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Investment Review and Outlook

During the first quarter of 2013, we believe the stock market has earned the moniker of "the Teflon market." No matter what ostensibly negative headlines crossed the newswires, the stock market brushed them off and moved steadily higher. In retrospect, a lot of the headline risk turned out to be nothing more than – well, headline risk. A number of clients expressed their concerns regarding headlines containing the dreaded words "fiscal cliff" and "sequester." But when one objectively evaluates the consequences of the political stalemate in Washington, it has emerged that both parties are heading toward making much needed progress in achieving fiscal discipline. While one can fret about the short term negative impact from austerity measures, one could argue that the fiscal cliff and the sequestration are heralding an era of more responsible government - not such a bad prospect!

As we look forward to the second quarter, we are mindful of the fact that stock prices have had a significant rally over the past five months. In fact, the market has gone through a period of time since the election without a correction greater than 3%. Market sell-offs have been met with fresh buying from cash-heavy investors waiting on the sidelines.

As we pointed out last year, there is an old Wall Street adage that advises investors to "sell in May and stay away" until November. This strategy has had some success over the past few years. But as long term investors, we are not in favor of wholesale liquidation of stocks in attempt to capitalize on short term trading patterns. But we believe that some caution is warranted as the market rally has gotten a bit long in the tooth.

The Land of the Rising Stock Market?

The Japanese name for their home country is Nippon or Nihon. Both of these names literally mean "the sun's origin." This is probably the source of Japan becoming known as the "Land of the Rising Sun". But Japan's economy, stock market, and global economic hegemony has been waning and fading into the sunset for over two decades.

We last wrote about Japan in July of 1998 when we began to see the emergence of a number of government policy actions that we believed would help the country emerge from its economic torpor. The market staged a strong rally over the next year. But as the dot.com bubble began to deflate in early 2000, the Japanese stock market rolled over and has had difficulty recovering those losses.

Japan has a number of economic and financial issues to address. And its fractured government has been doing a poor job in addressing its structural challenges. For example, while its population is aging and shrinking, the government maintains an unusually restrictive immigration policy. On the fiscal front, politicians have favored the elixir of deficit spending, resulting in the country's gross government debt well exceeding 200% of GDP. The ongoing deficit spending makes politicians even from Greece appear like fiscal hawks.

Recently elected Prime Minister Shinzo Abe is trumpeting an era of ultra-loose monetary policy and further increases in government spending. In the past few months, investors are giving Mr. Abe the thumbs up as the stock market has rallied sharply. But the question is whether this plan can work over the longer term. History is not so sanguine. After all, the US experiment of unconventional monetary policy and unprecedented fiscal deficits following the 2008 financial crisis has generated only modest economic growth. At the same time, unemployment remains alarmingly high for an economy in its fourth year of recovery.

While many investors have turned bullish on Japan, we believe that Japanese investors are discounting the magnitude of the country's fundamental challenges. So we recently sold our Japanese investments in client accounts. Given the checkered history of aggressive government fiscal and monetary alchemy, we believe that it pays to watch this experiment from a distance for now.