CORNERSTONE
Financial Management LLC

Economic and Financial Markets Review
2013 First Quarter

2013 Q1 Highlights

- Supported by very accommodative monetary policy from the Federal Reserve, the U.S. economy continued its moderate pace of growth at the beginning of the year. Employment continued to increase gradually, although it has yet to exceed the pre-financial crisis peak in 2007, and the unemployment rate continued its gradual descent due to the ongoing decline in the labor force participation rate. Europe remained mired in recession, while Japan attempted to stimulate its economy and eliminate its persistent deflation by undertaking a massive new program of quantitative easing.

- U.S. stocks posted robust gains during the first three months of the year. Small and mid-cap stocks generated gains of 12-13%, while large cap returns were in the 10-11% range. Value-oriented stocks did better than growth stocks across all market capitalizations, as investors favored financial, industrial, and high dividend yielding stocks such as REITs and utilities. These domestic stock returns were far better than the mid-single digit returns in developed foreign stock markets, and the small losses posted by emerging market stocks. Commodities also showed small losses during the quarter, reflecting expectations of slowing growth in China and other emerging economies.

- Investment grade bonds were essentially flat, generating returns ranging from -0.5 to +0.5%, as interest rates ticked up slightly during the first two months of the year. High yield ("junk") bonds returned nearly 3%, reflecting the continued reach for yield by investors during the first quarter. The nominal yields on high yield bonds reached all-time lows below 5.8% during the quarter, and yield spreads over Treasury bonds approached the lows reached in 2007 before the financial crisis.

- In March, the massive overextended banking system in Cyprus became insolvent. Cyprus begged its European partners for financial assistance. The initial rescue plan called for all bank depositors to take a partial loss ranging from 6.75-9.99%. The resulting revolt by small depositors nearly led to a political and financial collapse on the southern periphery of Europe. It reminds investors how fragile the current monetary and financial union within Europe is, and the serious consequences of the debt crisis in Europe and most other developed economies.

Warning: Prepare for (Much) Lower Investment Returns in the Future

All of the major U.S. stock indexes reached new historic highs during the first quarter, with the familiar Dow Jones Industrial Average and S&P 500 Index piercing their former highs in early March. U.S. mid cap and small cap stock indexes had hit all-time highs earlier in late 2012 or early 2013. This might lead some investors to think, "Happy days are here again," as many who kept the faith and did not leave the stock market during the 2008-2009 bear market and subsequent four year recovery have recouped most or all of their losses. In addition, bond investors have experienced very nice total returns over virtually all trailing periods of up to 30 years thanks to the decline in interest rates. However, we believe that the journey forward is going to be much bumpier, and result in significantly lower returns

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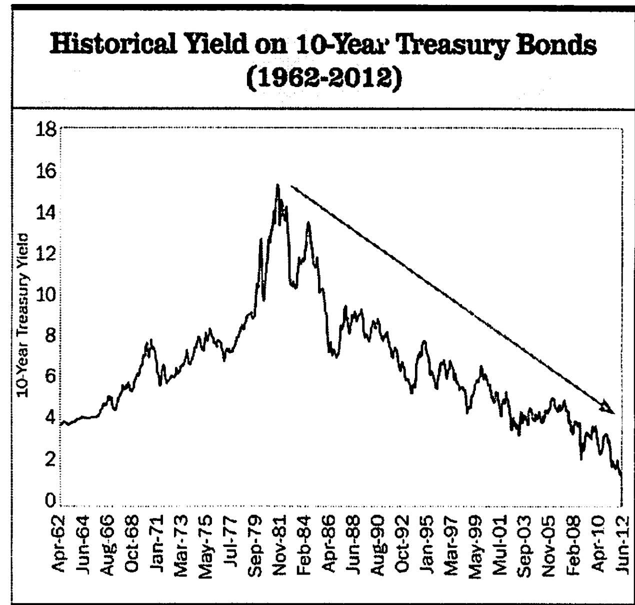
than has been the case in the last 30 years. To understand why this might be the case, let's look at some simple models for expected returns for stocks and bonds and "do the math."

