CHARTWELL REVIEW

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Chartwell Consulting

# CHARTWELL REVIEW

## FOURTH QUARTER 2012


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A mixed bag quarter, bringing to a close what proved to be a surprisingly strong year for equity investors. Domestic large-cap stocks, very high quality bonds (Treasuries, agencies, and agency-backed mortgages), and most hard commodities were weak for the 3-month period, but the rest of the global equity and bond markets did quite well.

It's not entirely clear whether "the event that we cannot name" (see title) was responsible for these results. There were many "risk-on" elements to the quarter from a US investor's perspective, as non-US stocks, high yield bonds, emerging market bonds, and smaller-cap stocks all produced price gains above their coupons or dividends.

Unfortunately, from a strategic investment perspective, the "cliff-walk" promises to be a journey of many parts. With the US running rather chronic $1+ trillion fiscal deficits for each of the past four years, the estimated $700 billion of additional tax revenues, *over ten years*, which the American Taxpayer Relief Act of 2012 is optimistically expected to raise, seems like a very small downpayment on a very large problem.

Thus, we can look forward to many more episodes of debt ceiling debates, sequestration challenges, and tax code "reforms." While moving closer to a (nearly) balanced fiscal budget is ultimately a good and necessary thing, the process promises to keep the investment environment in an extended state of uncertainty (read: risk) without any concomitant increase in the prospects for returns.

In that sense, 2012 looks like a bonus year, with equity markets up in the high teens despite slowdowns in global economic growth and global corporate profit growth. Repressed sovereign debt yields had a lot to do with this, and we shouldn't expect that to continue unabated for much longer. Central bankers have a nearly perfect record of taking the punch bowl away at *some* point.

***Figure 1: Index Benchmarks***

| *Market Index* | Trailing Returns * | | | | |
|---|---|---|---|---|---|
| | **4Q 12** | **1 Yr** | **3 Yr** | **5 Yr** | **10 Yr** |
| S&P 500 | (0.4) | 16.0 | 10.9 | 1.7 | 7.1 |
| U.S. Top-cap Stocks | (1.0) | 16.0 | 10.3 | 1.3 | 6.4 |
| U.S. Mid-cap Stocks | 2.9 | 17.3 | 13.2 | 3.6 | 10.6 |
| U.S. Small-cap Stocks | 1.9 | 16.3 | 12.2 | 3.6 | 9.7 |
| Non-US Stocks (**devel**) | 6.6 | 17.9 | 4.0 | (3.2) | 8.7 |
| Non-US Stocks (**emerg**) | 5.6 | 18.6 | 5.0 | (0.6) | 16.9 |
| 3 mo. LIBOR | 0.1 | 0.5 | 0.4 | 1.1 | 2.2 |
| U.S. Aggregate Bonds | 0.2 | 4.2 | 6.2 | 6.0 | 5.2 |
| High Yield Bonds | 3.2 | 15.6 | 11.6 | 10.0 | 10.4 |
| Global Bonds, unhedged | (1.8) | 1.3 | 5.0 | 5.7 | 6.2 |
| ***CPI, annualized*** | *(0.8)* | *1.7* | *2.1* | *1.8* | *2.4* |
| DJ-UBS Commodities | (6.3) | (1.1) | 0.7 | (5.2) | 4.1 |
| DJ US REIT's | 2.4 | 17.2 | 18.1 | 5.1 | 11.5 |
| *Chartwell Global 65/35* | *2.4* | *14.5* | *8.3* | *3.6* | *9.0* |

