Spring 2013

Market Overview

The stock market has continued its annual first quarter rally this year. Now, with everyone waiting for a pullback to reenter the markets, the contrarian position is to believe that the rally may continue upwards into the second quarter without a serious correction. However, there are significant headwinds that have been forming around the world. U.S. Treasury rates recently had their best week since the November election as the 10-year Treasury rate has declined from above 2% to below 1.7%. The first quarter was a very good quarter for U.S. equities. Risky sectors did well, but so did many lower risk sectors such as Health Care, Consumer Staples, Utilities, and MLPs. The key to first quarter success was to be fully invested in anything except Gold, Treasuries, and Emerging Markets. Oh yeah, and Apple.

So maybe finally the U.S. markets are just adjusting to what commodities, emerging markets, and global companies have been telling investors for a time now–Growth in the U.S. may be improving, but the rest of the world is still struggling to find positive growth. We believe we will continue to be in a high-risk, low-growth environment. The unemployment rate fell again last week as more individuals stopped looking for employment. A lower unemployment rate due to individuals leaving the job market is a sign of continued job weakness. As we enter the corporate earnings season, we will be watching very carefully how many companies continue to revise downward their earnings estimates. Overall, the number of economic indicators beating estimates has declined recently.

For the first time in many years, D.C. has actually been a friend to investors. Having bypassed the debt ceiling, sequestration, and a government shutdown so far this year, it has been a welcome trend for everyone to see bipartisan legislation. If the warm fellowship continues into the summer, 2013 could be a good year for many asset classes. However, if gridlock in Washington entangles the economy over the recent budget proposals, the stock market could quickly correct off its current five-year highs.

Except for a headline scare after the Italian election in February, Europe had managed to stay off the radar until Cypress last month. Although Cypress is just a small drop in the bucket in the Eurozone economy, the precedent set is one few could have imagined. The government actually seized cash deposits in banks. Although few believe this could happen in the U.S., it was a step few thought could happen in any European country before Cypress.

2013 Outlook

Below are a few bullet points from our outlook for 2013. Overall, they have not changed much from the prior newsletter, but we have added a few additional comments.

- Ben Bernanke will continue to backstop the equity markets. The printing of easy money will continue, but it will be less effective than previous attempts at stimulating the economy. Once again, the notes of the latest Federal Reserve Board meeting stated that several members are worried about keeping interest rates too low for too long.

  However, there is a new wrinkle to this issue. Other countries' Central Banks are now on the bandwagon with printing money as the United Kingdom, Japan, and others have turned their own printing presses to full throttle. Superior U.S. growth should support a rotation from bonds to equities and that will also strengthen the dollar. As the U.S. dollar had been weakening since 2009, many think the U.S. dollar could be on a multi-year uptrend as other countries now embark on their own printing schemes.

- U.S. GDP will continue to stall around 2% into 2013 which means unemployment will not drop significantly. When the job market begins to gain steam, we would actually look for an increase in the unemployment rate as prospective employees reenter the market.

- Bernanke stated he plans to keep interest rates low through 2015. We still believe in the premise that negative real returns for investors should bode well for hard assets such as precious metals and real estate. However, there are currently a variety of strong forces that are impacting currencies and therefore commodity prices.

- Currencies will play a bigger role as the Fed wants to weaken the dollar, but the crisis in Europe could maintain the U.S. dollar as a safe haven investment. A strong dollar will also have negative effects on

U.S. companies because it will lower reported revenues from foreign countries. This one ties right into the comments on the first bullet point above.

- Housing has bottomed in many areas which will be a positive for the economy. The housing sector has also seen many improvements over the last six months. We believe housing could be the biggest story of 2013 if it continues to improve as it could positively affect the unemployment rate, increase consumer spending, and increase sentiment as fewer homes would be underwater.

Investment Outlook and Strategy

Using the above as our backdrop, below are a few thoughts on different asset classes that affect our current allocation strategies. In the current environment there are headwinds as well as potential catalysts we feel could improve the economy. We continue to maintain a diversified investment strategy that attempts to protect portfolios against the known and unknown risks facing investors.

