2Q13

The Financial Solutions Advisor

Economic & Market Perspectives

Stocks Reached Record Highs
Stocks capped off a strong first quarter by closing at record highs. The S&P 500 Index surpassed its pre-credit-crisis 1,565 record from 2007. The Dow Jones Industrial Average rose to another new high of 14,578 and the Nasdaq Composite to a one-year high of 3,267. In fixed income markets, Treasury yields continued to fall (as prices correspondingly rose), with the 10-year yield dropping from 1.93% to 1.85%.

US Growth Has Been Stronger Than Expected
With the first quarter now in the history books, we thought this would be a good time to take a look back at how the economy and markets have performed versus our expectations from the beginning of the year.

Three months ago, our view was that the US economy would grow slowly, with inflation and interest rates both remaining low. We also expected Europe would continue to struggle and believed that Chinese growth would accelerate. From an economic perspective, the first quarter pretty much played out this way. The European economy is still contracting and Chinese growth (while erratic) looks set to come in at around 7.5% or 8% this year. In the United States, inflation remains low, hovering around 2% and interest rates appear to be on an uneven trajectory, but are slightly higher than where they were at the start of the year.

We came into the year concerned about the effects of the fiscal cliff, but despite a significant tax hike, consumption levels thus far have held up better than expected thanks to an improving labor market and an ongoing resurgence in home prices. We won't know exactly how fast the economy grew in the first quarter for another month, but the numbers will almost certainly be better than almost anyone expected they would be three months ago. Looking ahead, we do think the economy will slow in the second quarter as the effects of the sequester come into play more fully, but growth does appear to be strong enough to absorb the hit.

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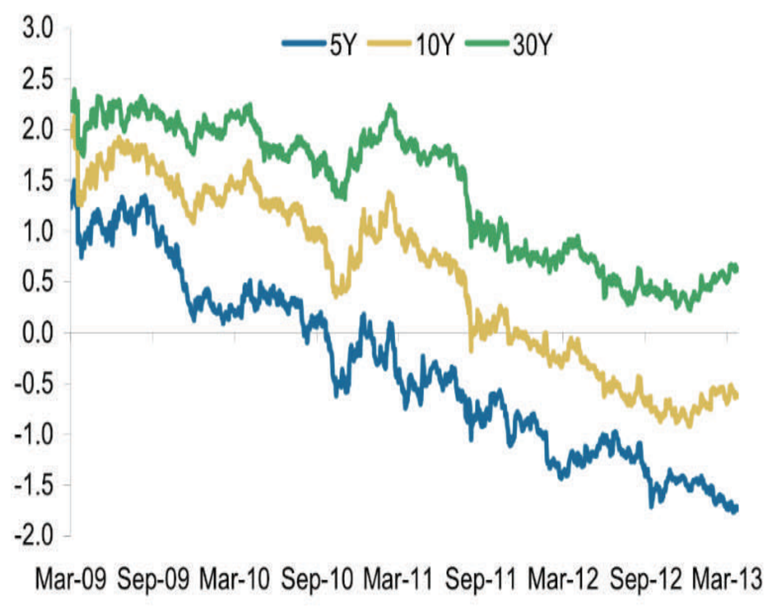
2013 Returns

S&P 500	*10.61%*
NASDAQ	*6.25%*
Russell Small Cap	*12.93%*
Russell Mid Cap	*12.96%*
MSCI EAFE	*6.81%*
MSCI World	*6.93%*
Barclay US Agg	*-0.19%*
Barclay Muni.	*0.29%*

US Real Rate %



Source: Bloomberg, Morgan Stanley Research

The US Real Rate is the rate of interest an investor will receive on a Treasury bond (5 year, 10 year, 30 year maturity) after allowing for inflation. If, for example, an investor were able to lock in a 2% interest rate for the coming year and anticipated a 3% inflation rate, he would expect to earn a real interest rate of -1%.

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The American Taxpayer Relief Act of 2012

The new year started with some political drama, as Congress passed legislation on January 1, 2013, to prevent the country from going over the "fiscal cliff." The American Taxpayer Relief Act of 2012 (ATRA) permanently extends a number of major tax provisions and temporarily extends many others. The legislation also temporarily postpones major automatic spending cuts that were scheduled to take place at the beginning of the year. Here's what you need to know.

Permanent federal income tax rates

For most individuals, the legislation permanently extends the lower federal income tax rates that have existed for the last decade. That means most taxpayers will continue to pay tax according to the same six tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) that applied for 2012. The top federal income tax rate, however, will increase to 39.6% beginning in 2013 for individuals with income that exceeds $400,000 ($450,000 for married couples filing joint returns).

