Market Commentary

First Quarter 2013

C. Angus Schaal, CFP®
Managing Director

we'll get there together

The first quarter of 2013 was a very strong one for the equity markets. Shaking off any concerns about US budgetary issues or sequestration, the benchmark S&P 500 index rose by 10.6% during the quarter on a total return basis. Fixed income markets saw reduced volatility as compared to the previous quarter. The benchmark 10-year US Treasury note yielded 1.85% at the end of the first quarter, modestly higher than the 1.78% three months earlier. The 10-year Treasury note did briefly surpass a 2.0% yield during the quarter before a rally in bond prices pushed the yield lower once again.

The tiny island nation of Cyprus held investors' attention for nearly two weeks in March. Many questioned the relevance of the Cypriot banking crisis to the broader markets. After all, Cyprus had a GDP that was only one-eighth the size of Detroit, Michigan. The reason it was so important was not because of Cyprus, per se. Rather, it was because investors feared the European Union and the European Central Bank (ECB) were establishing a precedent for how they would deal with other member nations facing a protracted banking crisis. Just imagine the sheer panic and severe dislocation that would be caused if the ECB decided it needed to tax Italian or Spanish bank deposits to ensure continued membership in the European Union. Thus, while Cyprus is extremely small relative to the size of other European nations, its potential implications rippled across the continent. The Euro Stoxx Banks Index declined 20% between early February and late March on these concerns.

Economic Outlook

The US economy continues to show more signs of sustained growth, and several economists have recently raised their economic forecasts for 2013. Job growth has picked up in recent months, but still remains below the 250,000 monthly average increases needed to meaningfully help the overall employment picture. It is now clear that the housing market has definitively turned which is significant as well as required to revive long-term economic growth. The biggest drag has been – and continues to be – Washington. In late 2012, we saw the near panic over the year end fiscal cliff. The most recent quarter witnessed brouhahas over the budget sequester, raising the debt limit, and funding the government through the end of September 2013. At times it seems our elected officials cannot help but be dysfunctional. Clearly, the long-term drivers of the budget deficits are spending on benefits, especially healthcare. Yet through all the budget negotiations of the past 24 months, absolutely nothing has been done to curtail these runaway expenses. Tax rates were simply raised, rather than reforming the tax code. The sequester saw a decrease in the rate of spending growth for core functions of the national government (defense, education and research) while leaving Medicare, Medicaid and Social Security untouched. And yet, when we compare the United States to many other developed nations, particularly in Europe, the US remains the "least bad" of the bunch. With investors continuing to lend the government money for ten years at less than 2%, there is little incentive to work towards real fiscal discipline. We would point out that with the National Debt surpassing $16.5 trillion, each 1% rise in interest rates adds an astounding $165 billion to the annual interest tab.

TANDEM
WEALTH ADVISORS

Tandem Wealth Advisors LLC
www.tandemwealth.com

1 East Camelback, Suite 550
Phoenix, AZ 85012
Tel 602-297-8600
Fax 602-297-8601

Despite these concerns, investors have been increasing their appetite for risk during the past several months across many asset classes. This is partially due to the multi-generation low rates in fixed income securities. The quest for returns has pushed people to move further out on the risk spectrum. This complacency can be seen through lower levels of volatility, lower spreads on high-yield bonds versus US Treasury bonds, and the continued outperformance of low-quality stocks versus their higher quality brethren. These cycles can last for years, but they always end the same – with a significant movement towards higher quality, lower-risk securities – albeit, usually after a painful financial crisis of some sort. As we have written many times, we view risk control as our primary task for clients. Tandem has always believed that portfolios should be based on companies and investments with solid, long-term fundamentals, rather than chasing the current craze. These securities are chosen for their stability and the ability to hold them for extended periods of time which contributes to lower turnover rates. While this methodical type of investing is not flashy and does not always strive for the highest possible returns, it does focus on controlling risk each and every day. This is what sets Tandem apart from many other investment managers that boast about their returns over a short time period without explaining how risky the underlying portfolios are.

Portfolio Positioning

Client equity portfolios have seen some modest changes in the past few months as we moved to take some long-term gains and reposition assets to benefit from our economic forecast. Looking through 2013 into 2014 and beyond, we believe the economy will strengthen as budget deficits continue to decline, interest rates remain very low, and debt service levels moderate. The equity markets usually anticipate events six to 12 months ahead and this is one of the reasons we believe further gains could be in store for equity holders. From the November 15, 2012 lows following the Presidential election, equities have risen an astounding 17.8% in 4 ½ months. A modest pullback would be not only expected but warranted at this point. As investors have rushed into dividend paying stocks during the past two years, they have bid up some areas of the market to levels that we would question. As an example, utility companies are now selling at higher earnings multiples than technology companies. This would normally imply that investors expect utilities to show stronger earnings growth than technology companies over the next several years. These are the types of market inefficiencies and mini-cycles we seek to exploit. As the bull market enters its fifth year, we believe earnings growth will become more challenging for some of the smaller, lower-quality companies. We look to larger companies and sectors that we believe will continue to show a combination of both top-line and bottom-line growth.

Conclusion

With one quarter of 2013 and hefty equity returns in the books, we believe some backing and filling in the equity markets may be likely. This does not mean we would be selling significant amounts of equities, but rather discriminately repositioning holdings where warranted. The past two years have seen strong equity returns into mid-spring followed by modest declines during the summer months. We plan to use the most recent rally to rebalance client portfolios to their stated asset allocation guidelines as well as taking profits in select holdings where prudent.

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Tandem Wealth Advisors LLC
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Phoenix, AZ 85012
Tel 602-297-8600
Fax 602-297-8601