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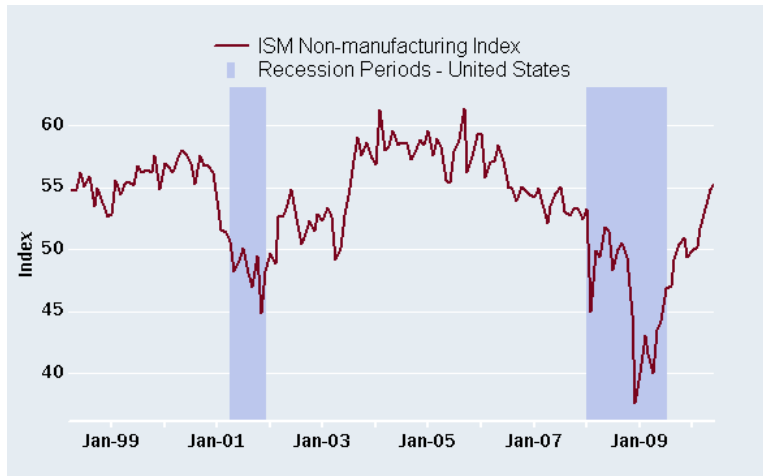
**Market Insight:
Is the Rally Sustainable?**

With the Dow hitting a record high and the S&P not far behind, there has been a barrage of media coverage from the financial experts to main-street Mom & Pop, offering opinions as to the sustainability of this rally. Fund flows have picked up and the US economic news has been generally positive and above expectations. However, Europe remains mired in recession and China's personal debt build-up is constricting growth. What will drive the market higher from here and what are the biggest risks? This week's Market Insight considers key factors on both sides of the argument, but draws a decisive conclusion.

Key Positive Factors Supporting the Global Markets:

- 1) Don't Fight the Fed. No doubt about it, the Fed is doing all it can to encourage financial assets to rise. With all types of fixed rate assets from CD's to long term bonds guaranteeing negative to zero real return (after inflation), investors are starved for another source of return. Hence, housing and equities are the benefactors.
- 2) Improved Housing market creating a 'Wealth Effect'. With inventories low, housing prices are beginning to rise again. Homeowners no longer live in fear of losing wealth, giving them confidence to spend again.
- 3) Housing set to contribute to job growth. 700,000-800,000 in new jobs will come from a strengthening housing market. This increase in employment is expected to add 1% to GDP.
- 4) Investors Neutral to Underweight Stocks. A combination of fear and fiscal uncertainty continue to weight heavily on investors' appetite for risk. After a decade on no return on equities, investors are just now beginning to regain confidence in stocks.
- 5) Bank of Japan to promote growth. Finally, after tolerating a decade of deflation, the new Prime Minister, Abe, is prompting the BOJ to move aggressively to improve growth and is changing its inflation target to 2%.
- 6) European Central Bank's bond buying program. Similar the US Federal Reserve's QE program, the ECB action is providing a 'safety net' to the credit markets and staving off downside risk.

- 7) US Manufacturing continues to crank higher. The Institute of Supply Management (ISM) Manufacturing Index is back near pre-recession levels, indicating continued expansion. (See chart below)



Key Negative Factors:

- 1) European growth is still declining. Eurozone GDP fell -0.6% in the fourth quarter. Unlike the US, the European Manufacturing Index is still falling, down to 47.9, indicating further contraction and drag on global growth. (Above 50 indicates expansion; below 40 indicates contraction)
- 2) China is no longer the main engine of growth globally. Industrial production gained 9.9%, the slowest since 2009 and retail sales growth is only 12%, the weakest since 2004. Meanwhile, inflation continues to accelerate. According to Schwab's economist, "China's economy is (now) more reliant on debt than in the past to generate growth, a potentially unsustainable situation." (Chart below show's China's Government Spending)



- 3) Rising Rates. The bond market is anticipatory, meaning it looks ahead typically 6-9 months ahead and predicts potential inflation and Fed action. With the recent improvement in US economic data, longer-term rates have already begun to rise slightly. The US 10yr treasury rate has risen from 1.5% last fall, to 2.3%. If data continues to strengthen, rates could easily rise to 2.5% and on their way to 3%. Of course, rising rates would pull the rug out from under the housing recovery.
- 4) North Korea Nuclear Threat. A wild card that could potentially and instantly change world dynamics. Both their increasing ability to reach further with nuclear weapons and their favorable relationship with China make this threat real. This factor has been an ongoing concern for many years.

Conclusion: With out any major shifts in the negative factors, the positive factors will likely continue to dominate and present a friendly, supportive investment environment that should continue through the end of this year. Of course the only thing that is certain is things will indeed change! As such, continual monitoring of these events and assessing new potential risks is both prudent and necessary.

Investment Strategy: Given the improving fundamentals over the last two months, portfolio allocations have been adjusted in two ways: Risk positions have increased toward upper bands of each client's risk range; asset mix has changed, decreasing exposure to Corporate Bonds and increasing exposure to Stocks.

Please contact me with any questions or concerns.

Kind Regards,

Barbara

Barbara HS Huff
CEO & President



614-216-6139
www.newalbanyinvestment.com