Long-term capital gains and dividends

Generally, the lower tax rates that applied to long-term capital gains and qualifying dividends have been permanently extended for most individuals as well. If you're in the 10% or 15% marginal income tax bracket, a special 0% rate generally applies. If you are in the 25%, 28%, 33%, or 35% tax bracket, a 15% maximum rate generally applies. Beginning in 2013, however, those who pay tax at the higher 39.6% federal income tax rate (i.e., individuals with income that exceeds $400,000, or married couples filing jointly with income that exceeds $450,000) will be subject to a maximum rate of 20% for long-term capital gains and qualifying dividends.

Alternative minimum tax (AMT)

ATRA permanently extends AMT relief, retroactively increasing the AMT exemption amounts for 2012, and providing that the exemption amounts will be indexed for inflation in future years. The Act also permanently extends provisions that allowed nonrefundable personal income tax credits to be used to offset AMT liability.

Estate tax

The new legislation makes permanent the exemption amounts ($5 million, indexed for inflation) for the estate tax, the gift tax, and the generation-skipping transfer tax--the same exemptions that were in effect for 2011 and 2012. The top tax rate, however, is increased to 40% (up from 35%) beginning in 2013. The Act also permanently extends the "portability" provision in effect for 2011 and 2012 that allows the executor of a deceased individual's estate to transfer any unused exemption amount to the individual's surviving spouse.

Itemized deductions and personal exemptions

ATRA provides that, beginning in 2013, personal and dependency exemptions will be phased out for those with incomes exceeding specified income thresholds. Similarly, itemized deductions will be limited. For both the personal and dependency exemptions phaseout and the itemized deduction limitation, the threshold is $250,000 for single individuals ($300,000 for married individuals filing joint federal income tax returns).

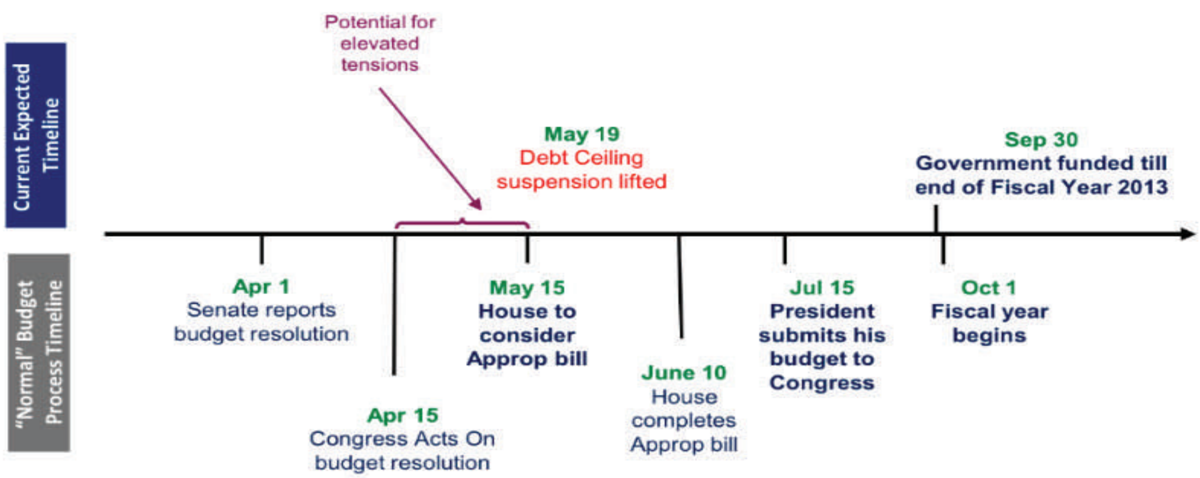
No extension of 2% payroll tax reduction

Many workers were surprised when they received their first 2013 paycheck. That's because one thing the new legislation did not do was extend the temporary 2% reduction in the Social Security (OASDI) portion of the FICA payroll tax that expired at the end of 2012. As a result, most workers are now receiving about 2% less in take-home pay.

Other provisions

The new legislation extends a host of other tax provisions that had expired--some are extended permanently, others temporarily. For more information, contact a tax professional or visit www.irs.gov.

The Next Fiscal Stress Points



Estate Tax After the Fiscal Cliff

After threatening to go over the fiscal cliff, the gift tax, estate tax, and generation-skipping transfer (GST) tax have come in for a soft landing. The American Taxpayer Relief Act of 2012 (ATRA 2012), enacted on January 2, 2013, permanently extended the $5 million (as indexed) gift tax and estate tax applicable exclusion amount and GST tax exemption. It also permanently extended portability of the gift tax and estate tax applicable exclusion amount between spouses. However, it also increased the top gift, estate, and GST tax rate to 40% starting in 2013. A number of other provisions were also permanently extended.

