



## Bob's Corner

### Two New Teammates

We are excited to introduce Andy Peters (Account Executive) and Trisha Downing (Executive Assistant/ Office Manager). They are the two newest members of the All Star Team.

Andy comes to us after working for 4 years at Thrivent Financial and in a smaller financial planning firm in St. Paul. Andy will work side by side with me in meeting with clients & running our new 401K Asset Allocation Program. Andy is a University of Minnesota grad (2006) with a business & communications degree. He also earned 4 letters in baseball and won team MVP as the lefty pitcher for the gophers. Andy is single and just starting his CFP coursework.

Trisha has worked in the child care profession for over 10 years helping to run one of the most successful child development center chains. Trisha was raised in Grand Rapids, MN and graduated from Mankato State University (2003) with a degree in family life & child development. Trisha brings a very upbeat personality as the "President of First Impressions". I know you will enjoy your contact with her when you call or come in to our office.

**Thank you** again for entrusting your financial future with the All Star Financial team. We are dedicated to helping you Build Wealth & Retain Wealth. Looking forward to visiting with you all soon.

## An Impressive Show of Resilience

### MARKET OVERVIEW

#### Overview

2013 began with hand wringing over the so-called "fiscal cliff" and wrangling among lawmakers in Washington over the federal budget, debt ceiling limits and "sequester" budget cuts. In the end, taxes went up for most people and the first stages of actual spending cuts were implemented, but little changed regarding long-term federal government challenges.

Uncertainty about the future went well beyond our shores. Europe's debt problems regained center stage, as the tiny island nation of Cyprus required a bank bailout. New political leadership installed in Japan and China is adding uncertainty to the Asian region as well.

Despite all of these issues, stock markets turned in impressive gains. Domestic stocks were among the leaders, as investors appeared encouraged about slow but steady economic growth. Among the most promising signs were improvements in the housing and job markets.

Stocks have clearly been given a boost by continued accommodative measures taken by the Federal Reserve. Its policy of buying \$85 billion worth of bonds per month helped keep interest rates low. That encouraged consumers to take advantage of low mortgage rates and re-enter the housing market. Bond investors are less willing to accept yields on 10-year Treasury notes that remain below 2% and are stepping into riskier sectors of the fixed income and equity markets.

Central banks around the world are following the Fed's lead. The European Central Bank, the Bank of England and the Bank of Japan have implemented similar bond buying programs. This global flood of liquidity has encouraged investors to take cash off the sidelines and put it back into the stock market. Close to \$100 billion was poured into equity mutual funds and ETFs in the first two months of 2013.

### ECONOMY

#### The 1<sup>st</sup> Quarter

The economic recovery continues in the U.S., but at a plodding pace. Cuts in federal government spending were a contributing factor as 4<sup>th</sup> quarter Gross Domestic Product (GDP), the nation's primary measure of economic activity, grew at just a 0.4% annualized rate. Analysts anticipate a modest improvement to the 2.0% range in the 1<sup>st</sup> quarter.

Even so, a number of bright spots are emerging. The housing recovery is taking hold due to pent-up demand and reduced borrowing costs. Existing home sales rose 9% year-over-year and prices have risen by 11% nationwide. New home sales are up 12% and new residential construction jumped 28%, making up for a drop in housing supply in recent years.

The job market gained momentum as employers increased hiring. The economy averaged approximately 170,000 new jobs each month in the last 6 months. Unemployment has dropped to 7.6% from its recessionary peak of 10.0%. Job gains are occurring across the board except in the budget-conscious government sector.

Consumer spending, the main engine driving the economy, held steady with a 3.2% annual rise. Fears that the payroll tax hike and government budget cuts would dampen spending have not materialized. There are other concerns. Personal income is not keeping pace with spending, the savings rate has fallen and consumer credit is expanding for auto purchases and education loans. Consumers are demonstrating a degree of caution, as revolving credit remains flat.

Broad measures of economic activity show steady improvement. Industry capacity utilization rates stand at 79%, the highest in the post-recession era and a sign of potential future growth. Business confidence surveys show improved sentiment, though cuts in government spending could dampen that. Inflation remains a non-factor, up just 2% from a year ago.

### **Looking Ahead**

The economy is likely to continue slow and steady growth this year. Agreement on long-term budget issues in Washington might boost confidence, but that remains elusive. The Federal Reserve, however, remains committed to greasing the skids to keep the economy moving in a positive direction.

The best hope for more significant growth at a time when consumers are cautious and governments are pulling back is to see a jump in business spending. It was surprisingly strong in the 4<sup>th</sup> quarter, and a similar surprise in 2013 could lead to a more broad-based recovery.

