

## 1<sup>st</sup> Quarter 2013 Economic Commentary

U.S. economic data came in stronger than expected and equity markets hit record highs during the first quarter of 2013. It was a promising start to the year. However, ongoing fiscal challenges in Europe, nuclear rhetoric from North Korea, and federal budget cuts in the U.S. could dampen economic growth.

After a relatively quiet end to the year, Europe came back into focus during 1Q13 as Cyprus became the latest Eurozone country to face financial crisis. In March, Cyprus requested a bailout from the EU for its two biggest banks. The EU and the IMF agreed to fund part of the bailout but proposed that Cyprus fund the remainder through a special tax on bank deposits, including insured deposits. The proposal sparked outrage throughout Cyprus and the Cypriot parliament did not pass the tax. With a collapse of the banking sector imminent, a new deal was struck in the final hours that protected insured deposits and shifted the burden to large depositors and bondholders. Although insured deposits were ultimately protected, trust in the safety of the EU deposit guarantee has been undermined and could result in runs on banks in future Eurozone crises. In addition, the haircutting of senior bondholders and uninsured depositors sets a precedent that has caused markets to yet again reassess the risks of the European banking system.

North Korea recently threw its disruptive hat into the ring of uncertainty when its new young leader launched a war of words against the United States. Angered by U.N Security Council sanctions imposed after an underground nuclear test in February, North Korea threatened to launch a nuclear strike against the U.S. and South Korea. While few believe that North Korea has nuclear launch capabilities, the daily clamor of threats continues to escalate and has drawn some defensive response from the U.S., including a B-2 bomber flyover to South Korea. After that not-so-subtle show of strength, the U.S. is now employing a more diplomatic approach to end the hostilities by sending U.S. Secretary of State John Kerry to South Korea and leaning on China to reign in its rogue ally. Although the belligerent posturing from North Korea is nothing new, it is yet another wildcard that investors must handicap when assessing market risk.

Meanwhile back in the U.S., the budget battle rages on. After narrowly averting the fiscal cliff at the end of last year, Congress failed to come to an agreement on spending cuts during the quarter. This failure to compromise triggered sequestration on March 1. While the across-the-board spending cuts, split evenly between defense and domestic spending, were designed to be painful for both Democrats and Republicans, the two sides appear to be no closer to consensus on a viable alternative for deficit reduction.

Despite the dysfunction in Washington, the U.S. economic recovery gained momentum during the quarter, particularly in the housing market. Home sales rose, spurred by low mortgage rates and improved labor market conditions. The increase in demand and the decrease in housing supply pushed up property values and resulted in a jump in housing starts. In addition, stronger housing demand contributed to growth in home-improvement, furniture, and appliance retailers. The wealth effect from rising property values also fed through to higher consumer confidence levels and increased consumer spending. The labor market had a strong start to the year as well, but job growth slowed in March. Concerns about the impact of the sequester likely contributed to employers' hesitation to hire. It is too soon to tell if this slowdown was just a temporary dip in the labor market recovery or if we are entering into another soft patch.

The Fed stayed the course on monetary policy at the March FOMC meeting. There was no change in rate guidance or in the pace of asset purchases. The Fed acknowledged the improvement in labor market conditions, but remained concerned about the elevated level of the unemployment rate. The minutes to the March meeting revealed that there was some discussion of the eventual tapering of the QE program conditioned upon ongoing improvement in the labor market. "Several" members "thought that if the outlook for labor market conditions improved as anticipated, it would probably be appropriate to slow purchases later in the year and to stop them by year-end." It was also noted, however, that if the outlook were to deteriorate, the pace of purchases could be increased. So if March's subpar employment data proves to be a trend versus an anomaly, the timeline for scaling back QE3 will likely be extended.

Overall the U.S. economic recovery appears to be on the right track. However, uncertainties both here and abroad could derail the positive momentum. These uncertainties combined with high unemployment and tame inflation should keep the Fed's foot firmly on the accelerator and interest rates low for some time.