Top gift, estate, and GST tax rate

In 2012, there was a 35% top tax rate for gift, estate, and GST taxes. It was scheduled to increase to 55% in 2013. ATRA 2012 provides a permanent 40% top rate, starting in 2013.

Applicable exclusion amount

You have an applicable exclusion amount that can protect a certain amount of property from the federal gift tax and estate tax. The basic exclusion amount was $5,120,000 in 2012 ($5 million as indexed for inflation), but was scheduled to drop to $1 million in 2013. ATRA 2012 permanently extends the basic exclusion amount at $5 million as indexed for inflation.

Portability of exclusion

The estate of a person who died in 2011 or 2012 could transfer the decedent's unused applicable exclusion amount to his or her surviving spouse, who could use the unused exclusion, along with his or her own basic exclusion amount, to shelter property from gift and estate tax (referred to as portability). The provision was scheduled to sunset in 2013. ATRA 2012 has permanently extended the portability provision.

GST tax exemption

You have a GST tax exemption that can protect a certain amount of property from the GST tax. The GST tax exemption was $5,120,000 in 2012 ($5 million as indexed for inflation), but was scheduled to drop to $1 million (as indexed for inflation) in 2013. ATRA 2012 permanently extends the GST tax exemption at $5 million as indexed for inflation (it is $5,250,000 in 2013).

State death taxes

In 2012, your estate could take an estate tax deduction for death taxes (estate tax or inheritance tax) paid to a state. In 2013, it was scheduled to change back into a credit for state death taxes, as available back in 2001. However, ATRA 2012 permanently extends the deduction for state death taxes.

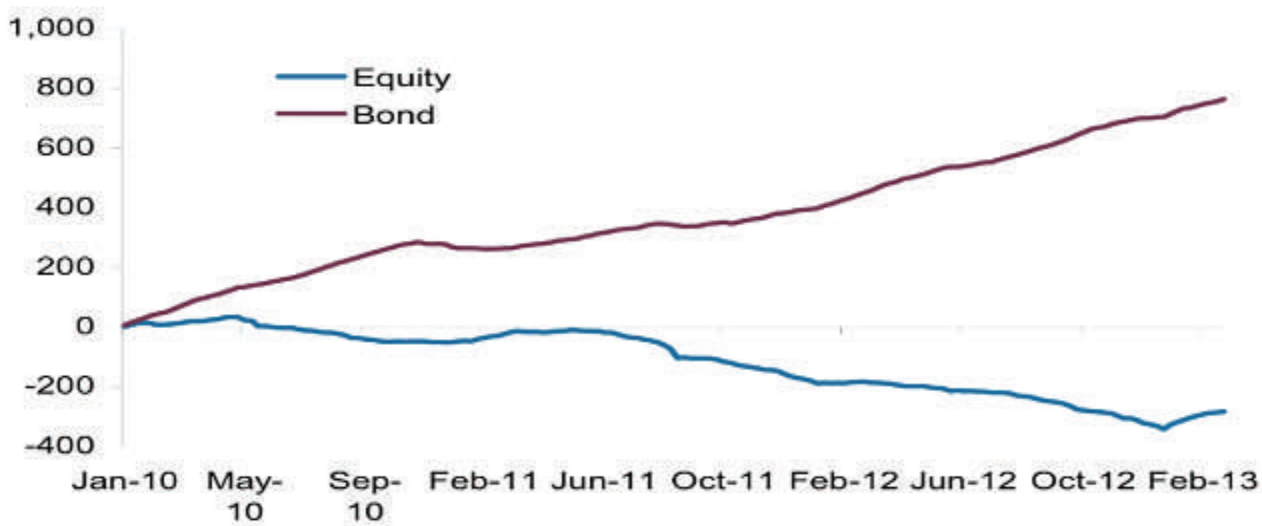
Conservation easement exclusion

An estate tax exclusion is available for qualified conservation easements. In 2012, the exclusion was generally available if the property was located anywhere in the United States. In 2013, the exclusion was scheduled to be available, as in 2001, only if the property was located within a limited number of miles from a National Wilderness Preservation System or an Urban National Forest. ATRA 2012 permanently extends the provision that the property can generally be located anywhere in the United States and the mileage requirements do not apply.