## **BOND MARKET**

### **The 1<sup>st</sup> Quarter**

The Fed's desire to encourage bond investors to take on more risk had its intended effect in the 1<sup>st</sup> quarter. Corporate High Yield bonds gained 2.9% to lead broad-based bond sectors. Short-term bonds, mortgage-backed securities and municipal bonds generated very modest gains over the period. The broad Barclays Aggregate Bond Index declined 0.1% for the quarter.

A number of sectors suffered losses. Global bonds declined 2.1% and emerging market bonds were down 2.3% as major global currencies lost ground to the dollar. Treasury Inflation Protected Securities (TIPS) lost 0.4%. Even though the yield on 10-year Treasury notes rose just 0.1% during the quarter, the total return on Long-Term Treasuries was -2.3% over the first three months.

### **Looking Ahead**

Bonds have enjoyed an almost uninterrupted bull market for three decades as interest rates have steadily trended lower. That era may be coming to an end. Yield spreads between government bonds and other categories – high yield, corporate, mortgage-backed and emerging markets – are near or below their long-term average. Although credit quality is sound, the reality is that bonds will not be able to match the record of the last 30 years.

At various times during the quarter, the yield on 10-year Treasuries rose above 2%. Even though the Fed is committed to keeping rates low into 2015, the bond market is forward looking and may begin to push rates higher. The concern has led bond fund managers to take more defensive positions. In this environment, floating rate loans, inflation protected bonds and other non-traditional sources of income are likely to become more prominent in bond portfolios.

## **DOMESTIC STOCK MARKET**

### **The 1<sup>st</sup> Quarter**

U.S. stocks were among the best performers globally in the first three months of the year, with the broad Russell 3000 Index returning 10.6%. Investors appeared to be encouraged by a stronger dollar and better-than-expected earnings and economic data. Both the Dow Jones Industrial Average and the S&P 500 surpassed records originally set in 2007 before the financial crisis hit.

Small- and Mid-Cap stocks gained 12.4% and 13.0% respectively, a bit ahead of the 11.0% return generated by Large-Cap stocks. Value stocks outpaced Growth stocks for the quarter (returns of 12.3% and 9.8% respectively), but the 1st quarter rally benefited nearly all segments of the market.

Consumer Discretionary stocks performed particularly well, returning 12.2%. Financial stocks were close behind at 11.7%. Technology stocks (+5.1%) and Materials stocks (+5.5%) trailed the pack.

### **Looking Ahead**

Corporate earnings have slowed and may actually decline in the first quarter before seeing some improvement. U.S. companies are facing the reality that future profit growth must come from improved consumer demand, increased business investment, innovation and the productivity gains it can bring. The strategy of boosting earnings by cutting costs has mostly been exhausted as most companies have little room for further cuts.

The improved employment picture and healthier housing market could buoy consumer spending and make a contribution to earnings growth. Any earnings acceleration later in the year would benefit cyclical and growth stocks, including this quarter's laggards, Technology and Materials stocks.

With many companies having large cash reserves and strong balance sheets, the environment is conducive to more merger-and-acquisition activity and higher dividend payouts. Both factors could lift stock prices. We expect dividend-paying stocks to play an increasingly important role for investors as the bull market, now heading into its fifth year, ages. Older investors more focused on income will also be attracted to high dividend stocks.

## FOREIGN STOCKS

### The 1<sup>st</sup> Quarter

The 1st quarter was a mixed bag for global stocks (ex-U.S.) as they gained 3.8%. The MSCI EAFE Index, a measure of developed market performance, rose 5.1%.

By contrast, the MSCI Emerging Market Index lost 1.6% as some of its most prominent players, Brazil, China and Russia experienced market declines in the early months of the year. Small Cap stocks outpaced other indexes with an 8.4% return.

China's performance contributed to a -0.5% loss in the Asia ex-Japan index. By contrast, Japanese stocks led all foreign markets during the 1st quarter with a gain of 11.6%. It was a sign that investors approve of the economic policies of new Prime Minister Abe, who has promised to implement pro-growth policies to revitalize the long stagnant Japanese economy.

Continued economic woes in Europe dampened returns in the region. European stocks gained just 2.7%. Markets in Germany, France and Italy all declined for the quarter.

### Looking Ahead

Investors should continue to diversify into foreign stocks even though performance has lagged in recent times. For starters, the most significant economic growth is likely to occur overseas. GDP in emerging markets is forecast to rise by 5% this year, led by China's projected growth of 7.5%. At the same time, emerging market stocks are selling at a significant discount to their long-term valuations.

