RITTMANN

Capital Management

Q1 2013 Commentary

Note to Clients:

Amid a choppy economic recovery, the first quarter of 2013 saw market averages continue to reach new highs as investor confidence stayed strong. This occurred despite concerns with the payroll tax increase, the budget sequester, and the notion that the Federal Reserve might stop the easing by the end of 2013. Investors appear to be less concerned with the health of the economy.

So far in 2013, there has been a marked change in investor behavior. For much of the past year, investors were focused on risks and what could potentially go wrong. But in 2013, it appears we have turned a corner to actually focus on what can go in the right direction.

During periods of uncertainty (the unfolding of our domestic financial crisis, political wrangling, and the European debt crisis), there were wild stock price gyrations as investors swung from frantic selling to bursts of buying and governments moved to stem a crisis. So far in 2013, there has been a big drop in volatility. This may be attributed to the fact that most major central banks are committed to "easy-money" policies, the belief that our economy is actually improving and that overall investor confidence is improving. We are in a much better place right now than at this time last year.

Since the Fed initiated its Quantitative Easing Part 3 (QE3) in September of 2012, equities have rallied, job growth has strengthened and consumer confidence is building. In addition, much of the optimism is based on the economy's resilience in the face of two major hurdles….first, the tax increases resulting from avoiding the fiscal cliff, and, then, the sequestration spending cuts that began to take effect at the beginning of the March. If the economy can withstand these two punches, it has some legs!

It is also interesting to note that never before have labor dynamics have been so important in Fed policy making. Much of the Fed's "easy money" policies have been driven by the outlook on the labor market. The Fed Chairman continues to see the "easy money" policy lasting through 2013 and does not see an "equity bubble" forming. Corporate earnings and dividends are rising and investor demand for equities has been rising, both positive for stocks. Also, bond yields are low, another good reason to be in the market. The Fed's efforts have definitely enabled the market to move higher and valuation wise, the S&P 500's price-to-earnings ratio is at about 15, right around its historical average.

There are signs that some of the developing markets' economies are improving, Fears of the Chinese economy's hard landing have subsided, and it is beginning to show growth. Many do not realize that China grows its economy by moving people from the farms to the cities. City working Chinese workers contribute six times more to GDP than a country worker, and when you move 10 to 20 million people to cities each year, that has enormous positive impact on China's GDP. This population mobility should continue for years to come, so the Chinese economy can withstand many positive or negative micro and macroeconomic forces over time and still be in growth mode.

Europe is inching out of a recession, albeit barely. Europe has a severe credit crunch, and it will take more than the normal business cycle inherent forces to get back on track. It will require coordinated policy responses as well. That is where the difficulty arises as the European countries don't always agree on what policy is best.

Domestically, the Fed is still in a low interest rate mode, housing is booming, and corporate balance sheets are in the best shape in years. Economic growth will remain choppy, and the job markets, while improving, are still challenged in the near term. We are adding jobs across all industries, and more high paying jobs, but we will need more jobs to create sustained economic growth. After two good months of job growth, we saw a dip in March figures, something we will keep monitoring. It appears as if the payroll tax increase that took effect in January may be starting to hurt hiring and spending.

The housing market recovery will propel economic growth, fueled by spending on everything from appliances to furnishings and other personal items. After nearly five years, it is nice to see strength in many American's most important asset.

The renaissance in domestic energy production continues, and will not only help our nation eventually become energy independent, but it will also create many new jobs. Also, the low cost and plentiful shale gas energy will help the economy grow its manufacturing base like it has not seen since the beginning of the century. Our electricity costs are half what our global peers pay, a huge competitive advantage from which we are just beginning to see the benefits.

The quarter was not without downside. Energy and technology sectors lagged the major averages. Energy stocks underperformed the averages due to tepid global oil demand and a steadily improving domestic supply. But oil is still trading in the $90-95 dollar range and that is very good for the companies that are in our portfolios.

Technology stocks were also weak during the first quarter. Several large-cap technology companies had earnings shortfalls, and that spooked the entire technology sector. However, there was overwhelming positive commentary from many companies regarding their forward sales pipelines and expectations for an acceleration in new business growth in 2013 and beyond. The overhang from the end of year fiscal cliff situation prevented companies from firming up information technology budgets, and as a result, budgets were set much later than normal. We saw that many large deals were pushed out into later months. So while results reported in the first quarter were somewhat underwhelming, we should see corporate IT spending weighted to later quarters more than normal.

With risks abroad and interest rates near zero, some have coined this rally the "TINA" market – There is No Alternative to U.S. stocks as a place to store your money.

We are still positive on the stock market and continue to believe that valuations are attractive. U.S. interest rates remain at historically low levels, and the fixed income markets offer limited returns. The combination of the improving housing and labor markets and a booming energy sector supports tailwind moving the market higher.

We hope that the market performance continues into the second quarter of 2013.