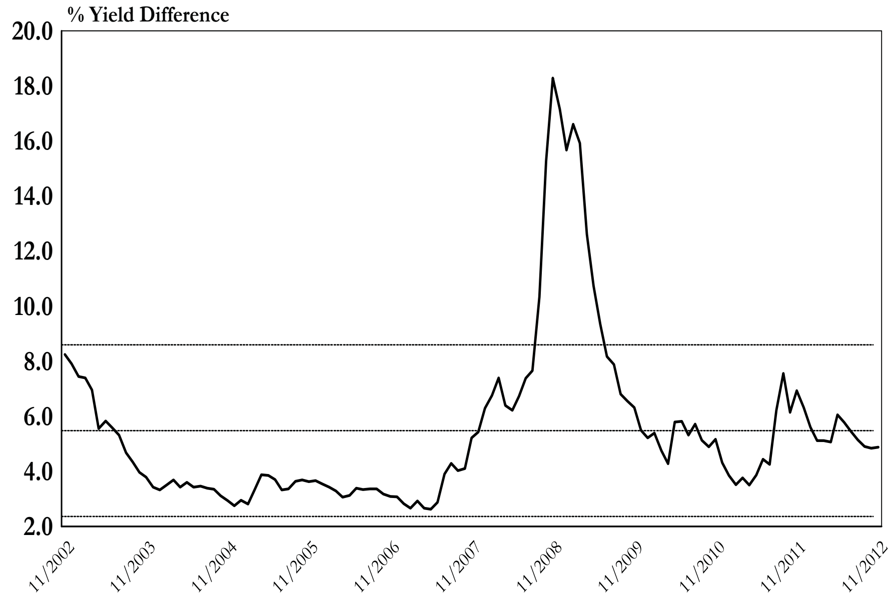


# Bond Market

**ML High Yield**




**ML High Yield Less 10 Year Treasury**




**ML High Yield Less ML Emerging Market Corporate**