MARKET PERSPECTIVE

APRIL, 2013

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"The average long-term experience in investing is never surprising, but the short term experience is always surprising. We now know to focus not on rate of return, but on the informed management of risk."
Charles D. Ellis, world-renowned investment consultant, author and professor

IN VIEW: The Economic Landscape

As we contemplate the risks of investing in 2013, the macro-economic landscape still dominates investor perceptions.

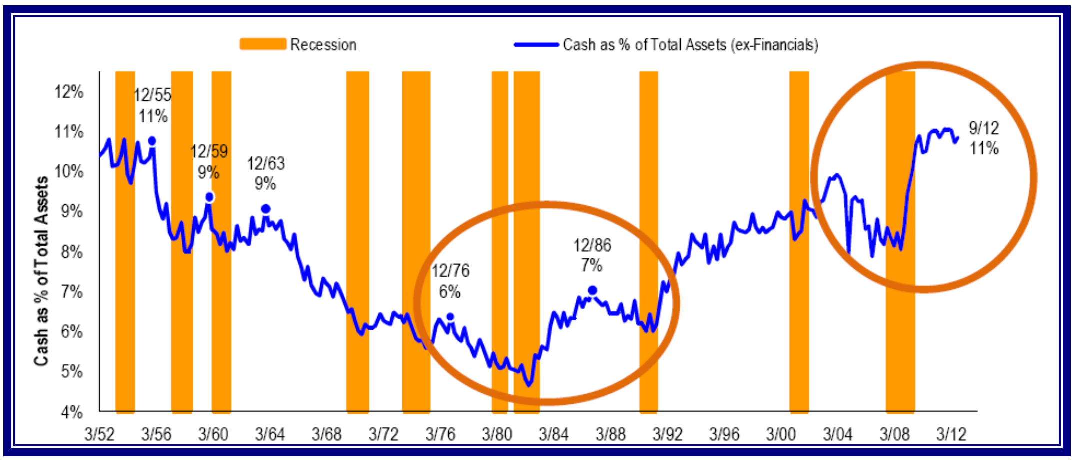
The improvement in financial markets in 2012, and so far in 2013, has been primarily caused by quantitative easing by the central banks with the hope that rising asset prices will result in stronger employment, higher spending, and generally faster economic growth rates. About forty central banks, following the Federal Reserve's lead, are engaging in monetary expansion coincident with policies of fiscal austerity measures being applied to rein in widening deficits. Despite offsetting headwinds from fiscal consolidation, regime uncertainty, and southern Europe's on-going deleveraging, our global growth projections remain relatively steady at 3.1% and rising a full percentage point in 2014. We reiterate that the U.S. GDP forecast will resume the 2.5% trend-line growth rate in the back half of this year.

In Europe, where fiscal policies are extremely tight, most countries have fallen back into recession. In the United States, where fiscal austerity is being applied for the first time in 2013, growth is expected to be 75 basis points less than it otherwise would be without fiscal restraint. On a quarter-to-quarter basis, economic growth was .4% in the fourth quarter of 2012 versus 1.7% for the year. China, in contrast, continues to experience high single-digit growth. Since inflation picked up in February, China is less inclined to maintain an expansionary monetary policy. For the U.S., however, Chairman Bernanke of the Federal Reserve has reiterated that monetary easing (QE3) through the purchase of $85 billion of treasuries and mortgages will continue until 2015. He has stated that some variability of the purchases may occur depending on changes in inflation or unemployment. The policy of maintaining interest rates close to zero with the federal funds rate at 0 to 25 basis points will also continue, despite the potentially negative effect on savers and pension funds who have been unable to earn an adequate rate of return on their assets.

The impact of austerity policies in Europe and the United Kingdom can be measured by the effect on industrial production. In the Euro zone, industrial production contracted. In the U.S., where some austerity is in its early stages, namely the $212 billion in additional taxes, industrial production year over year increased to 3.5% in March versus 2.5% in February. However, the sequester is expected to add $85 billion of contraction by end of September. Overall, the Federal Reserve has estimated that economic growth may be reduced by as much as 1.5% in 2013, because of fiscal contraction which is about the same level estimated by the Congressional Budget Office. We believe that these figures are far too negative. The first quarter rate of real GDP growth is running currently at 2.5% versus the prior quarter's rate of .4%, with personal consumption at 3.2% and inflation modest at 1.2%.

