**SURPRISING SURGE!!!** Momentum from 2012's surprisingly strong performance continued into the first quarter of 2013 with stocks rising sharply. Our portfolios did well but lagged behind our benchmarks in the quarter. Taking a little longer view, over the trailing 12 and 36 months we mostly matched the double-digit gains of our benchmarks, which we are very pleased with since we usually underperform during strong market advances. So far this year small- & mid-capitalization, value, and domestic stocks were the market leaders, while international, growth, commodity stocks and Apple were laggards. We made a few minor changes during the quarter and are very happy with the make-up of our portfolios. We see considerable value in our international holdings, especially emerging markets. Based on MSCI's global indices, emerging markets' forward price-earnings of 11 times is at a historical discount to developed markets' multiple of 14 times.

There are plenty of valid reasons for investors to be bearish. In fact, three separate events during the quarter knocked stocks down briefly – (1) Federal Reserve minutes highlighting that several members would prefer a winding down of quantitative easing; (2) the Italian elections widely seen as a blow to austerity; and (3) the Cyprus bank bailout that calls into question the value of depositor guarantees throughout Europe. In addition, Europe's economy is shaky including the perennial stalwart Germany which saw output shrink 0.6% in the fourth quarter of 2012 compared with the previous three months. Our biggest concern is the trend in corporate profits which has been the rock upon which the bull market has been built. In the fourth quarter of last year, earnings per share of companies in the S&P 500 grew at an annual rate of 6%. The growth rate is expected to be just 1.2% in the first quarter of this year, and 0.1% if financial companies are excluded. Not surprisingly, analysts are expecting profit growth to accelerate in the second half of the year. But if this outlook proves optimistic, stocks could falter.

Despite these concerns investors have chosen to emphasize the positive. The narrative widely touted is that "tail risk" has been avoided and that equities look better than the alternatives. That is, the probability of a serious negative event is much lower, primarily due to the actions of the world's central banks. We've written quite a bit about our Federal Reserve and the European Central Bank supporting stock prices through their various programs collectively referred to as quantitative easing. More recently, the Bank of Japan (BOJ) has joined the party. Japan's new Prime Minister Shinzo Abe is agitating the BOJ to get more aggressive to revive their moribund economy by targeting a higher inflation rate of 2% and committing to an open-ended asset-purchase program. Furthermore, Abe unveiled a $116 billion economic stimulus package that the government says will lift gross domestic product by 2% and create 600,000 new jobs. It is not unreasonable to believe the bull market will continue as long as the central banks of America, Britain, Europe and Japan keep buying assets.

There are other positive factors supporting stock prices. On balance we see the fiscal cliff resolution as a positive. Although the very wealthy will pay higher taxes, it shouldn't be enough to hurt their spending habits and the overall economy. For most individuals, the tax rates on long-term capital gains and dividends, as well as federal income tax rates for 2013 will be the same as last year and are now permanent, along with a permanent patch for the alternative minimum tax. Slowly but surely economic fundamentals are improving: US jobless claims dropped to 5-year low, housing starts surged 12.1% in December to a near 5-year high, and household debt, which peaked at almost $13 trillion in 2008, has fallen to $11.4 trillion as mortgage debt has declined. U.S. households are feeling better as their net worth rose to $66.07 trillion, the highest level since the fourth quarter of 2007, according to a Federal Reserve report.

On one hand we've come a long way from the depths of the financial crisis, but on the other hand, the stock market is still trading at a level it first reached 13 years ago. Will the third time be the charm? Conditions are much more favorable this time around(see Chart). The big difference is that valuations are attractive, especially for high-quality, dividend-paying stocks. While there is less value than a year ago and we expect volatility to increase, the stock market remains an attractive place to invest.


***The chart (right) views the market from a valuation perspective. While the markets have returned to levels reached pre-financial crisis, earnings for the same companies in the market are much higher than they were at that time.***

***Jim Tillar, CFA Steve Wenstrup***

## Yardeni Research Blog

**March25, 26. 2013**

**The US economy doesn't stink. In fact, it is reasonably strong.**

**F**ed officials, particularly the dovish ones calling the shots, are clearly preparing the financial markets for the phasing out of QE. That was obviously the intent of NYFRB President Bill Dudley on Monday when he delivered a speech titled "The Economic Outlook and the Role of Monetary Policy." He has been an early and leading advocate of QE. However, for the first time he talked about "dialing back" QE.

I believe that the bull market can survive the phasing out of QE if the US economy continues to strengthen, which is the only reason why the Fed would do so in the first place. A strong case can be made that the bull market of the past four years has been directly tied to the Fed's purchases of fixed-income securities.

I have also related the bull market to our Fundamental Stock Market Indicator (FSMI), which continues to rise to new cyclical highs. We may be reaching an inflection point where bad news out of Europe and the prospects of less QE from the Fed aren't bearish for stocks because the US economy is fundamentally sound, which is bullish for stocks. Yesterday's fundamentally sound reports on durable goods orders and home prices helped boost stock prices. Enjoy your Spring Break! We will be back on Tuesday.

Today's Morning Briefing: Give Us Your Tired Rich. (1) Never mind. (2) The Dutch finance minister is new on the job. (3) Cyprus is very special to Russians. (4) Putin's threat. (5) There will be repercussions. (6) The US dollar, stocks, and real estate are all safe havens for wealthy foreigners. (7) Dudley is ready to dial back. (8) Phasing out QE should be bullish for stocks. (9) Focus on S&P 500 housing-related industries.

The next big positive surprise in the US economy is likely to be that federal tax receipts are increasing faster than expected. That would certainly help to improve the budget deficit outlook and might make it easier to achieve at least some modest bipartisan agreements to lower the structural deficit and to reform the tax system.

I monitor the Treasury's daily data on federal tax receipts and deposits for individual and payroll taxes as well as for corporate income taxes. The daily data obviously are very volatile so I smooth them out with 260-day moving sums, which closely track the Treasury's monthly data on a 12-month sum basis. The Treasury's deposits of withheld income and employment taxes rose to a new record high on March 22. Corporate income tax receipts are the highest since February 2009