HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

By William N. Hudson, Jr. & David D. Burrows **Volume 55** **April 2013**

We are living in a period of "contrarian events" – what we expect to happen does not quite turn out that way. In our last quarterly commentary, our anticipations for 2013 were tempered. We forecast economic recovery to continue – but sluggishly and painfully. Thus, we expected the stock market to be positive, but less vibrant than in 2012.

Boom! The first quarter was spectacular. The economy showed fresh momentum: accelerating GDP, increasing job growth, and revival in the housing sector. Investors hungry to make money responded. The major stock indexes climbed to record levels – with three-month growth rivaling that achieved in all of 2012. Our optimism at Hudson Advisors was bolstered.

Thump! The first week of April was like a bucket of ice water. Job growth in March – just 88,000 new jobs – fell way short of the expected 200,000. Other reports suggested slowdown in manufacturing activity and consumer spending. The news smacked the stock market – reversing some of the first quarter gains. Analysts pondered. Perhaps the March job numbers were just a one-month anomaly. But, then again, perhaps they signaled more sustained economic slowing.

Fortunately, our strategy at Hudson Advisors is constructed to weather through this zigging and zagging of financial events. We prefer stocks and appreciate the acronym "T.I.N.A." – meaning There Is No Alternative to equities as the best asset class. But, as our clients know, this strategy does make us defensive and selective pickers of the stocks to buy.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the first quarter of 2013. The equity markets remained strong throughout the quarter – with some indices ending at record highs. Meanwhile, the bond market was supported by the aggressive buying program conducted by the Federal Reserve.

Equity Market: Encouraged by signs of economic resilience, investors turned to the stock market with enthusiasm that continued and exceeded that seen in 2012. The trend spread to include smaller retail investors – in addition to larger institutional investors. U.S.-focused stock mutual funds – the vehicle of mom and pop investors - showed a net gain of $34 billion, reversing the outflow of previous years. What used to be called the "Nifty 50" stocks – large cap companies with consistent earnings – were the big winners in the quarter. The Dow Jones Industrial Average grew 12.02% to a record level of 14,578. The S&P 500 Index grew 10.73% to a record level of 1569. The Nasdaq Composite increased 8.21% for the quarter and the Russell 2000 index gained 12.39%.

Fixed Income Market: In normal market conditions, strong interest in equities would cool investor appetite for bonds and prices would decline. But the aggressive monetary policies of the Federal Reserve has them buying about $85 billion of bonds every month. This amount constitutes an estimated 90% of total Government, municipal, and corporate debt being issued in the U.S. The result is to bolster prices. The yield on the 10-year Treasury note, which moves opposite to prices, finished the quarter at 1.851% -- up only slightly from 1.759% at the beginning of the quarter. Consequently, private investors have flocked to "junk", or below investment grade bonds, which offer yields of 5% or better.

THE OUTLOOK

The Economy: We readily admit to being uncertain about the future course of the economy. As mentioned, we started the year cautious, were buoyed as the first quarter progressed, and now are less confident what to predict. The U.S. GDP reportedly expanded at an annual rate of 3% in the first quarter. Many analysts now predict that rate will be 2.2% in the second quarter. Countervailing forces are at work.

MAJOR MARKET INDEXES

	1Q Total Return*
Dow Jones Industrials	12.02
S&P 500 Index	10.73
Russell 2000 Index	12.39
NASDAQ Index	8.21
MSCI EAFE	4.40

*Total Return Includes Reinvested Dividends.

On the negative side:

- The March job numbers demonstrate the tenuousness of our economic recovery. We still do not know if the numbers are a fluke in reporting, or a repeat of 2011 and 2012 in which the year started strongly, but then sputtered in latter quarters. We can only watch the trend in future months.
- Corporate earnings have been an upbeat story overall in recent years. But now analysts expect reports on the first quarter earnings of the S&P 500 companies to be down 1.8% from the same period last year. This will be the first year-to-year decline since 2009. Perhaps expense control has run its course and consumer spending is too weak to help the revenue side.

- The market seems to have grown numb to the fiscal shenanigans in Washington: tired of debt ceilings, fiscal cliffs, sequestrations, and all the partisan squabbling. Underneath, however, some economists warn that the higher payrolls taxes and cuts tied to sequestration create an untimely economic drag.
- We no longer expect the problems in the Euro Zone to create meltdown in the fiscal system. But Europe is mired in recession with little hope of recovery in the foreseeable future. The impact is negative for the U.S. and Asian economies.

On the positive side:

- The housing sector in the U.S. is clearly recovering. Values on existing homes have recovered an average 20% in recent months and new home starts are giving life to the construction industry. These trends have a strong impact on economic confidence.
- The Federal Reserve is committed to keeping interest rates low. Any suggestion of monetary tightening will be delayed until the jobs outlook is clearer. This policy is now uniform among the central banks of the major economies.

The Market: Despite these economic pros and cons, we are optimistic on how stocks will perform for the rest of 2013. We do expect the markets will gyrate as good and bad economic news unfolds. We are not surprised to see the market pull back somewhat because of weak job growth. But much of the underlying momentum is positive. Most important is that "T.I.N.A." phenomenon. Investors are hungry for return and other asset classes offer weaker rewards and more uncertainty than stocks.

Both institutional and retail investors like what they observed in the first quarter equity performance. The psychology of enthusiasm is powerful right now – and will only be deterred by repeated bad news on the economic front. Helping the situation is that the average stock in the S&P 500 is fairly valued at 15 times earnings. Good buying opportunities do exist.

On balance, we expect the major stock indexes to hold their first quarter gains and to advance further by the end of the year.

OUR STRATEGIES

Asset Allocation: For clients investing new money, we recommend 65% allocation to equities and the remaining portion to cash, bonds with maturities under two years, and alternative investments.

Preferred Equities: We remain focused on large cap companies with strong balance sheets, sustainable cash flows, and credible business models. Companies that pay attractive dividends are central to our strategy.

We are cautious now on the consumer staple companies that have done so well in recent months. Their stocks are expensive. Instead, our focus is on other sectors where prices are still reasonable and growth opportunities exist. We like selected companies in the financial, health care, energy, materials, technology, and industrials sectors. Many of these stocks will see a rotation of investor interest – and we want to buy before prices are driven higher.

Fixed Income: Although not in 2013, but in future years, there will be a price to pay for the aggressive creation of money by the major central banks. That reckoning will come in the form of inflation and higher interest rates. As our clients know, our aversion to long-term bonds is rooted in the inevitability of that reckoning. We prefer to keep the non-equity portion of client portfolios in cash. To assist return, we also have been putting some monies into instruments like municipal tax liens and certain high yield corporate debt funds.

Dow Jones U.S. Sectors
(Percent Change for YTD, Ending March 31, 2013)

Sector	%	Sector	%
Oil & Gas	10.94	Consumer Services	12.80
Basic Materials	1.86	Telecommunications	8.72
Industrials	11.82	Utilities	13.45
Consumer Goods	13.71	Financials	12.00
Health Care	16.04	Technology	3.91

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