Bonds have generated annualized returns in the high single digits (roughly 8% annualized) over the last 30 years (1982-2012) due to two primary factors. First, interest rates began the period in 1982 at extremely elevated levels, with the 10 Year U.S. Treasury bond yielding almost 15% (see chart at right) compared with 2% today. This was a result of the policy decision by the Federal Reserve, led by Chairman Paul Volker, to crush inflation and inflationary expectations by raising interest rates from 1979-1982. Second, the long decline in interest rates from 15% to below 2% during the last 30 years resulted in capital gains for bond investors. With interest rates now at all-time record low levels (again the result of policy decisions by the Federal Reserve), it is very likely that rates will be higher in the next 5-10 years than they are today. This will result in capital losses rather than capital gains. For example, if the interest rate on the 10 year U.S. Treasury bond were to increase from 2% to 3% in the next year, the result would be an approximately -6% total return for an investor holding the 10 year U.S. Treasury bond. If interest rates "normalized" to 4% in the next 5 years, bond investors will still experience total returns of roughly 0% if they hold the benchmark Barclays U.S. Aggregate Bond Index. The low future expected returns for high quality bonds are the result of today's very low bond yields that investors are locking in today in the current low interest rate environment.

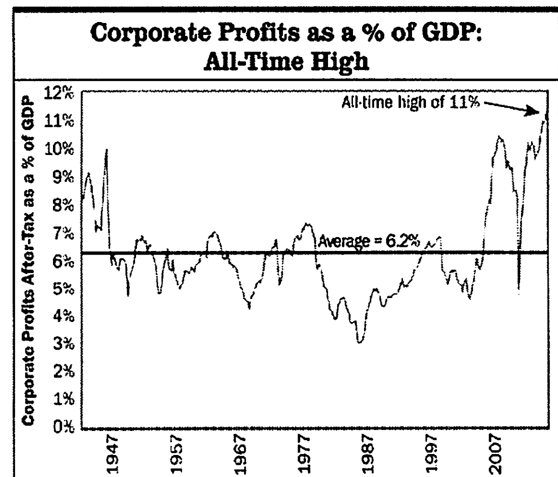


For the past 30-plus years, interest rates have trended lower. With falling bond yields come higher prices, which has resulted in a massive bull market for bonds. Today, interest rates are near all-time lows. This low-rate environment is great for borrowers, but lousy for investors. Going forward, we don't think investors are being compensated for the risk of rising interest rates.

The total return for stocks can basically be broken down into three components:

1. Current dividend yield (about 2% in the U.S.)
2. Long-term corporate earnings growth
3. Valuation (the expansion or contraction of the Price/Earnings (P/E) ratio for stocks)

We are assuming a relatively conservative long-term corporate earnings growth rate of 4-6% for a few reasons. First, corporate profits as a percentage of GDP are above 10% today, which is well above the long-term average of approximately 6% (see chart at right). Corporate profits and profit margins have a strong tendency to be mean-reverting, meaning that they tend to move toward the long-term average if they are



Data as of 28 February 2013. Source: U.S. Bureau of Economic Analysis.

higher or lower than average. If corporate profits gradually move from above 10% of GDP toward their long-run average of 6%, then profits are unlikely to grow at their historical rate in the high single digits. Second, given the slow demographic growth rate of roughly 1% in the U.S. (and even lower or negative rates in other developed nations), our aging population which requires more services and care, and slower real GDP growth rate of roughly 2% in the U.S. since the turn of the millennium (versus 3+% from 1946-1999), it seems unlikely that corporate earnings will grow significantly faster than the rate of nominal GDP growth, which should be roughly 4-6% (2% real GDP growth plus 2-3% inflation, plus 1% for faster emerging market growth and unforeseen innovation).