***Figure 2: Average Mutual Fund Returns***

| *Fund Category* | Trailing Returns * | | | | |
|---|---|---|---|---|---|
| | **4Q 12** | **1 Yr** | **3 Yr** | **5 Yr** | **10 Yr** |
| U.S. Large-cap | 0.3 | 15.5 | 9.6 | 1.2 | 7.2 |
| U.S. Mid-cap | 2.4 | 15.7 | 11.4 | 2.9 | 9.6 |
| U.S. Small-cap | 2.0 | 15.4 | 12.2 | 3.7 | 9.9 |
| International Lg. Cap | 6.6 | 18.1 | 4.4 | (3.0) | 8.9 |
| International Sm. Cap | 6.2 | 23.2 | 9.1 | 0.1 | 13.0 |
| Emerg. Mkt. Equity | 6.3 | 18.6 | 4.3 | (1.1) | 16.5 |
| Balanced/Hybrid | 1.3 | 11.5 | 7.8 | 3.0 | 6.8 |
| General Bonds | 0.7 | 7.3 | 7.5 | 6.5 | 5.6 |
| Government Bonds | (0.4) | 2.9 | 7.4 | 6.3 | 5.0 |
| High Yield Bonds | 3.0 | 14.5 | 10.6 | 8.4 | 9.1 |

* Annualized trailing returns for periods ending 12/31/12.

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## Economies, Economics, Prices, and Policy

Final numbers for Q3 GDP were released in December, and indicated a substantially stronger annualized growth rate, +3.1%, than previously estimated (+2.0%). The big factors affecting 3Q growth were much higher than expected government spending at the federal level, continued high inventory build-up by businesses, solid residential investment numbers, and a favorable import-export mix. Standing in offset was declining business fixed investment.

***Figure 3: Breaking Down Real GDP - final #'s***

**% Change from Preceding Period** *(seasonally adjusted)*

| *Factor* | 3Q '12 | 2Q '12 | 1Q '12 | 4Q '11 |
|---|---|---|---|---|
| **Real GDP Growth** | **3.1** | **1.3** | **2.0** | **4.1** |
| **Nominal GDP Growth** | **5.9** | **2.8** | **4.2** | **4.2** |
| **Final Sales** | **2.4** | **1.7** | **2.4** | **1.5** |
| Personal Spending | 1.6 | 1.5 | 2.4 | 2.0 |
| Private Investment | 6.6 | 0.7 | 6.1 | 33.9 |
| *- Fixed, Businesses* | *(1.8)* | *3.6* | *7.5* | *9.5* |
| *- Fixed, Residential* | *13.5* | *8.5* | *20.5* | *12.1* |
| *- Chg. In Inventories **($bn)*** | *$60* | *$41* | *$57* | *$71* |
| Export growth | 1.9 | 5.3 | 4.4 | 1.4 |
| Import growth | (0.6) | 2.8 | 3.1 | 4.9 |
| Government Spending | 3.7 | (0.7) | (3.0) | (2.2) |

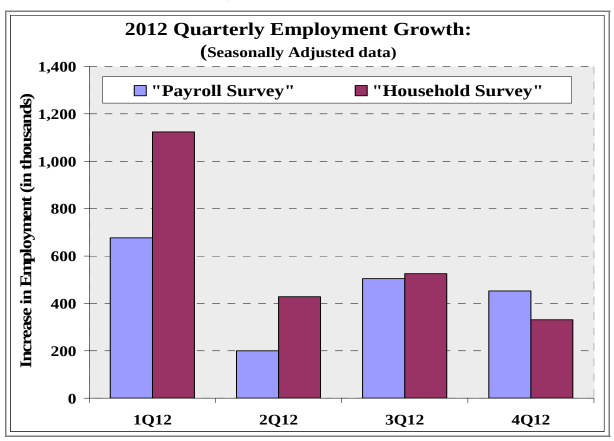
Expectations for 4th quarter economic growth have been all over the place, as economists struggle to account for the impact of Superstorm Sandy and the f****l c***f negotiations. The consensus seems to be that the annualized US economic growth rate sputtered in the 4th quarter, dropping to between 1% and 2%.

