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Quotes:

Economics is extremely useful as a form of employment for economists.
John Kenneth Galbraith

I never attempt to make money in the stock market. I buy on the assumption that they could close the market the next day and not reopen it for five years.
Warren Buffet

As a bull market continues, almost anything you buy goes up. It makes you feel that investing in stocks is very easy and safe and that you're a financial genius.
Ron Chernow, author

The government deficit is the difference between the amount of money the government spends and the amount it has the nerve to collect.
Sam Ewing, athlete

Market Recovery: Are We There Yet?

Economists worried at the beginning of the year that our expansion might be stopped in its tracks by the antics taking place in Washington and the resulting triple threats of the fiscal cliff, sequestration, and the debt ceiling impasse. Instead, the economy has now chalked up its 45th consecutive month of growth, with both the Dow Jones and the S&P 500 finishing the quarter at all-time highs.

Index	3/31/2013	YTD
Dow Industrials	14,578.54	11.3%
S&P 500 Index	1,569.19	10.0%
Russell 2000	951.54	12.0%
MSCI EAFE	1,674.30	4.4%
Global Bond Index	456.91	-2.2%
10-Year Treasury yld	1.85%	

Finally! After nearly 5½ years, we're back to 2007 market highs. Right? Has it taken that long? Exactly what do these new highs mean — and more importantly, what do they mean to you?

The obvious good news is that rising markets drive your portfolio values higher. Most investor portfolios, even widely diversified ones, have a healthy exposure to S&P 500 stocks and the broad market movement. So, you are probably seeing record highs in your portfolios, too.

During the previous expansion, the S&P 500 closed at its peak value of 1,565 on October 9, 2007. Over the ensuing months, the housing meltdown and the near-collapse of our financial system took the index down 57%. It bottomed out at 676 on March 9, 2009. From that point, it has been a steady four-year climb upward.

Simple math shows us that a decline of 50% requires an increase of 100% to regain full value. For the S&P, recouping a 57% decline means the index has risen 131% in the last four years. Some skeptics say that even though the numbers are back, 5½ years of inflation has taken a toll, and we still have ground to make up: between 9% and 11% more to go, depending on the inflation statistic. However, the other noteworthy nugget is that the generally quoted S&P 500 index does not include dividends. With dividends and inflation both around 2%, the adjustments cancel each other out.

For investors with diversified portfolios, all this is old news. What's really interesting is that this is where diversification really pays. Using a generic blended diversified model, a loss of 25% in 2008 only needed a 33% increase to regain its original value. Diversified portfolios did decline, but not nearly as devastatingly as the S&P 500, so the recovery was much quicker. For those diversified portfolios that remained invested, losses were fully regained by the end of 2010. Diversification feels slow when the markets are hot, but over the long term, the risk mitigation pays off.

Economic Improvement

Broadly speaking, the signs are everywhere: the economy is improving. Massive liquidity injections by the Federal Reserve have been the fuel driving the engine of economic recovery, and improving employment numbers are now sustaining economic growth. While initial claims for unemployment benefits are volatile, the underlying trend continues to move downward. Today, 1.7 million fewer Americans are receiving unemployment benefits than just one year ago. Growth in family income leads to improved tax revenue and lower annual deficits.

Increased hiring translates into an increased demand for housing: home builders report that they are struggling to keep up with demand. The inventory of homes for sale will now support only five months of activity, and builders are expected to construct 30% more homes this year than last. The resurgence of housing demand creates more jobs, as builders rehire laid-off construction workers. The increase in residential construction, this year alone, is estimated to generate nearly 400,000 new jobs and $20 billion in additional

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Safety in Numbers:
Passwords and Portals

Firestone is rolling out a new service for our clients: online access to your aggregated financial data through personal, private internet portals. You'll be able to view information about your accounts, receive reports through secure electronic transmission, and even send us documents.

We've done extensive security reviews of the service, and it has only one weakness: your own password, which you create yourself. Password hacking has reached epidemic levels in recent months, with particular focus placed on email passwords. Once an email account has been hacked, the compromised password is then used to access other accounts, especially bank accounts.