Finally, there is the issue of valuation. U.S. stocks currently trade at a P/E ratio of approximately 16, which is very close to the long-run historical average. There are many other valuation metrics that are available (for example Shiller's 10 year CAPE ratio, Tobin's Q ratio, total stock market capitalization/GDP ratio, etc.), and almost all of them indicate that stock valuations are well above their long-term historical averages. Therefore, it would not be wise to expect to receive a boost from expanding stock valuations in the decade ahead.

If we assume no expansion of the price/earnings valuation for U.S. stocks, corporate earnings growth of 4-6%, and a current dividend yield of 2%, then the total return for U.S. stocks over the next 7-10 years will likely fall in the 6-8% range. This assumes that we don't have any major external shocks to the global economy such as another financial crisis, energy shortages or price spikes, widespread war, etc. It also assumes that there are no fiscal (tax and spending) or monetary policy mistakes made by elected officials and global central bankers, a very big assumption given the current experimental monetary policy being pursued by global central banks and since policy mistakes have been common in history. If interest rates rise, as we expect them to, then the valuation for stocks should decline modestly. Also, as we have mentioned previously, historical economic research by Reinhart and Rogoff shows that nations with debt to GDP ratios above 90-100% experience slower economic growth than those nations with lower levels of debt. The U.S. public debt is currently at about 106% of our GDP and rising, and that does not include all of the promised entitlements and other "off balance sheet" debt that has been accumulated during the last 60 years. If continued deleveraging is necessary in the U.S. and other developed nations, economic and corporate profit growth will by necessity be slower in the future. Based on all these considerations, it seems prudent not to assume a 6-8% return for stocks going forward, but something slightly lower, more likely in the 4-6% range.

In summary, the expected total returns in the next 5-10 years for investors are as follows: stocks are most likely to generate returns in the mid-single digits, bonds are most likely to generate almost no total return, and cash is unlikely to generate much of any return until the Federal Reserve and other global central banks begin to withdraw the massive monetary stimulus they have been engineering during the last four years. **The result is that investors are likely to receive low to mid-single digit returns on their investments before inflation (very low single digit returns after inflation) in the next 5-10 years if there are no external economic shocks or policy errors.** As a result, you need to structure your future financial plans with this lower total return world in mind. If you are in your working and savings years, this means saving more aggressively and minimizing debt unless it is locked in at today's very low interest rates. If you are in your retirement years, it means being very careful with your spending and being willing to assume more investment risk (higher exposure to stocks and stock price volatility) than you might otherwise take on.

Looking Ahead and Investment Portfolio Positioning

The sharp increase in U.S. stock prices during the first quarter has resulted in U.S. stocks being at best fully valued and probably overvalued. The U.S. stock market generated more than a full year's worth of average stock returns in the first three months of the year! In addition, all of the stock price returns during the last 12 months have been the result of valuation expansion (increases in the P/E ratio for stocks) because corporate earnings growth has been flat. We are cautious about adding to U.S. stock exposure at this level and would wait for a correction before committing new money to stock funds. If U.S. stock prices continue their ascent, we would likely reduce stock exposure to rebalance equity allocations back to each client's target.

Foreign developed market stocks have lower valuations than U.S. stocks, reflecting the myriad of challenges they face including a lack of growth, excessive debt, inflexible labor markets, and poor demographic trends. We are emphasizing funds that invest in European and Japanese domiciled global blue chip stocks that are similar to high quality U.S. blue chip stocks but trade at lower valuations. Emerging market stocks also have attractive valuations, but slowing growth and reduced liquidity have us waiting for better values (lower prices) before we add dedicated emerging market funds to client portfolios.