- The December advanced retail sales report indicated that sales increased 0.5% in the month, and were up 4.7% versus December 2011. The quarter's sales were 4.2% ahead of the same period in 2011.
- U.S. industrial production in December rose to its highest level since mid-2008, as manufacturing and mining output climbed. Industrial output increased 0.3% last month, and capacity utilization inched ahead to 78.8%. Overall industrial production, which includes manufacturing, mining and utility output, increased 2.2% from a year earlier. Manufacturing is up 2.4% from a year earlier, the Fed said. This was a positive development after the sector sputtered last spring and has since struggled to regain much momentum.
- The ISM's manufacturing purchasing managers' index, which is a forward-looking measure, increased to 50.7 in December from 49.5 in November. A modest positive, as any reading above 50 indicates expanding activity.
- The Conference Board's Consumer Confidence Index, which surged to a five-year high of 73.1 in the early October survey, dropped to just 65.1 in the December survey. However, the Present Situation Index actually rose to 62.8 from 57.4. It was the Future Expectations Index that plunged.
- One small comfort had been that this divergence wasn't showing up in the net import figures. While the global slowdown has certainly led to a slump in non-agricultural exports, the moving average of net imports had also been down sharply. This changed with the recent report of November's overall trade deficit. It was $8 billion higher than forecast, representing one of the worst "misses" in history.

Price indices were exceptionally benign during the final quarter of 2012. The unadjusted all-city Consumer Price Index declined almost 1% in the 4th quarter (see Figure 1), and was up only 1.7% last year. The PPI-finished goods index declined by 1.2% in the quarter, and rose just 1.3% in 2012. The energy dominated PPI-crude goods index rose just 1.6% for the year, despite its third quarter spike.

Based on seasonally-adjusted data, the domestic employment situation continued to make moderate progress in the 4th quarter. As Figure 4 reflects, most of the year's gains occurred in the first quarter. Adjusted for seasonal factors, non-farm payrolls increased 453k in Q4, compared to a revised 505k in the third quarter. Not really great numbers, but better than the weak 2nd quarter. The smaller household survey produced somewhat different results. According to it, employment rose just 331k in the fourth quarter. During 2012, non-farm payrolls increased by 1.8 million persons, while the household survey indicates employment levels increased by 2.4 million persons.

***Figure 4: US Employment Growth***



## The Race for Yield

Macro developments that shaped third quarter bond returns continued to dominate in the 4th quarter. Fixed income markets were buoyed by exceptionally accommodative monetary policy, tame inflation, and global recession fears. In addition to maintaining low target interest rates throughout 2012, the US Federal Reserve, European Central Bank, Bank of Japan, and Bank of England all continued engaging in varying degrees of quantitative easing in the 4th quarter.

While these actions helped bolster returns on fixed income investments, the sectors most directly affected by central bank purchases - sovereign bonds and (in the US) mortgage bonds, were also the sectors which showed the least positive price affects. In continental Europe, sovereign yields in the more creditworthy countries (e.g., Germany, Switzerland and Scandinavia) were flat-to-rising. Somewhat perversely, rates declined in peripheral Europe, in some cases very sharply, despite the continued deterioration of economic conditions in the region, as the “Draghi put” gave investors confidence. See Figure 7.

US government yields moved modestly higher in the quarter, as better economic data and guarded optimism over an acceptable resolution in Washington saw investors continue to favor higher risk assets. As we can see in Figure 5, yields on Treasuries were up about 10 bps, agency-backed mortgages jumped by over 30 bps, but yields on BBB, <BBB, and $-denominated emerging markets bonds all shifted downward, as investors bid-up the prices of higher yielding paper.

The effect on 4th quarter bond sector returns is captured in Figure 6. The top performing sector was high yield corporates. Here we track just the US$ index, which was up a robust 3.2% for the quarter, and 15.6% for the year. However, European high yield corporate bonds were much stronger, returning 5.9% in the quarter and 24% for the year. US$ emerging market bond returns fell between these two sectors, returning an attractive 2.8% in Q4, and 17% in 2012. Conversely, high credit quality assets, which were already trading at low initial yields, fared poorly. The weakest returns were from long-term Treasuries, which lost nearly 1%. The Long Treasury index was up just 3.6% last year. In direct juxtaposition, the Long Credit index returned 1.4% in the quarter, and 13% in 2012. Again, investors sought yield in 2012, but did not hide from duration.

