MARKET OVERVIEW
FIRST QUARTER, 2013

INDEX	1ST QUARTER %	1 YEAR %	3 YEAR %	5 YEAR %
Dow Jones Industrial	11.93	13.37	13.32	6.50
NASDAQ Composite	8.21	5.69	10.86	7.47
Standard & Poor's 500	10.61	13.96	12.67	5.81
Russell 1000	10.80	13.69	12.25	5.48
Russell Midcap	12.96	17.30	14.62	8.37
Russell 2000	16.30	13.45	8.24	11.52
Barclay US Aggregate Bond	-0.12	3.77	5.52	5.47
MSCI World ex. US	4.70	10.43	4.78	-0.75
MSCI Emerging Markets	-1.62	1.96	3.27	1.09
COUNTY OF SAN BERNARDINO 457(b) PLAN PERFORMANCE	**8.56**	**13.85**	**10.70**	**5.77**
COUNTY OF SAN BERNARDINO 401(k) PLAN PERFORMANCE	**8.47**	**13.56**	**10.68**	**5.92**
COUNTY OF SAN BERNARDINO RMT PLAN PERFORMANCE	**7.12**	**12.12**	**10.65**	**6.26**

EQUITY MARKETS

The Dow Jones Industrial Average (DJIA) had its biggest first quarter gain since 1998. The DJIA ended the quarter with a record high of 14,579. The DJIA increased 1,474 points in the first quarter. This is the largest quarterly point gain in the DJIA history. The S&P 500 also closed at a record high at 1,569. The only key negative for the S&P 500 was the drag incurred by Apple, Inc. Apple shed more than a third of its value in the most recent six (6) month period. The S&P 500 hit a recent low point of 677 on March 6, 2009. The S&P 500 surpassed the record close of 1,565 set in March, 2007. The two key drivers behind the market growth are the resilient corporate earnings and the low yield on fixed income securities that led investors to the more volatile equity markets.

The S&P 500's cumulative market capitalization at its previous peak was $13.8 trillion in October, 2007. That figure fell to $5.9 trillion at its low in 2009 and it has now rebounded to $13.9 trillion.

For the second consecutive quarter the smaller capitalized 400 stocks had a distinct advantage over the top 100 stocks. The S&P 500 returned 10.61% in the first quarter versus the S&P 100 with a return of 9.58%.

Small cap stocks had the best performance of all major asset classes in the first quarter. This is due to the growing appetite of investors toward riskier investments. As monies poured into small cap mutual funds some small cap managers found it increasingly difficult to expand as investment opportunities become more difficult to identify or holdings in favorite stocks grew to uncomfortably high levels. This has caused eight (8) small cap funds to close their fund in the first quarter. The performance of the Russell 2000 index of small company stocks has tripled off its low from March 6, 2009. In all, eighteen mutual funds closed in the first quarter. International and emerging market funds had the next most closings.

The average domestic general stock fund in Morningstar's® database rose 11.02% in the first quarter, following a return of only 0.13% in the fourth quarter, 2012.

Commodities posted their worst first quarter since 2010 with a negative performance of -1.1%. The Emerging Markets index fell -1.62%. The NASDAQ index has been more up and down due to large losses sustained by what was the world's largest stock in terms of capitalization, Apple, Inc. Apple is also in the S&P 500 and its impact in that index has been felt, as well. A share of Apple stock has dropped from $702 in mid-September, 2012 to $532 on December 31, 2012 and to $443 as of the end of the first quarter, a decline of 37%.

One reason for the very strong first quarter equity performance may be due to pent up anxiety dating back to the last quarter of 2012. First, investors had to wrestle with the election and the emotions of having to sort through a wide dichotomy of proposed policies. Then came the Fiscal Cliff tax compromise followed by the anxiety over sequestration with many economists worried that a reduction in spending would tip the economy into a recession.