U.S. bonds look uniformly unattractive at the current low yields and the very tight credit spreads in the high yield corner of the bond market. Therefore, we have been initiating alternative fixed income funds and adding to existing positions in the following areas:

- Non-agency mortgage backed bonds
- Bank loans and floating rate bonds
- Unconstrained bond funds that can "short" long-term bonds and/or build a negative overall bond duration, hopefully generating positive returns if interest rates rise to more "normalized" levels.
- Emerging market local-currency bonds
- Funds that employ hedging, arbitrage, and managed futures strategies, which can provide some downside protection should stocks and/or bonds enter another painful bear market.

If you have any questions or concerns about your investment portfolio, please contact us. As always, we appreciate your continued confidence and trust.

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Index Returns for the Period Ending 3/31/2013

	2013		Average Annualized Returns				
Equities and Equity Alternatives	**Q1**	**YTD**	**1 Yr**	**3 Yrs**	**5 Yrs**	**10 Yrs**	**15 Yrs**
US Stocks							
S&P 500 Index (US Large Caps)	10.6	10.6	14.0	12.7	5.8	8.5	4.3
S&P Mid Cap 400 Index (US Mid Caps)	13.5	13.5	17.8	15.1	9.9	12.5	9.3
S&P Small Cap 600 Index (US Small Caps)	11.8	11.8	16.1	15.2	9.2	12.4	7.8
Russell 1000 Index (US Large and Mid Caps)	11.0	11.0	14.4	12.9	6.2	9.0	4.6
Russell Mid Cap Index (US Mid Caps)	13.0	13.0	17.3	14.6	8.4	12.3	7.9
Russell 2000 Index (US Small Caps)	12.4	12.4	16.3	13.5	8.2	11.5	6.0
Russell 3000 Index (98% of US Stock Market)	11.1	11.1	14.6	13.0	6.3	9.2	4.7
Foreign Stocks							
MSCI EAFE Index (Foreign Large Caps - Developed Markets)	5.1	5.1	11.3	5.0	(0.9)	9.7	3.8
MSCI EAFE Small Cap Index (Foreign Small Caps)	8.4	8.4	13.3	8.4	2.1	13.2	n/a
MSCI Emerging Markets Index (Foreign Emerging Markets)	(1.6)	(1.6)	2.0	3.3	1.1	17.1	n/a
Equity Alternatives							
FTSE NAREIT Equity REIT Index (US Real Estate)	8.1	8.1	17.1	17.7	7.1	12.6	9.5
Dow Jones UBS Commodity Index (Commodities)	(1.1)	(1.1)	(3.0)	1.4	(7.1)	3.7	4.2
Fixed Income and Cash							
High Quality Taxable Bonds							
Barcap 1-5 Year Govt/Credit Index (US Short-Term Bonds)	0.3	0.3	2.0	2.8	3.3	3.6	4.8
Barcap Aggregate Bond Index (US Intermediate-Term Bonds)	(0.1)	(0.1)	3.8	5.5	5.5	5.0	5.9
Barcap US TIPS Index (US Inflation Indexed Bonds)	(0.4)	(0.4)	5.7	8.6	5.9	6.3	7.3
High Quality Tax-Exempt Bonds							
Barcap Municipal Bond Index (US Tax-Exempt Bonds)	0.3	0.3	5.3	6.2	6.1	5.0	5.4
Low Quality Taxable Bonds							
Credit Suisse High Yield Index (US High Yield Bonds)	2.9	2.9	12.4	10.9	10.8	9.8	7.2
Cash & Equivalents							
3 Month US Treasury Bill (Cash)	0.0	0.0	0.1	0.1	0.3	1.7	2.5
US Inflation (Urban Consumers)							
US Consumer Price Index (US Urban Inflation as of 2/28/13)	0.7	0.7	2.0	2.3	1.8	2.4	2.5

The index data shown represent past performance, which is not a guarantee or indicator of future returns.
You cannot invest directly in an index. Investing involves expenses which are not reflected in the above return figures.
Diversification does not assure a profit nor protect against losses in a declining financial market environment.
The above data were gathered from sources known to be very reliable, however data accuracy is not guaranteed.