Unfortunately, such robust returns in the credit sector have come at a steep future price – market yields on high-grade and high yield corporate bonds plunged in 2012, to 2.72% and 6.01%, respectively. These were the lowest levels for these indices, ***ever***. Credit *spreads* have been lower, but never yields. Perhaps unsurprisingly, companies around the world responded with all-time record debt issuance in 2012.

***Figure 5: Primary Bond Sector Yields***

| US Treasuries | Dec-12 (%) | Sep-12 (%) | Jun-12 (%) | Dec-11 (%) | *Y-T-D Change (%)* |
|---|---|---|---|---|---|
| 3-month | 0.06 | 0.08 | 0.09 | 0.01 | ***0.05*** |
| 2-year | 0.25 | 0.24 | 0.31 | 0.25 | ***0.00*** |
| 5-year | 0.72 | 0.63 | 0.73 | 0.95 | ***-0.23*** |
| 10-year | 1.75 | 1.64 | 1.66 | 1.92 | ***-0.17*** |
| 30-year | 2.93 | 2.83 | 2.77 | 2.91 | ***0.02*** |
| BarCap Aggregate | 1.74 | 1.61 | 1.99 | 2.28 | ***-0.54*** |
| BBB Credit | 3.22 | 3.37 | 3.87 | 4.35 | ***-1.13*** |
| AA Credit | 1.66 | 1.63 | 1.72 | 2.41 | ***-0.75*** |
| Agency MBS | 2.22 | 1.77 | 2.44 | 2.68 | ***-0.46*** |
| Emerging Mkts | 4.50 | 4.75 | 5.50 | 6.07 | ***-1.57*** |
| US High Yield | 6.01 | 6.76 | 7.35 | 8.36 | ***-2.35*** |
| UST30y-UST2yr | 2.68 | 2.59 | 2.46 | 2.66 | ***0.02*** |

***Figure 6: Primary Bond Sector Returns (%)***

| *Index* | 4Q ‘12 | YTD | 3 Years |
|---|---|---|---|
| US Aggregate Bond index | 0.2 | 4.2 | 6.2 |
| US Gov’t: 1-3 Yrs. | 0.1 | 0.5 | 1.5 |
| US Treasury: Long | (0.8) | 3.6 | 13.7 |
| US Inflation-Linked | 0.7 | 7.0 | 8.9 |
| Mortgages | (0.2) | 2.6 | 4.8 |
| CMBS | 1.3 | 10.0 | 12.3 |
| Asset-Backed | 0.2 | 3.7 | 4.9 |
| Inv. Grade Credit, 1-10yr | 1.0 | 8.8 | 7.3 |
| Inv. Grade Credit, 10+yr | 1.4 | 13.2 | 13.7 |
| US High Yield Credit | 3.2 | 15.6 | 11.6 |
| Municipal Bonds | 0.7 | 6.8 | 6.6 |
| Global Aggregate | 0.9 | 5.7 | 5.2 |
| Global Aggregate Credit | 1.7 | 10.4 | 7.4 |
| Emerg. Mkts Bonds (US$) | 2.8 | 17.4 | 12.3 |