Whether you take advantage of the new service or not, please be vigilant with your security. "Password fatigue" tempts us all into reusing the same passwords for numerous sites, leaving us more vulnerable. Some excellent password managers are available to ease the burden.

Several clients have already suffered password breaches at major email providers including Gmail, AOL, and Yahoo. If this happens to you, please call us immediately so we can help you keep your accounts secure.

Economic Improvement

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wages. Beyond housing, the most recent report from the Institute of Supply Management shows manufacturing activity continuing to expand.

In light of strengthening economic data, the Federal Reserve has debated intensely over how long to maintain aggressive monetary stimulus, ultimately concluding that while the unemployment rate is dropping, the pace of the recovery remains underwhelming. We concur. The Fed is committed to maintaining current policy until unemployment falls to 6.5% or inflation ticks up to 2.5%. It may take several years to reach these targets.

In the meanwhile, the bright prospect of recovery now faces the threat of our own enforced austerity measure: the sequester.

Understanding the Sequester

To avoid default and settle the debt-ceiling crisis in 2011, Congress created the Joint Select Committee on Deficit Reduction (the "supercommittee"), tasked with making recommendations before Thanksgiving 2011 to cut $1.2 trillion or more from expenditures. If they failed, there was a backstop: the sequester, automatic cuts across the board, from defense and non-defense programs equally. Both political parties decried this as an onerous means to achieve deficit reduction, yet no agreement could be reached to avoid its implementation.

Sequestration took effect March 1, with layoffs and unpaid furloughs, pay cuts and reduced hours, service and staff cutbacks from Head Start to medical research to the FBI and the FAA. The sequester is a form of austerity, where spending cuts impede the economy's efforts to create new jobs. By most estimates, nearly 1 million fewer jobs will be created over the next two years, while the massive budget cuts could reduce GDP by an estimated half of a percent. With estimated growth at only 2%, this represents a quarter of potential economic gain.

The sequester is best described as a blunt — no, make that a jagged and rusty — machete whose only purpose is to cut the federal deficit. In its sole task of hacking spending to a smaller size, the sequester will be successful. But a smaller knife would have sufficed, and a scalpel would have been a much better tool.

In fiscal year 2013, the US is expected to run a budget deficit of $850 billion, equal to 5.3% of GDP. This is a staggering amount, but the deficits are actually decreasing. This will be the first year since 2008 that the budget deficit is less than $1 trillion. More significantly, it will be the fourth year in which the budget deficit as a percent of GDP will decline.

Will the Infection in Cyprus Spread?

Europe is still in recession and faces a difficult recovery. The Northern European countries are reluctantly bailing out the South, but the struggling countries can only roll over their outstanding sovereign debt with the guarantee of the European Central Bank. Austerity measures have been imposed as a condition of the bailouts, which further suppresses economic activity. Additionally, increased capital requirements are causing a credit crunch as banks call in loans to beef up their reserves.

The impact of Cyprus's problems is disproportionate to that country's size because of the painful precedent set for the Euro zone. Cypriot banks are broke. Unable to raise money via the bond market, the government declared that bank depositors would bear the cost of refinancing the bank — affecting even smaller, insured deposits. (In the US, our national deposit insurance pays depositors if a participant bank in any state becomes insolvent.) The Cypriot finance ministry quickly changed its tune after a wave of outrage, but the damage to global confidence in the stability of the European financial system has been done.

Even after the retreat, depositors in Cypriot banks still had to absorb some of the loss from the insolvency. With this precedent, other European countries face greater challenges to keep their depositors from losing faith in their banking systems, and the resulting fear and uncertainty creates another roadblock to Europe's recovery.

Changes in the Tax Code

We avoided the fiscal cliff in January, but Congress reinstated the 2% payroll tax which had been temporarily suspended in the attempt to get the economy moving again. Income taxes remain unchanged for most Americans, except for the top earners (married couples with combined incomes over $450,000 and individuals earning above $400,000) whose marginal rate increases from 35% to 39.6%. Capital gains tax rates increase to 20% for those same higher-income earners.