	3 Yr Beta	3 Yr Alpha	5 Yr Beta	5 Yr Alpha	1 <sup>st</sup> Qtr	1 Year	3 Years	5 Years
	vs. GLB BMI		vs. GLB BMI					
<b>Income</b>	0.47	1.42	0.43	3.05				
<b>Balanced</b>	0.63	0.13	0.58	1.57				
<b>Cons Growth</b>	0.73	0.07	0.67	1.18				
<b>Growth</b>	0.81	-0.92	0.78	0.31				

Market Index	1 <sup>st</sup> Qtr	1 Year	3 Years	5 Years
DJ Industrial Average	10.98	14.34	12.99	6.41
S&P 500	10.61	13.96	12.67	5.81
Russell 2000	12.39	16.30	13.45	8.24
S&P Mid Cap 400	13.45	17.83	15.12	9.85
<b>Russell 3000</b>	<b>11.07</b>	<b>14.56</b>	<b>12.97</b>	<b>6.32</b>
<b>S&amp;P Global BMI</b>	<b>7.02</b>	<b>11.60</b>	<b>8.68</b>	<b>3.06</b>
MSCI EAFE	5.13	11.25	5.00	-0.89
MSCI Emerging Mkts	-1.62	1.96	3.27	1.09
NASDAQ Composite	8.52	7.14	12.10	8.59
Barclays US High Yield Bond	2.89	13.13	11.24	11.65
Barclays US Aggregate Bond	-0.12	3.77	5.52	5.47
Barclays Global Aggregate Bond	-2.10	1.25	4.52	3.66
JPM Emerging Local Mkts Bond	-2.26	10.11	9.87	9.44
Barclays US Government Bond	-0.16	3.01	5.04	4.36
Barclays US Credit Bond	-0.17	7.00	7.86	7.52

*The above annualized total returns and betas represent All Star Financial models. Your actual beta may differ depending on your portfolio holdings.*

Europe's recession is likely to linger through the year. Conditions are particularly difficult for Italy, Spain, Portugal and Greece. The region's powerhouse, Germany, is experiencing improved business conditions. Despite the economic challenges, however many of Europe's multi-national companies are paying attractive dividends.

Investors are keeping a close eye on Japan's promised reforms, though similar efforts have fallen by the wayside in the past decade. Investors would welcome a more substantial contribution by Japan to global economic growth.

### Summary

Does the break through by the major stock indices to record levels (see "Domestic Stocks" above) carry much meaning for investors? Not really. Stocks should be part of a well-diversified portfolio, and that fact hasn't changed. Neither has the fact that investors should also include government and corporate bonds, foreign stocks and bonds, commodities and REITs in their asset mix. All of these categories underperformed U.S. stocks in the 1st quarter, but any one of them could be a market leader in the next quarter.

Are the solid gains racked up by stocks a sign of more upside ahead? It isn't clear that this will happen. Research by Standard & Poor's shows that when broad market indexes hit new highs, they tend to rise just a few percentage points more before experiencing about a 10% correction. A temporary market pullback is possible. Fed Chairman Ben Bernanke said he would like to see "permanent and sustained" improvements in housing and the job market along with higher levels of business investment. Stock investors may need more convincing about future economic prospects to move prices higher in the short run.