***Figure 7: Sovereign Bond Yields, selected countries***

| *10 yr. bond yields* | Dec-12 (%) | Sept-12 (%) | June-12 (%) | Dec-11 (%) | *Y-T-D Change* |
|---|---|---|---|---|---|
| United States | 1.75 | 1.64 | 1.66 | 1.92 | ***-0.17*** |
| Germany | 1.43 | 1.44 | 1.45 | 1.80 | ***-0.37*** |
| Switzerland | 0.55 | 0.59 | 0.65 | 0.70 | ***-0.15*** |
| Britain | 1.87 | 1.69 | 1.81 | 2.04 | ***-0.17*** |
| Poland | 3.91 | 4.71 | 5.13 | 5.83 | ***-1.92*** |
| Italy | 4.45 | 5.11 | 5.77 | 6.84 | ***-2.39*** |
| Spain | 5.41 | 5.73 | 6.27 | 5.61 | ***-0.20*** |
| Greece (new bonds) | 12.77 | 19.17 | 26.15 | 34.74 | ***-21.97*** |
| China (5 year) | 3.26 | 3.20 | 2.82 | 3.57 | ***-0.31*** |
| Australia | 3.38 | 2.84 | 3.11 | 3.74 | ***-0.36*** |
| South Korea | 3.19 | 2.97 | 3.57 | 3.81 | ***-0.62*** |

## Domestic Equity Markets take a break

After staging an impressive rally in the third quarter, the domestic stock market took a breather in the fourth. This was particularly true for large-cap and growth stocks, as Figure 8 reflects. Large-cap stocks, represented by the S&P 500, had ended September only a bit off the year's high (1466, reached on 9/14). Values moved sideways through mid-October. Then politics entered the equation. On 10/17, with the S&P index at 1461, investors quite apparently decided they did not like the way the presidential election was going to turn out. During the next four weeks, the market dropped more than 7%, closing at 1353 on 11/15. From there it staged a nearly 7% rally, only to be again derailed late in the quarter by the spectacular lack of progress in Washington. Then, before the ink had dried on a New Year's Day compromise agreement, a 4% early-January rally ensued.

That's one theory of the quarter. Here's another. By late September, with the market very near its highs for the year, investors were grappling with forecasts that third quarter earnings would be off 9% from early year estimates, the 4th quarter would be off almost 5%, and 2013 earnings would be 2% lower than initial forecasts. As we moved through the fourth quarter, actual Q3 earnings came in 12% below earlier forecasts, the 4th quarter earnings forecast dipped 11% below earlier estimates, the forecast for 2013 was now 5% off the original figure and its whisper number was even lower. Since investors had to digest all of these negative revisions, the fact that US equity markets were nearly flat in the quarter was just short of amazing.

Per Figure 8, the size effect (*smaller-cap beats larger-cap*) was clearly observed in the quarter, but not so much for the full year. Three-year returns, which are now above average, favor mid-cap stocks. Normally, we expect to observe higher beta small-cap stocks outperforming in a strongly positive environment.

Per Figure 9, there was once again a preference for procyclical stocks, with the industrials, materials, consumer discretionary, and financials sectors outperforming. The missing piece of that puzzle was the energy sector. Normally a strong area during a procyclical rally, energy stocks lost almost 3%. The weakest sectors for the quarter were technology and telecom, both off 5.5%. Of course, tech was driven down by Apple's fall to earth, after soaring for three quarters (and more). AT&T reported an unexpectedly large decline in subscriber growth.

For the full year, energy and utilities stocks were the clear laggards (up <5%), with financial services and consumer discretionary stocks the leaders (+25%).

Value risk factors, including low Price/Book, low P/E, and high dividend yield, were the most positive return drivers. Value stocks in the tech, finance, and consumer sectors all outperformed their growth peers.

Figure 10 reviews the percentage of actively managed mutual funds outperforming their respective size/style benchmarks during the fourth quarter, per Morningstar. Growth managers had the easiest time beating their passive benchmarks. Large-Growth managers had the best relative performance, with 92% of managed funds outperforming. They also had the lowest hurdle, with a benchmark return of (2.5)%.

