WEEKLY MARKET UPDATE

Stocks move higher despite lackluster economic news; bonds remain unchanged

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ARTICLE HIGHLIGHTS

- U.S. equity markets continue to move higher despite economic reports that suggest uninspiring growth.
- When bad is good – weak European economic reports lead to rising expectations for interest rate cuts at next week's European Central Bank meeting.
- Bond markets were range bound with continued Fed purchases offsetting growing sentiment that the global economy has weakened.
- Weak economic data in part reflect sequestration and the continuing political standoff on Capitol Hill.
- Our expectations are for continued economic softening in the second quarter, with a step up in growth in the second half of 2013.

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Despite macro concerns, U.S. equities extend their streak this week as the Dow Jones Industrial Average gained 1.3% and the S&P 500 gained nearly 2%. Lower corporate revenue growth and weaker first quarter earnings have contributed to worries of a slowdown in growth. However, relative to Europe's struggling economy, slow and steady U.S. growth continues to attract investors.

European stocks advanced this week despite very poor economic reports. Weak economic data has led to expectations for the European Central Bank (ECB) to cut interest rates by 25 basis points, thus fueling European stock market gains. Weak data includes a declining German manufacturing and service sector activity and weak unemployment reports in Spain.

Fixed Income markets were range-bound this week, with strength limited to residential and commercial mortgage-backed securities. Treasury yields remain relatively low and fund flows into investment grade corporates, emerging-market debt and high-yield bonds continue to be strong as investors seek higher yields.

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Economic releases point to uninspiring U.S. growth

Following an anemic 0.4% gain in the fourth quarter that reflected delayed spending due to fiscal cliff negotiations, the U.S. economy grew at 2.5% in the first quarter. Underlying private sector growth is closer to 2%, and we expect second quarter GDP to come in close to this level.

Additional data points during the week mostly indicated continued slow growth:

- Weaker consumer sentiment suggests consumer spending may cool after posting the strongest 1Q gain since 2010.
- Unemployment claims fell to a six week low of 339,000 in the week-ended April 20, modestly better than consensus expectations of 350,000. Taking into account seasonal adjustments, claims are now sitting just 5,000 above the recovery low.
- The Federal Housing Finance Agency reported home prices gained 0.7% in the month and were up +7.1% for the 12 months ending in February, though they are still 13.6% below the index peak reached in April 2007. Home sales continue to climb albeit at a slower pace in March, reflecting weakening consumer sentiment.
- Early measures of purchasing activity are showing weakness, as evidenced by durable goods orders and a Markit PMI reading that came in at 52, indicating only very modest growth.

Outlook

We continue to be cautious on U.S. equities in the near term due to weak technical indicators. The economically sensitive Dow transports, historically a key measure of market strength, have rallied several times in the last month, only to pull back to previous levels. This and other technical factors cause us to be concerned of a short-term pullback.

In general, first quarter corporate earnings have been much weaker because of revenue shortfalls, both from declining demand and because of the stronger dollar, resulting in fewer upside surprises this quarter. Moreover U.S. corporate margins look as if they have peaked, while valuation and short-term trading sentiment remain extended. U.S. profit margins may be weakening from elevated levels, but that does not mean that they are going to break sharply lower. The 1990s proved that margins can remain at high levels for many years. In addition, the current environment of declining commodity prices may help corporate margins as the cost of goods declines. However the 1990s also proved that flat to down profit margins generally favor large cap and growth stocks, which also may come into favor as we move beyond the phase of an early economic recovery.

While the US remains a bright spot globally, it is not immune to a global slowdown. As a result, the Fed is likely to continue to buy Treasuries and mortgages rather than taper their purchases in late 2013. This action will support mortgages and

Treasuries as well as all riskier asset classes as bond investors continue to reach for yield. Housing strength may continue to offset weakness from sequestration effects and payroll tax hikes and we believe job growth will slowly improve as housing growth absorbs excess labor. However, as new jobs are added, more people will enter the labor force keeping the actual unemployment rate from falling quickly. As U.S. growth outpaces much of the developed world, U.S. assets will likely see increased demand in both equities and debt. This may come at the expense of some emerging market country assets that have slowing growth momentum in contrast to the potentially accelerating trend in the U.S. We expect treasury yields to rise from current levels into year-end.

Our outlook for Europe is positive but hinges on ECB and political outcomes—the European equity markets have reacted positively to a number of statements by EU politicians proclaiming the need to end austerity. In addition the European markets are anticipating a potential rate cut, and the possibility of programs to induce bank lending, an action that would further support European stocks especially in southern Europe.

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