While the U.S. stock market is setting new records, stock markets in nearly every other large economy around the world are still well below their records. In fact, an index of the world's stock market, excluding the U.S. is still down 29% from its high set in 2007, according to Ned Davis Research.

There are reasons for the U.S. markets to outperform other country's stock markets:

- The U.S. addressed the problems of the financial crisis faster and with more ferocity than the rest of the world.
- Economists give the Fed much credit for reacting quickly and strongly with actions to boost the economy through low interest rates. The Fed's action drove investors looking for higher yield to stocks. Also, the Fed worked quickly to bailout and revamp banks. The world's central banks only started actions in earnest last year.

- American corporations exacted a toll on the American worker by reducing the workforce. This action led to higher profits and an increase in dividends to the shareholders. In Europe, the greater legal protections offered to workers made it more difficult for businesses to revamp their businesses.

The Barclays U.S. Aggregate Bond Index was slightly negative at -0.12% for the first quarter and up 3.77% for the year. While there is an abundance of enthusiasm for equities, corporate bond investors have grown more cautious. With a risk on attitude high yield bonds did not perform as well as expected in the first quarter with a return of only 1.02%. The one (1) year return is still strong at 13.13%.

STYLE COMPARISONS*				**Performance includes dividends*
INDEX STYLE	**1ST QUARTER %**	**1 YEAR %**	**3 YEAR %**	**5 YEAR %**
RUSSELL 1000 GROWTH	9.41	9.52	12.53	6.78
RUSSELL 1000 VALUE	12.12	17.86	11.92	4.02
RUSSELL MIDCAP GROWTH	11.51	12.76	14.23	7.98
RUSSELL MIDCAP VALUE	14.21	21.49	14.96	8.53
RUSSELL 2000 GROWTH	13.21	14.52	14.75	9.04
RUSSELL 2000 VALUE	11.63	18.09	12.12	7.29

Over the one (1) year period value continues to outperform growth and during the first quarter the margin of difference grew in the large and midcap asset classes. The strength of the defensive sectors drove the strong performance of value stocks.

In the first quarter there were only three (3) categories where active equity managers outperformed their respective indexes. The two asset categories where active management had the biggest tailwinds against the indexes were large growth and large value which is very similar to the fourth quarter, 2012. 83% of active large cap growth managers and 67% of the large cap value managers beat their index in the first quarter of 2013. Only 6% of the large cap blend managers beat their respective indexes in the first quarter and only 9% of the mid cap value managers beat their index.

SECTORS

All eleven key sectors finished in positive territory for the first quarter.

Defensive Super Sector – In stark contrast to the fourth quarter, 2012 when cyclical stocks were the best performing sector and the Defensive Super sector had an overall negative performance of -1.12%. This sector was the clear winner in the first quarter with a return of 15.01%. The

Defensive sector has benefited from the low interest rate environment. Investments with steady, robust cash payouts are difficult to find. So, investors are identifying dividend payers and those are typically in the Defensive sectors.

- **Healthcar**e stocks led the rally with a return of almost 16%. Pharmaceutical stocks had double digit returns, Celgene Corporation had a 48% return in the first quarter. Healthcare is considered a defensive sector because demand is fairly stable except for voluntary procedures.

- **Consumer Defensive** stocks had a quarterly return of 14.63% with Walgreen's gaining 30%.

- **Utility** stocks rebounded from an underperforming 2012 when investors had a greater appetite for risk with a return of 13.61%.

Cyclical Super Sector – This super sector provided the best performance in 2012 and strong performance continued into the first quarter with a return of **11%**.

- **Basic Materials** stocks were the weakest performers of all sectors with a quarterly return of 3.56%.

- **Consumer Cyclicals** rose almost 12%. Netflix returned 104% after significantly beating its earnings estimate.

- **Financials** continued to be a key driver as the U.S. banking system continued to demonstrate strength compared to its European counterparts.

Sensitive Super Sector – This super sector returned 8.79% for the quarter after rising 12% in 2012.