***Figure 8: U.S. Equity Market - Size/Style Returns***

| | | | | Trailing | |
|---|---|---|---|---|---|
| | 4Q '12 | YTD | 1-yr | 3-yrs | 5-yrs |
| **Growth** | | | | | |
| Large Cap | (2.5) | 15.1 | 15.1 | 10.9 | 3.2 |
| Mid Cap | 1.7 | 15.8 | 15.8 | 12.9 | 3.2 |
| Small Cap | 0.4 | 14.6 | 14.6 | 12.8 | 3.5 |
| **Value** | | | | | |
| Large Cap | 0.5 | 17.0 | 17.0 | 9.7 | (0.7) |
| Mid Cap | 3.9 | 18.5 | 18.5 | 13.4 | 3.8 |
| Small Cap | 3.2 | 18.1 | 18.1 | 11.6 | 3.5 |

***Figure 9: US Sector Returns - primary***

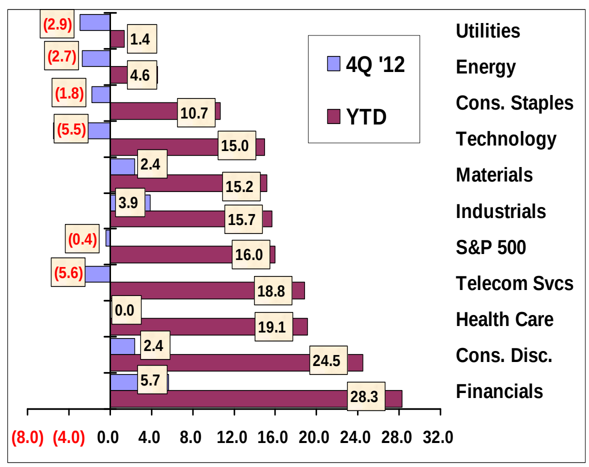



***Figure 10: Active vs. Passive (Morningstar)***

| | Value | Core | Growth |
|---|---|---|---|
| **Large** | 86% | 33% | 92% |
| **Mid** | 25% | 23% | 56% |
| **Small** | 41% | 41% | 52% |

## International Markets Rebound

Receding investor fears trumped political elections and transitions in the world's three largest economies, generating strong equity returns in all but the US. Developed markets, as measured by MSCI EAFE, were top performers with a 6.6% quarterly gain (+17.9% for the year) The MSCI All Country World ex-US index was held back by slightly weaker results in emerging markets and Canada, rising 5.9% for the quarter and 17.4% for the year.

***Figure 11: International Equity Markets - Returns***

| *thru Sept. 30, 2012* | U.S. Dollar Returns (%) 4Q '12 | U.S. Dollar Returns (%) 1-Yr | Local Currency Returns (%) 4Q '12 | Local Currency Returns (%) 1-Yr |
|---|---|---|---|---|
| **World ex-USA** | **6.0** | **17.0** | **7.0** | **16.7** |
| *- MSCI Growth* | *4.9* | *15.9* | *6.0* | *15.7* |
| *- MSCI Value* | *7.0* | *18.1* | *8.0* | *17.7* |
| - Europe ex-UK | 8.6 | 22.5 | 6.1 | 20.0 |
| - Pacific, ex-Japan | 6.1 | 24.7 | 6.1 | 22.6 |
| - Japan | 5.8 | 8.4 | 17.6 | 21.8 |
| - United Kingdom | 4.2 | 15.3 | 3.5 | 10.2 |
| **Int'l Small Cap** | **4.9** | **17.9** | **6.7** | **18.5** |
| **Emerging Mkts** | **5.6** | **18.6** | **5.4** | **17.4** |
| *- EM Asia* | *5.9* | *21.2* | *5.2* | *18.2* |
| *- EM Europe & ME* | *6.4* | *25.1* | *4.5* | *18.6* |
| *- EM Latin América* | *4.4* | *8.9* | *5.1* | *12.5* |
| *- EM BRIC* | *6.7* | *14.9* | *7.3* | *17.8* |

Both China and Japan elected new leaders. It's too early to say what the policy priorities might be for the new Chinese leader, but for the moment, investors were happy to see China's growth prospects get back on track. China's 12.9% fourth quarter return lagged only Greece and Turkey for the quarter, and doubled its calendar year return to 23%.