Overall, while many U.S. economic statistics are improving, such as capital goods orders, consumption, employment, industrial production, and housing, investors are still quite cautious with respect to the effect the austerity measures will have on economic growth. Trade growth has been slowing because of the recession in Europe which accounts for 20% of global GDP. The U.S. government sector, particularly at the state and local level, has also had a negative effect on economic growth. According to some employers, particularly small business owners, such factors as the Obama-care tax and extended unemployment payments are presenting additional challenges in hiring new workers. With unemployment close to 7.5%, the working force as a percentage of the population remains consistent instead of growing, as it normally would during an economic recovery.

Not only are corporate profits back to pre-recession levels, balance sheets have also strengthened, having increased the level of cash as a percentage of total assets. Many companies in turn are returning that cash back to shareholders in the form of increased dividends.



Source JP Morgan and Federal Reserve Flow of Funds

We are maintaining that corporate profits grow 7% in 2013, although many companies involved in international trade have reported lower profits in recent months. We believe that inflation will remain moderate at 2%, as measured by the CPI.

The Outlook for the Financial Markets

The U.S. seems to remain the country of choice and stability in a very uncertain world - with Europe in a recession, the Middle East in turmoil, and China facing a new government along with political concerns regarding environment degradation and growing income inequality. It is understandable that the U.S. can be viewed as a relative haven, despite the political divide in Washington concerning our fiscal difficulties.

Commodities in general have fallen as many global economies have weakened over the past year. Copper fell as much as 15% since the start of the year, mainly because of China's slowdown from a very rapid pace and Europe's recession. Oil ($92 per barrel) is down 11% from a year ago, but flat from levels in early January. Gasoline was an exception, due to refinery problems in blending new formulations under EPA regulations. However, in recent weeks it too is now falling. Overall, there is a modest weakness in commodities despite widespread currency depreciation in many countries, particularly in Japan. The new government is dedicated to depreciating the Yen in order to overcome the deflation of recent years by setting a target of 2.0% inflation. Japan's debt-to-GDP ratio is 260% which could become a potential problem if the government continues in this direction.

Despite these crosscurrents, our current asset allocation remains fairly bullish with equities at the high end of our range (70%) for balanced accounts. Although we are concerned about the global slowdown in the face of widespread central bank monetary expansion, against the backdrop of fiscal austerity programs, we are compelled based on attractive relative and absolute valuations to stay the course.

A Bullish Case for Equities

⇒ The Federal Reserve is expected to remain accommodative throughout the year as long as inflation remains range bound and unemployment improves.

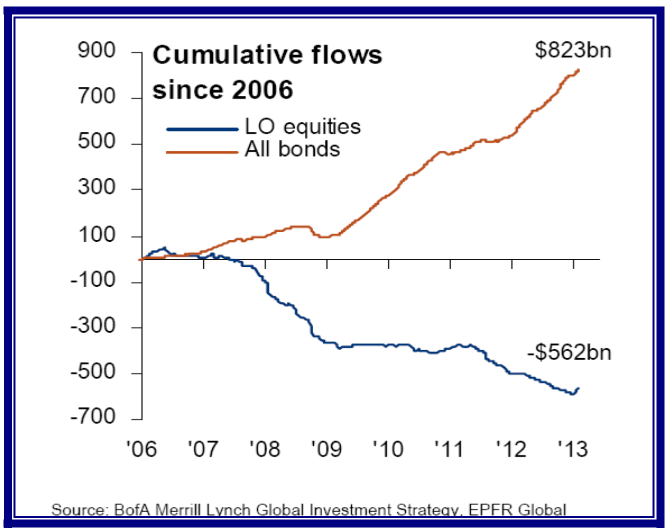
⇒ The wealth effect from rising home prices and corporate cash continues to bolster consumer confidence.

⇒ Corporate profits are at all time highs but valuations lag.

⇒ The current bull market is in its 5th year offering a compelling perspective on historical standards.

⇒ Volatility has returned to normal levels.

⇒ Fund flows from stocks into bonds that began in 2008 present a buying opportunity in stocks as the money flow gradually returns to the stock market (see chart below).



⇒ At its current price, the S&P 500 Index is at 14.4 times our $110 per share estimate of earnings for 2013. In contrast to the last stock market peak in 2007, the S&P 500 book value, sales and earnings are up substantially at 25%, 23% and 18% respectively. The equity markets continue to offer an attractive investment alternative to fixed income or cash.