- **Technology** stocks, (a growth sector), after providing the worst performance of the fourth quarter with a negative -4.94%, followed up with the second worst sector performance in the first quarter, 4.95%. The one (1) year performance is by far the worst of the eleven sectors with a negative return of -2.29%**.** This is due in large part to the negative performance of what was the largest stock, Apple, Inc. Apple stock fell about 20% since a mid-September high of $705 to the end of 2012. The free fall continued until late March when Apple rallied about 10%, minimizing the quarterly loss to 16%. Hewlett-Packard posted a 68% gain and other big technology names, IBM and Google posted double digit gains.

- **Energy** stocks were up and down during the quarter, but posted a return of 11.52% for the quarter. The one (1) year performance was the third worst of the eleven major sectors. The bright spot was natural gas. Due to high demand natural gas rose 20% in the first quarter.

ECONOMIC ISSUES

The federal deficit, the difference between government revenue and spending, is shrinking. In the depths of the recent recession, the fiscal year ending September 30, 2009 the deficit was 10.1% of the gross domestic product (GDP), the value of all goods and services produced. Since then the deficit shrunk to 7% of the GDP in 2012 and is now reported to be near 5%. The driver behind the decrease is the slow improvement in the economy and unemployment and the reduction in stimulus spending.

The average annual economic growth rate was 3.5% between 1960 and 1999; since then the pace of growth has been half of that. The U.S. economy grew at a 2.5% rate in the first quarter, less than what is needed to be considered a healthy economy, but significantly better than the fourth quarter revised growth rate of 0.4%. The slower economic growth is blamed on higher taxes, particularly the previously suspended payroll tax of 2%, reduced government spending and political inaction.

One gauge of economic forecasting is the Transportation Index. The Dow Jones Transportation Index increased by 18.26% in the first quarter. This index is 12 years older than the DJIA. This index is an indicator of how much raw material and packages are shipped to manufacturers, businesses and to personal consumers. Greater appreciation of this index can indicate economic growth. Charles H. Dow, who developed both this index and the DJIA, wrote in 1902, “That a rise in the Industrial Average must be confirmed by a rise in the Transportation Index in order for the market to be sustainable.”

A weak global economy is holding down commodity prices. Crude oil prices are down 10% from a year earlier. Gold is down 11% from a year earlier. Overall prices of goods imported to the U.S. are down 2.7% from a year earlier according to Labor Statistics. U.S. wage inflation is modest. Average hourly earnings of workers in March were up only 1.8% from a year earlier.

U.S. household wealth is at its highest level since 2007. The net worth of U.S. families rose by $1.17 trillion by the end of 2012. Rising home values and gains in the stock market boosted household balance sheets. According to the Fed, household net worth rose 1.8% in the fourth quarter. Household net worth is the combined total of home values and the stocks and other investments minus debts and other liabilities. This is the highest level since the fourth quarter, 2007.

FEDERAL RESERVE BOARD

The Fed is well in its third round of Quantitative Easing in which it buys longer term assets to bring down long term interest rates. In their April meeting they concluded that the Fed will continue their $85 billion a month bond buying program. The purpose of the program is to ease credit conditions by maintaining artificially low long term interest rates, i.e. mortgage rates, encourage spending, particularly on capital investments and encourage economic expansion through hiring. The Commerce Department reported that the personal consumption price index, (one of the Fed’s favorite measures), was up only 1.2% in the first quarter and only 1.5% over the last twelve months.

The Fed's actions to boost economic growth have led many investors who are desperate for yield to invest in riskier investments like equities, high yield bonds and real estate. According to the Standard & Poor's Case-Shiller index home prices in Phoenix increased by 23% in the last twelve months. More than one (1) in four (4) homes sold in Phoenix over that period was purchased by an investor.

UNEMPLOYMENT

The unemployment rate was 7.8% in December, 2012 and has fallen to 7.6% as of March 31, 2013. In the first quarter 2013, 617,000 net jobs were added to the economy.