Bonds- The upside of bonds has decreased substantially. How much lower can rates go, right? However, we still believe in most regards that it's useless to fight the Fed. The "Great Rotation" of money moving from bonds to equities that was trumpeted in at the beginning of the year simply has not happened. The record inflows into equities did not rotate out of bonds, but came from savings accounts. Bonds have continued to see increased demand even as stocks move up. Although some bond funds have seen negative returns this year, the volatility has remained quite subdued. In this environment, we continue to see advantages of using managers which have the ability to go where the opportunities are in fixed income.

Enhanced-Yield Strategies- Yields on many income-producing investments including utilities, high-yield bonds, MLPs and REITs have decreased as values have soared from investor demand. We see high-yield bonds as a good diversifier to stocks in the current environment. We also believe this is a great opportunity in the private market as bank lending is still tough to access. We continue to work with Keystone and even real estate groups whose strategies are to replace banks that are no longer willing to lend. With opportunities of strong cash flow backed by great collateral, we feel this is a great risk/reward investment.

Stocks- Overall, the Eurozone continues to be in a period of negative growth. Contrary to our former outlook, emerging markets have also lagged this year after a strong 2012. That has left the U.S. the darling of the investment world. Recent European events above barely affected the U.S. markets which quickly moved on. This next quarter could be a catalyst for moving markets higher or a short-term correction if companies show weakening results and cuts in future earnings. The payroll tax hike which was feared would cut into consumer spending has had no significant impact so far. Companies continue to be very healthy with lots of cash, but investors are now focusing on revenue growth rather than just a strong balance sheet. We now recommend tactical strategies for equity exposure. For any long-only exposure, an investor must be willing to ride out the downturn unless he's willing to call a top and a bottom. Any market correction could be short lived with a Fed Board ready and eager to assist by printing more money.

Real Estate- As we've stated before, the multi-family housing sector saw a lot of investor money come in to acquire assets last year. This has placed Virtu, one of our managers, in a very good position as it acquired most of its properties at least two years ago. Virtu currently has six properties for sale set to close in the second quarter. Omninet, another manager, which is acquiring commercial properties, expects to be active during the second and third quarters. We still think certain real estate sectors present a good investment opportunity as well as diversification from the stock market. Specifically, we favor commercial opportunities that generate ongoing cash flow. As inflation expectations increase, this asset class could do well if property values increase and rents move upward.

Commodities/Managed Futures- These asset classes continue to be the biggest drag on clients' portfolios. Another twist to this asset class is the increased stimulus plans from other countries and its effects on the U.S. dollar. This could be a continued headwind for U.S. dollar based commodities. However, we continue to use these asset classes to mitigate the risks of increased inflation expectations and a weakening dollar while the Federal Reserve continues printing money at historic rates.

Cornerstone Team Notes

Cornerstone Employee Milestones

We'd like to congratulate and thank Vivean Smith who will hit her 8-year anniversary with Cornerstone in May. We'd also like to celebrate the 7-year anniversary of Julie Ricks in June. We are thankful for their hard work and dedication to the Cornerstone team and clients. We are truly blessed that they are both part of our team.

Rancho Santa Fe Office Open House

We are pleased to announce the opening of an office in Rancho Santa Fe to better serve our clients. We welcome you to join us at the official Open House on either of the following dates:

May 7, 11am-2pm
May 9, 4:30pm-7:30pm

6105 Paseo Delicias, 6-C
Rancho Santa Fe, CA 92067

March Madness Event

We'd like to thank everyone who attended the March Madness basketball event at the Meacham home while Chris and Lesley were away. Everyone enjoyed some excellent burgers and basketball. Well, the basketball part depends on who you were rooting for. We look forward to similar events later in the year. Hope you can join us.

Vivean goes to London

Vivean is currently sightseeing in London with her son. Obviously missing the San Diego warmth and sunshine, here she is in front of Westminster Abbey.