Estate tax deferral for closely held business

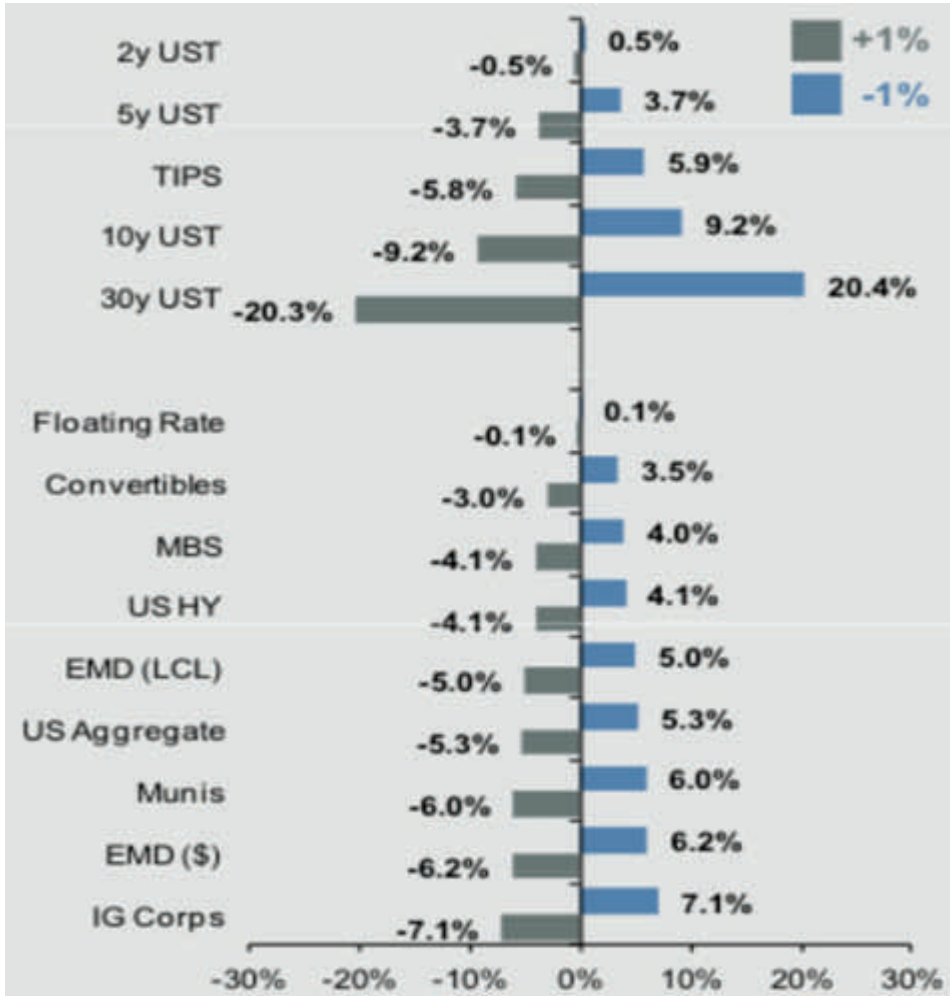
Where the value of a closely held business exceeds 35% of the value of the adjusted gross estate, payment of estate tax attributable to the business can be deferred for up to 5 years and then paid in installments over 10 years, all at favorable interest rates. In 2012, a closely held business could have 45 partners or shareholders. In 2013, the permissible number of partners or shareholders was scheduled to drop to 15, as in 2001. ATRA 2012 permanently extends the provision allowing up to 45 partners or shareholders.

Fund Flows



Source: ICI, Morgan Stanley Research

Price Impact of a 1% Rise/Fall in Interest Rates



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Stocks Still Look Inexpensive
Regarding our investment outlook, one of the main themes we emphasized at the beginning of the year was that stocks would outperform bonds. Clearly, stocks have had an exceptional run to start the year and handily outperformed bonds. We certainly don't expect this pace of gains to continue, but even after the first-quarter rally, stocks still look inexpensive compared to fixed income alternatives. That said, however, we do expect volatility to be higher than it has been in the months ahead.

From a capitalization perspective, mega-cap stocks have narrowly underperformed smaller caps, but we would advise investors to stick with a mega cap bias. This area of the market continues to offer value and should benefit from solid corporate profits. Additionally, they remain a good defensive play in the event the Federal Reserve chooses to pull back on its asset-purchase program faster than expected since smaller-cap companies tend to have more exposure to changes in monetary policy.

Bonds: Focus on High Yield and Bank Loans
Three months ago, our fixed income outlook centered on our view that Treasuries looked risky and that credit areas such as high yield and bank loans looked attractive. In general, this positioning proved to be correct and our outlook has not changed. Treasury yields have been mostly range-bound, but have moved slightly higher over the last three months and high yield and bank loans have outperformed. Looking ahead, we would suggest investors continue to look at high yield and bank loans, which offer attractive yields and can help protect against the effect of rising rates.

Source: BlackRock

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