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CONFERENCE RECAPS:

Forecast: Tailwinds with the ever present chance of headwinds.

As 2013 began the economy and equity markets benefitted from an uptick in housing and automobiles, some real resolution of fiscal policy and very accommodative monetary stimulus on a global basis. However, as this current quarter began we continued to face global headwinds outside the U.S. which could result in bouts of market volatility. The strong market move in the first quarter of 2013, combined with complacent performance chasing sentiment and potentially a disappointing earnings season may leave us susceptible to a pullback in the near term, but the longer-term views remains solidly constructive. I will use this letter to highlight the thoughts and forecasts of the many industry leaders I had the privilege to listen to and see during the first quarter conference season.

MAJOR TAILWINDS

Risks are receding. For sure, analysts have been talking about the gradual decline in the perceived risk of a recurrence of the "Category 10" financial earthquake of 2008 since they first took equities to overweight back in the spring of 2009. This remains a key theme. About once a year since, we've had some form of aftershock that at first was thought to be "the next big one:" Greece Crisis I, 2010; Greece Crisis II/U.S. Fiscal Crisis I, 2011; Spain/Italy Crisis I, 2012; U.S. Fiscal Cliff II, November 2012. Every time we go through one of these and the bottom doesn't fall out of the world, investors become a little more convinced that the "one-in-a hundred" event of 2008 ***really was*** a "one-in a-hundred" event. And when this happens, they creep a little bit further out of the risk cave, and the multiple they're willing to pay for equities goes a bit higher. At 1,500 on the S&P, equities are roughly priced at 14.5 times earnings; strategists see them going back to a more normal 17 or 18 times as risk concerns recede. But for this year, even with sluggish earnings, we can get to 1,660 with just a point or two of earnings-multiples expansion.

"Don't fight the Fed, ECB, BOJ, BOC and every other central bank in the world." Globally synchronized central-bank easing is providing fuel for growth and a backstop to potential crises. It's difficult to be out of equities when the central banks are all in.

Housing moves from zero to hero. What arguably was the biggest private-sector drag a year ago has become one of the biggest catalysts, with year-over-year home sales up sharply (2012's increase in new-home sales, was the most since 1983), housing starts and permits are at four-year highs, home prices on pace for their first annual increase in six years, and the gauge of builder sentiment also is at a six-year high. The multiplier effect should not be overlooked, as higher home sales and prices also drive construction, remodeling, furniture and furnishings, jobs, etc. The only concern appears to be a supply issue-inventories are so low some buyers are having a hard time finding homes, a near-term drawback with positive long-term implications as the market moves to catch up to demand.

U.S. manufacturing renaissance. Fueled by cheap and abundant sources of domestic energy (more below), stagnant wages and productivity-enhancing investment-and by opposite trends in Asia, where wages, land and other input costs are rising-American manufacturing is experiencing a resurgence. As Barron's reported last month, companies with global operations such as Apple, Caterpillar, Ford, General Electric and Whirlpool are expanding production back home again. Foreign companies are doing the same-Samsung and Airbus are building huge new plants here and Toyota is now exporting minivans made in Indiana to Asia. This is a trend that in many ways is just getting started.

U.S. energy production moves toward self-reliance. Manufacturing's domestic resurgence is being fed and in some ways led by a surge in U.S. energy production. Fueled by technologies that have allowed energy companies to tap heretofore unreachable large pools of oil and natural gas trapped in shale, U.S. energy production and supplies are expected to outstrip domestic demand by the end of this decade. Not only is this creating a huge cost advantage domestically-natural gas prices here are about a third of those in Europe and a fourth of those in Japan-it is helping abet manufacturing growth as companies further up the energy production supply chain (i.e., steel pipe fabricators, industrial fittings makers, etc.) rush to supply the natural gas producers as energy companies ship output to other countries.

China soft lands and then takes off. The world's second-largest economy surprised in the fourth quarter as GDP growth accelerated to a better-than-expected 7.9%, ending a two year string of declining growth. While there is debate about whether China will attain the pre-slump double-digit growth of the past decade, there's little doubt the pace of expansion is picking up, aided by a healthier and more sustainable mix of both external and internal demand, the latter being led by a rapidly growing middle class and new wave of government infrastructure spending.

