HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

By William N. Hudson, Jr. & David D. Burrows **Volume 54** **January 2013**

The most annoying part of the "fiscal cliff" hysteria was the endless repeating of the term itself. We heard the phrase what seemed liked a million times during the Holiday season. If nothing else, the Congressional action over New Years should vanquish that phrase to the history books. Happy 2013!

Despite the Washington shenanigans, and the agonizing pace of economic recovery, 2012 was a decent year for investors. Stocks posted healthy returns, aided by good corporate earnings. The bond market showed signs of fatigue – but held together.

We are hopeful for 2013 – but filled with caveats and cautions. We anticipate the U.S. economy to chug along slowly as in recent years. Politically, the impasse in Washington over how to address the country's long-term fiscal problems will persist – and the financial markets will be jittery. While corporate balance sheets are strong, government debt remains an anchor on economies globally. But we expect a series of patchwork, short-term fixes that will avert any financial panic or market meltdown.

We predict for the equity markets to be positive in 2013. However, we will be surprised if they reach the gains achieved in 2012. Thus, we will stay with our current investment strategy. Use cash and alternative investments for the safety portion of client portfolios. Avoid the price risk of long-term bonds. To provide some return for clients, we look primarily to stable companies that pay healthy dividends. We remain in an era where dividend-paying stocks are the best investment choice.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for full year 2012. The equity markets fluctuated throughout the year – with two positive quarters and two negative quarters. But the outcome at year-end was interestingly positive. The action in the fixed income market was with issuers of investment-grade and junk corporate bonds who raced to take advantage of low interest rates.

Equity Market: The market seemed to have trouble making up its mind in 2012. The first quarter was positive, but lost ground in the second quarter largely over concerns about the problems of the Eurozone. Then, when the Federal Reserve announced its even more aggressive monetary actions, the market cheered and turned in a spectacular third quarter. The market retreated again in the fourth quarter as the fiscal cliff deadline loomed.

The Dow Jones Industrial was down 1.74% for the fourth quarter and ahead 10.24% for the year. The other major indexes were better performers. The S&P 500 lost just 0.38% in the quarter and gained 16% for the year. The Nasdaq Composite was 3.10% down for the quarter but 15.91% positive for the year. The Russell 2000 index held up in the quarter – with a gain of 1.85% -- and closed the year up by 16.35%

Fixed Income Market: The long-run fascination with U.S. Treasury bonds as safe haven investment abated in 2012. The yield on the 10-year Treasury note stayed in a narrow range most of the year – ending at 1.76% -- or .12% below where it began the year. Investors hungry for more yield showed strong interest in corporate debt – and issuance in that sector was at record levels. The U.S. investment grade market issued over $1 trillion of new debt. The high-yield or junk bond market, in the U.S. won investor acceptance for over $350 billion – even though much of that debt was issued with weak safeguards for investors. Action in the international arena was also at record levels. Companies in Latin America, non-Japanese Asia, and Eastern Europe issued nearly $950 billion—more than 50% higher than in 2011. Despite this glut of supply, there was not enough corporate debt to satisfy investor appetites. The result was that rates fell to their lowest level in recent history. Average yield on U.S. investment grade corporate debt was below 3%.

MAJOR MARKET INDEXES

	4Q Total Return*	YTD Total Return*
Dow Jones Industrials	-1.74	10.24
S&P 500 Index	-0.38	16.00
Russell 2000 Index	1.85	16.35
NASDAQ Index	-3.10	15.91
MSCI EAFE	6.17	13.55

*Total Return Includes Reinvested Dividends.

THE OUTLOOK

The Economy: Our caution on 2013 stems from the core outlook for the economy. On balance, the sails seem just too weak to gather much speed given all the heavy ballast on board. We expect the GDP growth rate to stay in the vicinity of 2%. The U.S. labor market is structurally damaged. The most optimistic view is that unemployment might fall to 7% by the end of 2013. This prognosis explains the Federal Reserve decision to keep interest rates at near zero levels.

Weak labor markets dampen consumer spending power – a problem compounded by the 2% rate hike in the Social Security payroll tax. Congressional attention will now turn to spending cuts. The resulting fiscal austerity – despite it long-term benefits – is an economic drag in the short-term. Finally, we do not see much stimulus from abroad. Europe and Japan are in recession and the outlook for China is uncertain.

Yes, there are some bright spots. The housing market is slowly coming back to life. New technology to extract oil and natural gas offers the promise of U.S. energy independence. Nonetheless, these few bright spots will not contribute significantly to GDP in 2013.

The Market: Given this economic viewpoint, we agree that corporate earnings may face a period of slowed growth in 2013. Many companies have pushed expense control to the maximum and earnings growth will be muted. This trend could dampen the fuel that propelled the market in 2012.

However, some positive forces are at work. Stocks are fairly valued by historic standards. The price/earnings ratio on the average S&P 500 stock is below 13. Also, we believe stocks will win over many bond investors in 2013. Treasury debt offers almost no return and the corporate market is now subject to heavy credit risk.

On balance, we expect the major equity indexes to be positive in 2013 – even if they do not reach the levels seen in 2012.

OUR STRATEGIES

Asset Allocation: For clients investing new money, we recommend 55% allocation to equities and the remaining portion to cash, bonds with short maturities, and alternative investments.

Preferred Equities: We remain focused on large cap companies with strong balance sheets, sustainable cash flows, and credible business models. Given the economic and market uncertainties, we are defensive in our equity selections. Companies that pay attractive dividends are central to our strategy. Interestingly, over half the companies in the S&P 500 now have dividend yield higher than the 10-year Treasury note.

HEALTH: We are interested in companies with products and services for the demands of an aging population – including certain pharmaceuticals.

CONSUMER STAPLES: Companies that provide the necessities of life are good dividend payers in the current market.

TECHNOLOGY: Both corporations and consumers seem willing to spend to stay current with the latest information technology innovations.

FINANCIALS: Certain regional and super regional banks – and even several of the big national banks -- have good value as the result of low risk profile and conservative balance sheet management.

MATERIALS: This sector has been a weak point in the markets and many material stocks trade at highly discounted values. The discounted value and the prospect of a pick up demand in emerging markets suggest an attractive entry point this year.

Fixed Income: Our aversion to long-term bonds is undaunted. The day of reckoning is coming and all those buyers will get steamrolled by even a modest hike in interest rates. 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, explained in our last newsletter, and certain high yield corporate debt funds.

Dow Jones U.S. Sectors
(Percent Change for YTD, Ending December 31,2012)

Oil & Gas	**4.71**	**Consumer Services**	**24.17**
Basic Materials	**10.49**	**Telecommunications**	**18.79**
Industrials	**17.87**	**Utilities**	**1.76**
Consumer Goods	**12.80**	**Financials**	**26.85**
Health Care	**19.26**	**Technology**	**12.08**

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