In Japan, a "new" (re-tread) prime minister was elected, and has been very clear about the need for aggressive monetary easing, to help reflate Japan's economy and improve its trade imbalance. This resulted in a 10% decline in the yen and a rising stock market (17.6% in local currency terms, but only 5.8% in US$). The relatively weak Japanese stock market, up only 8.4% in US$-terms last year, had a notable impact on regional results. The Pacific region gained 14.6% for the year. The Pacific *ex-Japan* index rose 24.7% in 2012.

In Europe, investor perception about the eurozone crisis appears to have shifted. Europe's economies will remain weak while the deleveraging process grinds on. However, the ECB's announcement and aggressive actions to "do whatever it takes to rescue the eurozone" have relaxed investors fears – for now. Europe ex-UK markets experienced strong regional gains, +8.6% for the quarter and 22.5% for the year.

The European region's strongest quarterly gains were posted by peripheral countries – Greece (28%), Portugal (10.5%), Spain (9.9%), and Italy (9.5%). Germany also continued to post strong results. Its stock markets rose 8.5% in the quarter and 32% for the year.

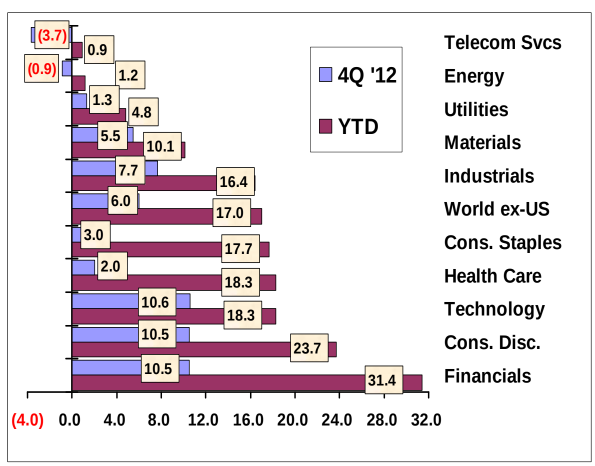
Emerging markets rebounded strongly in 2012, gaining 5.6% in the quarter and 18.6% for the year. China's resurgence enabled the BRIC countries to edge out emerging Europe as the best performing region, 6.7% versus 6.4%, although India, Brazil and Russia rose only 0.5%, 3.5% and 2.5%, respectively, for the quarter. Propelled by Poland and Turkey's strong performance, Emerging Europe (25.1%) sharply outperformed Latin America (8.9%) and Asia (21.2%) for the year.

As we observe in Figure 12, two sectors posted negative results during the quarter, telecomm (-3.7%) and energy (-0.9%). The best performing sectors were consumer discretionary, financial services, and technology, which all advanced 10.5% in the quarter. Given the optimistic environment, defensive sectors lagged - consumer staples, utilities, and healthcare, rising only 1.5% to 3%. The heavily weighted financial services sector, which is dominated by banking enterprises, was up over 30% last year, in what must be inferred as a large vote of confidence for international economies.

From a style standpoint, value outperformed growth for the quarter (7% versus 5%) and the year (18% versus 16%). Small cap stocks lagged slightly, rising 5% in the quarter, and 17.9% for the year. Canadian small-cap stocks, which are largely energy-related, lost 2.5% in the fourth quarter.

From a currency perspective, the major news was the yen, which declined by 10% versus the US$. The Euro gained 2.5% in 2012, all of it during the fourth quarter. The Pound rallied by 5% versus the Dollar last year.

***Figure 12: Ex-USA Sector Returns (in US$ terms)***



## Back Page Perspectives

If you ever needed evidence that fund flows don't drive markets, 2012 provided it. We once again saw huge inflows into bond funds and huge outflows from US equity funds, yet US equity funds more than doubled the returns of general bond funds. In total, $105 billion left US stock funds, while $21 billion went into foreign equity funds, and an amazing $265 billion flowed into taxable-bond funds. Balanced funds took in $21bn, and municipal bond funds $50bn.