Brazil reaccelerates. The economy in this leading Latin American country slowed to a crawl last year, with GDP expanding by less than 1%, in large part because its export-oriented economy felt the drag of China's slowdown and the Eurozone recession. But unemployment remains near historic lows, its fiscal situation remains solid and inflation remains somewhat subdued. With China picking up and global tech and energy companies planning expansions, Brazil's economy is projected to perk up this year and next, as the country prepares to host the 2014 World Cup and 2016 Summer Olympics.

Individuals reallocate back to equities. This may be the biggest catalyst for the market this year-and potentially years to come. After essentially abandoning equities after the dot.com collapse and global financial crisis, individuals in recent months have begun dipping their toes back into the equity waters. The New York Times, citing Lipper data, said nearly $15 billion flowed into all stock-focused mutual funds the first three weeks of the year, the most in any three-week period since 2001. Mutual funds focused specifically on American stocks collected nearly $7 billion the same period, the most in all but one comparable three-week span since the 2008 financial crisis.

POTENTIAL HEADWINDS

European sovereign debt crisis and recession. The promise of bond purchases by the ECB has driven down borrowing costs for problem countries and bought policymakers time, but it cannot solve the underlying problems in Europe. Austerity measures are serving only to weaken growth further and cause higher unemployment and social unrest. After how it dealt with Cyprus, there is again risk of policy error in Europe. We are also closely watching the Italian elections in June after February's elections were inconclusive.

U.S. policy uncertainty continues. After passing the fiscal cliff compromise to start the year, Washington passed a short-term extension of the debt ceiling and more recently agreed on a continuing resolution to avoid a government thus down. The sequester, which was temporarily delayed as part of the fiscal cliff deal, went into effect on March 1. The automatic spending cuts have not been felt by most, but it will soon start to show up in the second quarter and will shave an estimated 0.5% from GDP. In addition, the debt ceiling will need to be addressed again this summer.

Geopolitical Risks. Recent events in North Korea are cause for concern. Iran remains a threat.

Terrorism. Is both homegrown and generated from those outside the country. Including threats on individual companies, attacks via computer hacking. Attacks on the energy sector, the financial system, and unfortunately those on a mass scale like 9/ 11 and smaller target incidents such as Boston.

BEHAVIORAL FINANCE

Since 2008 I feel it is important to remind investors of their longer term goals in the face of rapid-pace financial sound bites. We continue to be bombarded with news raising concerns about the U.S. economy, the Eurozone, China, the domestic political impasse and all manner of other problems. We are not sure things are more uncertain than they have ever been, but people and markets remain anxious. While markets have decidedly improved and market volatility has subsided. it is hard to forget the recent past, although 2008 and early 2009 are now more than four years removed. Yet, there remains a heightened awareness of uncertainty which colors investors thinking today. It is a fact that can't be avoided.

So, how are investors to proceed in the midst of continuing uncertainty? You can't really ignore it. but we spend a lot of time worrying about things that, with 20:20 hindsight, don't turn out to be important. As an advisor to my clients, I must remember that clients' investment profiles are looking out years or even decades. "Begin with the End in Mind." For long-term investors, "the End," is usually a comfortable retirement or family wealth objective. Ordinarily, this requires investors to grow their portfolios over long periods of time and, historically, the way to do this is to invest in stocks. Investing in publicly traded companies, within the context of an intelligent long-term investment program, remains a proven way to build lifetime financial security.

So, over long periods of time. it's about investing in the long run rather than the short run. If you are an investor. it is all about making decisions in context of your long-term plans. To be comfortable with this position, you have to have clarity about your long-term goals and confidence in your long-term course of action so that you can control your emotions and think rationally during the short-term ups and downs of the investment markets. So, in my view, it's much simpler to stick with a plan than to make ad hoc investment decisions in the face of the constant pounding of the day-today news.

So, as we look back, over the past few months and years, we see that despite the recent rise and fall of the so-called new economy, the internet bubble, the financial crisis, the increased threat of terrorism and the increasingly linked global economy, the tried and true tenets of long term investing continue to make sense and withstand the test of time. Invest for the long-term. Diversify your portfolio. Avoid market timing. Expect markets to rise. Expect markets to fall. Don't expect miracles.

As we all have experienced, this advice is easier to give than to follow. But, if you can keep a long term perspective, you may be able to avoid overreacting to events. In all events. I'm here to help you with the process and I am always willing to work through any questions or issues you may have. Please don't hesitate to call. I hope I hear from you soon.

Sincerely,

Gary J. Najarian