As of April 30th the unemployment rate is 7.5%. This is the lowest rate since December, 2008. Private companies added 176,000 jobs in April while governments reduced employment by 11,000 jobs. Year to date through April, 198,000 jobs on average were added to the U.S. economy each month. This compares to a monthly average of 183,000 in 2012. There could be a decline in the monthly average going forward. Typically employers increase existing workers hours before adding new staff. The average workweek fell to 34.4 hours from 34.6 hours; this indicates that employers do not need to add to staff but rather expand the workweek.

The Misery Index is an economic indicator designed to help determine how the average citizen is doing economically. It is calculated by simply adding the inflation rate to the unemployment rate. The current Misery Index as of December was 9.54%. The misery index as of March, 2013 was 9.07. We categorize 9.07 as Moderately Miserable. In November, 2011, the Misery Index was 12.87%.

According to the Wall Street Journal, Americans are leaving the labor force in record numbers. But, the trend has more to do with baby boomers than frustrated job seekers giving up their job search. The share of the population either working or looking for work in March hit its lowest level since 1979. The measure known as the Participation Rate now stands at 63.6%, down from 66% in December, 2007 when the recession began. The participation rate had been declining prior to 2007 as baby boomers began exiting the workforce. Another reason for the decline in the Participation Rate is that because of the tight labor market more teenagers are staying in school or going to college. The high school dropout rate has fallen and college enrollments have increased.

HOUSING

The Commerce Department reported that the monthly average of new home sales was 424,000 in the first quarter. This is marked improvement over the same period in 2012 when the average was 352,000 new home sales. This is a 17% increase. However, economists estimate that in a healthy economy the average should be 700,000. The current growth is the best since July, 2008. National homeownership was 65.4% in the fourth quarter, according to the U.S. Census Bureau. This is the lowest level since 1997.

Steady job creation and record low mortgage rates are spurring consumers to buy houses. The inventory of new homes has fallen to the equivalent of a 4.4 month supply. The rise in demand and the reduction in supply has driven up the price of new homes to an average of $247,000 in March. According to the CoreLogic Home Price Index, housing prices rose 9.7% in January from a year earlier. Home prices in

February increased 9.3% over a year earlier and were up 3% in March from one year earlier. According to the Standard & Poor's Case-Shiller index, home prices posted gains in February and March over the same periods the previous year in all twenty major metropolitan areas. Price increases in consecutive months in all major metropolitan areas has not occurred since 2005. The supply of homes available in twelve of the twenty major metropolitan areas are down to a three (3) month level. Supply is lowest in areas that were originally the boom and bust areas. In some parts of New York and in the Midwest supply levels are still high at eleven months.

The credit bureau, Equifax, has highlighted some trends that demonstrate some weaknesses and some strengths:

