

The S&P 500 erased all losses from the financial crisis and rose to within 1 percent of its high, gaining 131 percent from its lows and 10.75% in Q1 2013. The index trades at 15.4 times reported earnings, below the average of 19.9 in bull markets since 1962 (Bloomberg). While almost \$20 billion were added to U.S. stock funds this year, the amount is just 3.5 percent of the withdrawals since 2007 and compares with \$44 billion placed with fixed-income managers in 2013. Institutions have been the main beneficiaries as individual investors remain doubtful over the question whether this rally is too dependent on Federal Reserve stimulus which is maintaining target interest rates at almost zero and is purchasing \$85 billion a month in treasuries and mortgage bonds to stimulate the economy.

Our equity outperformance in Q1 was based on individual stock selection and themes. We limited investment exposure to the overall market by adding a few exchange-traded- and closed-end funds to diversify risk especially in fixed income investments.

#### Credit Markets not a bargain anymore

Rising interest rates more than offset modest spread tightening, leading to a negative 0.122% total return of the Barclays US Agg TRA Index in Q1. We view the corporate bond market to be fully valued at current spread levels and expect returns in the low- to mid-single-digit range this year. While we expect the strong technical factors supporting the corporate bond market to lead to some upside in the short run, credit spread levels are unlikely to tighten meaningfully from here. Demand for corporate bonds is likely to remain especially strong as investors continue to invest new money into the fixed-income markets. The new issue market reached record levels in 2012 but could not keep pace with investor's demand. We doubt that structured credit vehicles, such as collateralized debt obligations and investment vehicles, or CDOs, which performed poorly in the credit crisis, will re-emerge in the foreseeable future, leaving fewer investment alternatives for institutional investors and, thus, increasing demand in corporate bonds even more. We expect the market to continue to respond favorably to demand over the long term, however, fundamental considerations resulting from the impact of the sequestration on domestic growth could eventually adversely affect issuers' credit strength in 2013. Companies that have the wherewithal to expand capital expenditures and infrastructure investments to take advantage of competitors will most likely be the winners, particularly in sectors like basic materials, finance, energy and consumer cyclicals.

#### Europe taking time

In the first quarter the S&P 500 Index far outpaced European markets which were up 3% and the decline of 4% in Asia (ex Japan). A potentially weak government and increasing unwillingness to adhere to austerity measures required by the ECB in Italy due to the unclear recent election results, and German election in fall are likely to limit core Europe's willingness to innovate across alternative policy-making fronts. We are worried about both an ECB and core European policy vacuum in coming months. A return to positive economic growth has also been delayed until to the second half of the year, mostly due to an ongoing breakdown in credit transmission. The longer this continues, the more likely it is to challenge debt sustainability metrics and weaken investor appetite for peripheral Eurozone bonds, which is negative for growth. The confluence of these three factors, a political vacuum, reversal on policy and disappointing growth, are a reminder of the 2010-2012 years and need to be monitored closely. We also think the continuing growth in nonperforming loans in Spain and Italy will most likely lead the markets to further question the stability of many European banks.

#### Federal Reserve staying its course

The Fed will continue its economic stimulus program until either the unemployment rate reaches 6.5% or inflation 2.5%. The Fed anticipates a slight

uptick in inflation to a range of 2.3% to 2.7% and expects the unemployment rate to be in the range of 7.3% to 7.5% in 2013. To avoid market disruptions the Fed is likely to gradually reduce its monthly purchases of bonds and hold its bond positions until maturity to avoid losses on its bond portfolio, and prevent a rapid rise in borrowing costs as interest rates climb. The Fed finances the expansion of its portfolio by creating bank reserves and while it gained the ability to pay interest on these reserves in 2008, they have never used it to tighten policy. We expect bond purchases to start tapering off in Q4. Under this scenario the yield on 10-year Treasuries is likely to remain between 1.8 percent and 2.25 percent this year. Furthermore, we think that federal spending cuts, moderate credit expansion and a stronger dollar will keep long-term rates (over 10 years) from exceeding 3% in 2013.

#### Corporations invest in growth again

S&P 500 companies currently generate earnings equal to 6.5 percent of their share prices, about 4.5 percentage points more than the 1.8% yield on 10-year Treasuries (Bloomberg). Per-share earnings are estimated to reach \$109.50 this year from \$61.84 in 2009. Corporations are holding more than \$1.7 trillion in liquid assets (Bloomberg), reflecting uncertainty over future policies. Only 80 percent, the lowest ratio since 1958, of their available internal funds are invested in capital projects. Corporations not only stepped up efficiency, but more than four years of the Federal Reserve's near-zero interest rates have led to a large scale refinancing of companies to pay off high-cost borrowings. Last year, U.S. corporations issued more than \$1.5 trillion in debt, up from \$1.2 trillion the year before. Although EPS growth will continue to be partly driven by non-fundamental factors such as share buybacks and merger and acquisition activity, corporations are increasingly shifting from insuring their financial future to growing their businesses, which should bode well for earnings in our opinion.

#### Outlook

The U.S. economy is better positioned and growing faster than many other developed economies. Longer term advantages for the economy are new-found supplies of oil and gas, low electricity prices, more available land for construction and mining, an improving auto industry, the relative strength of the U.S. manufacturing industry, and a noteworthy housing market recovery. As the U.S. economy continues to show improvement while the weakness in Europe and uncertainty in Asia persist, there are attractive risk/return opportunities in the U.S. equity markets. Although the stock market is at an all time high, the relative absence of private investors indicates that there is ample liquidity to continue to support this rally. Correlations among asset classes have started to decline from very high levels. In our opinion this trend will continue as economic and market performance has meaningfully diverged during the first quarter. It is therefore time to be selective. We will continue to focus on specific stock opportunities and interesting long term themes, such as an improving picture for U.S. energy independence.

The most undervalued sector is basic materials, a sector that should do well when the economy in Europe starts to turn around. Energy remains also materially undervalued. After years of depressed gas prices the market is recovering and the U.S. natural gas theme is particularly compelling. Real estate is overvalued by 7% on average as fixed income has become less attractive and investors are searching for yield. Commercial real estate trusts are however still fairly valued. Caution is warranted in Financials as troubles in the finance industry in Europe may well affect U.S. global banks. Broadly diversified asset managers with solid equity and fixed-income franchises, exchange-traded fund (ETF) platforms, and the ability to offer exposure to international markets, however, will likely continue to do well in this sector.

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