Is the bull market for US stocks getting a little long in the tooth? After all, 2012 represented the fourth consecutive calendar year the S&P 500 produced a positive return. What's the likelihood we see a fifth consecutive "up-year" in 2013?

To help us with that question, we did a little research. Since the beginning of 1942, a span of 71 years, the S&P 500 index has a provided a positive calendar year return to investors in 56 instances. That's 79% of the time. If each year's result was independent of the others, we'd be tempted to say there was a 4 to 1 chance in favor of 2013 being another positive year.

But, future market returns are of course not completely independent of past returns, for many reasons. So we kept digging. We found the S&P 500 has produced *four or more* consecutive years of positive returns **7** times. We find that somewhat remarkable, and would have guessed such extended bull markets to be more rare. This compares to only **1** time when the market declined for *three* consecutive years; the grinding "super bear" market of 2000-02. Since 1941, declines in our stock market have been sharp and steep, but rarely extended.

After those 7 times when the S&P was up for 4 consecutive calendar years, what happened the next year? The S&P rose 4 times, and fell in 3 of the cases. That is, most of the time it rose.

The stock market is going to rise or fall this year because of the complex interaction of many fundamental factors. But, don't dismiss 2013 just because of the outcomes for 2009-2012. Previous bull markets of this length have extended themselves even further. For those who simply want to play the odds, we'd be careful not to bet too much on red.

Which brings us to the other side of the balanced portfolio coin - bonds. The most dangerous observation in this report is that US corporate bond yields reached all-time lows in the 4th quarter. Earlier in 2012 we took out the lows on Treasury and mortgage yields. Now we've taken out the lows on corporates. And, if we look closely at the make-up of the US$-denominated emerging markets sovereign bond index, we observe the same phenomenon (you just have to remove Venezuela and Argentina from the investable index - which almost everybody does anyway).

Beyond offering extraordinarily low yields-to-maturity compared to their own histories, bond sectors are also priced at substantial premiums versus par and reflect interest durations that are longer than just a few years ago. See Figure 13.

***Figure 13: Selected Bond statistics***

| | US Aggregate | US Gov't | US Corporate | High Yield |
|---|---|---|---|---|
| **Price, 12/09** | $103.57 | $103.53 | $105.63 | |
| **Price, 12/12** | $109.13 | $107.25 | $113.72 | $104.35 |
| **Y-T-M, 12/09** | 3.68 | 2.41 | 4.74 | |
| **Y-T-M, 12/12** | 1.74 | 0.86 | 2.72 | 6.01 |
| **Duration, 12/09** | 4.57 | 4.64 | 6.35 | |
| **Duration, 12/12** | 5.06 | 5.21 | 7.18 | 3.77 |

Since bonds mature at par, the current structure ensures regular capital losses on a mark-to-market basis, mitigating the positive impact of coupon income. Longer durations represent increased sensitivity to shifts in the yield curve. With very little current return in offset, even moderate upward shifts in market rates will drive fixed income returns into negative territory. For instance, if market yields were to rise back to December 2009 levels during the course of 2013, a market neutral portfolio of investment grade corporate bonds would return approximately -11%. High yield bonds, with their much higher current yields and shorter durations, offer considerably better protection against adverse interest rate shifts.

We think equity market returns in 2013 will be a function of realized corporate earnings and perceived growth prospects. Current multiples aren't stretched, although the market is fully priced on current earnings. The bond market, on the other hand, is fundamentally overpriced from almost every perspective. Yet demand for fixed income product remains unabated, and the relative lack of available supply (after central banks vacuum up most government issuance) is likely to have a profound "crowding-out" effect on portfolios. This leaves us precious little margin of safety for the protection of principal should rate levels rise. Bonds really aren't low risk at current prices, even though they remain well supported by technical factors.

Chartwell celebrated its 19th birthday on January 20th. Thank you!

**Sell high, buy low. See you next quarter!**

***Natalka Bukalo*** ***Richard Shaffer, CFA***