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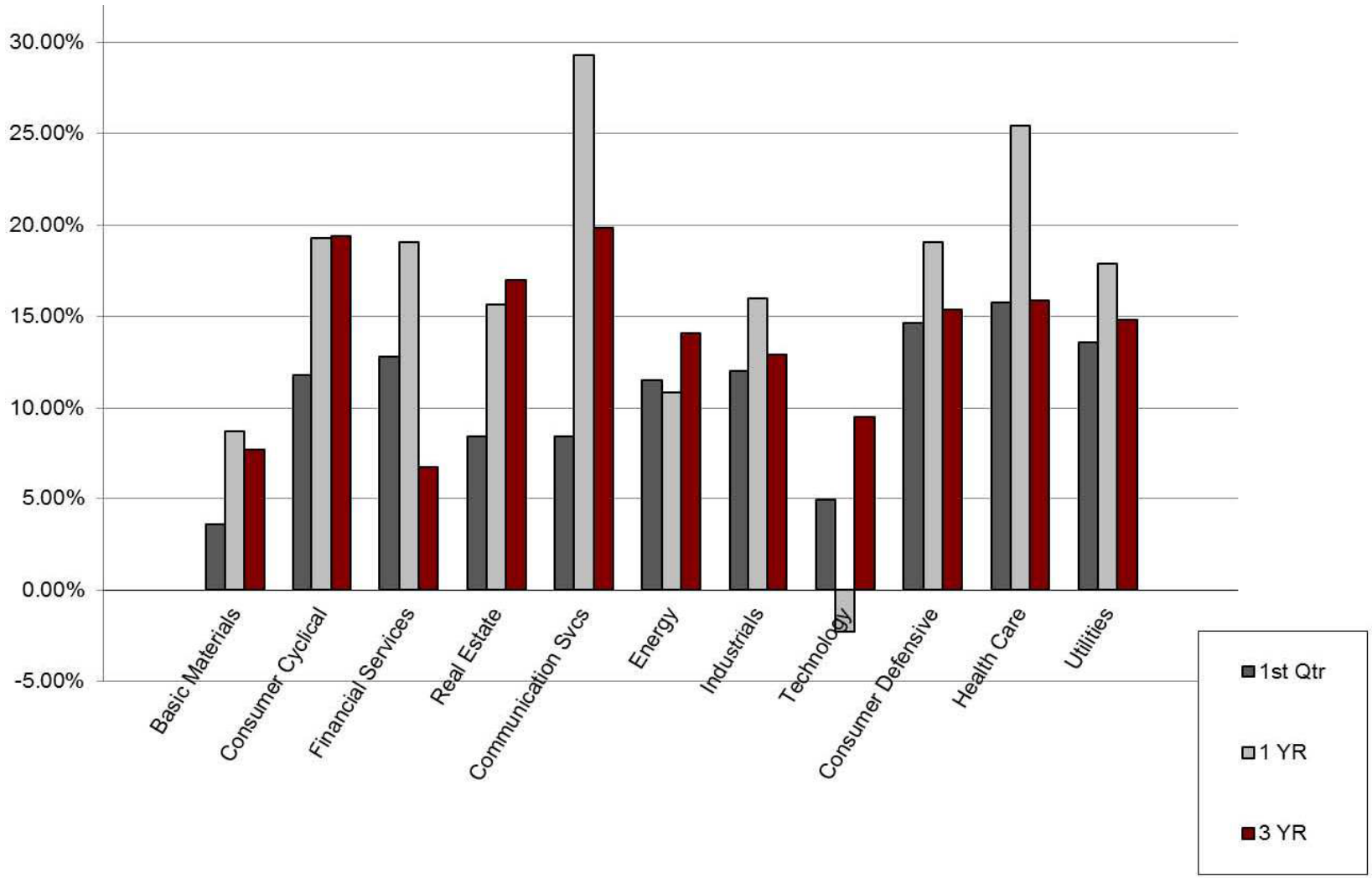
- The amount of severely delinquent or charged off student loans is up 36% over the previous year,
- Auto balances are high and rising, yet auto delinquencies have trended lower. A concern is that auto purchasers with poor credit can obtain an auto loan at a cost; that is a high interest rate and therefore a high monthly payment. If economic conditions worsen those loans could be unaffordable.
- Credit card balances have risen modestly over the past year, yet delinquencies continue a three (3) year improvement trend. One quarter of all credit card debt, almost $1 trillion, was paid or written off during the recession.
- Severely delinquent first mortgages, home equity and line of credit loans all fell between 23% and 28% over the past year. Of the problem first mortgage loans that remain, most were opened in 2005-07, during the liar loan period where supportive documentation was not necessary.

CONCLUSION

One conclusion from the renewed interest in defensive stocks, beyond the income provided by dividends, is that investors are getting skittish about economic growth and are concerned that the equity rally will falter. Another concern is that very large amounts of deposits are going into the stock markets at levels not seen since 1998. The exuberance for the stock market causes concern that it is overheating. There is also some fear that the stock markets are rising too quickly and this, too, may signal that a pullback is near.

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