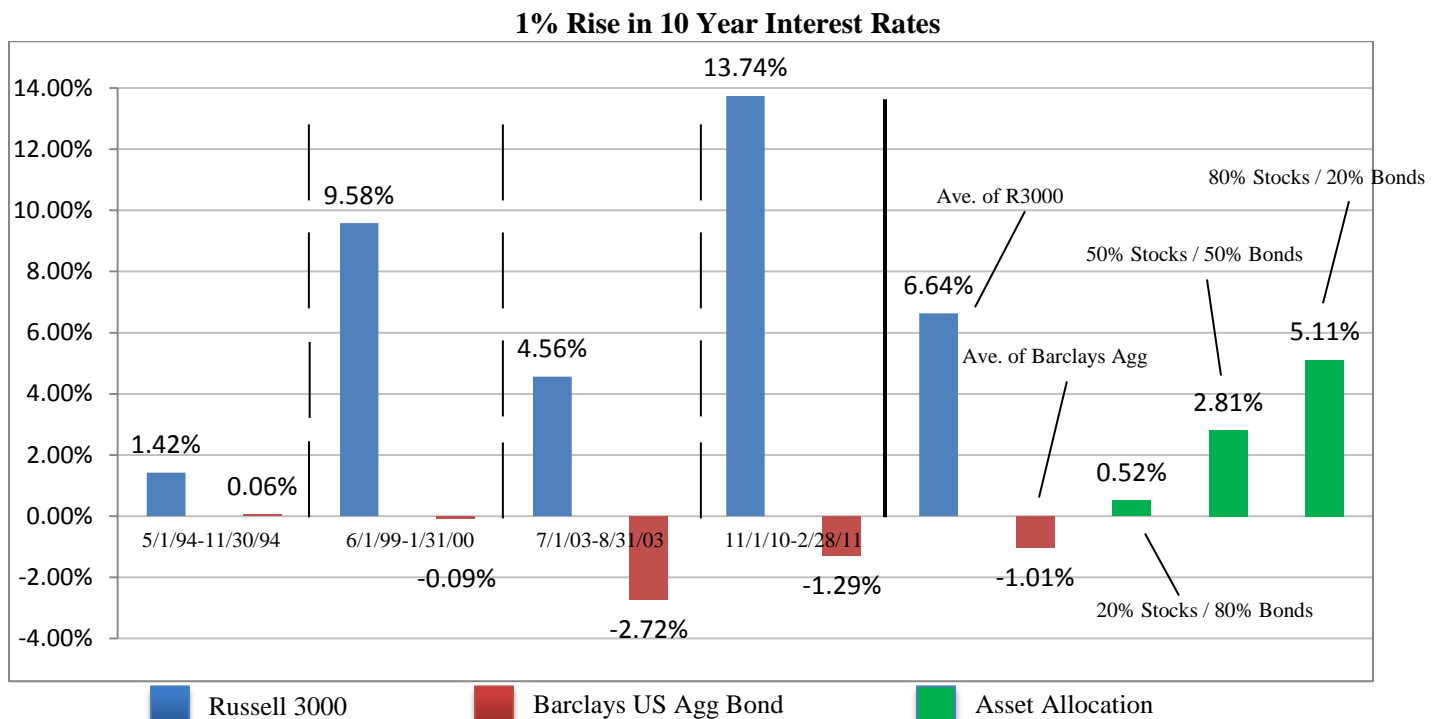
Bond investors have plenty of reason for caution as well. At some point, interest rates will begin to move higher, depleting bond values. Investors should consider dividend-paying stocks and more diversified income investments. We will increasingly focus on those categories in the months ahead.

## What Will Happen When Interest Rates Rise?

It has been 12 months since we talked to you about the “Paradigm Shift” that will eventually have to happen in our clients’ portfolios as they approach and enter their retirement years. Gone are the days of 20% equity/80% bond portfolios outperforming the domestic stock market. Since January 1, 2000 the Barclays Aggregate Bond Index is up over 120% while the Russell 3000 Index is up only 50%. Needless to say bonds have benefitted greatly from the long decline of interest rates over the past 30 years (+900% Total Return).

We believe that the tide is turning and that over the next 10+ years interest rates will rise. Vanguard Chairman and CEO Bill McNabb is quoted as saying, “The one thing that we can be fairly confident about is the fact that the next 10 years of bond returns are not going to be like the last 10 years.” This begs the question, “What happens during periods of rising interest rates?”

The chart below depicts how stocks, bonds and blended portfolios have performed during the most recent periods of rising interest rates. As you can see stocks have actually held up well, while bonds are in negative territory. The portfolio with a higher stock allocation did much better than the one with a higher allocation to bonds. This reiterates the fact that bonds (specifically U.S. treasury bonds) do not fare well during periods of rising interest rates, and thus beware of the “paradigm shift” from more bonds as you get older to MORE STOCKS in the next 10+ years.



As referenced, the changing tide taking place in the bond market is going to necessitate a larger allocation to stocks. We are morphing slowly into a world of great interest rate risk (for bonds), and investors are going to have to have a higher allocation in stocks. While this does carry its own risks, you will be better protected during a rising interest rate environment and have a better overall return! We will continue to monitor the interest rate cycle while researching and potentially using other asset classes that hold up well as rates rise.

**ALL STAR FINANCIAL**

3800 American Blvd. W.  
Suite 1450  
Minneapolis, MN 55431

Phone: 952-896-3820  
Fax: 952-896-3819  
Toll Free: 888-809-7901  
E-mail: [asf@allstarfinancial.com](mailto:asf@allstarfinancial.com)  
Website: [www.allstarfinancial.com](http://www.allstarfinancial.com)



**ASF CONTACT INFO:**

**Bob Klefsaas, CFP®, AIF®**  
President 952-896-3816  
**Maren Aipperspach, CFP®**  
Vice President 952-896-3817  
**Bruce Bonner, CFA**  
Research Analyst 952-896-3818  
**Beth Johnson, CPA**  
Tax Advisor 952-896-3829

**Paul Sommerstad, AIF®**  
Qualified Plan Mgr./Acct Exec. 952-896-3835  
**Andy Peters**  
Account Executive 952-896-3823  
**Matt Cosgriff**  
Paraplanner/Jr. Account Exec. 952-896-3815  
**Elise Pederson**  
Marketing Mgr./Jr. Acct Exec. 952-896-3826  
**Trisha Downing**  
Executive Assistant 952-896-3820