

Although progress remains uneven, the global economy appears to be on better footing than it was at the same time one year ago. The outlook in the residential housing sector, one of the most important sectors for the health of the overall economy in the U.S., has brightened considerably. The Flow of Funds report published by the Federal Reserve in early March indicated that the net worth of the household sector rose by almost \$5.5 trillion in 2012. Household net worth—the difference between the value of households’ assets and liabilities—totaled approximately \$66.0 trillion at the end of last year. Analysts from J.P. Morgan Asset Management predict that this increase in wealth could set the stage for faster economic growth in 2013. Despite the end of the payroll tax holiday and high gas prices, consumer spending increased modestly throughout the first quarter across all income groups, according to data compiled from Gallup Daily Tracking Surveys. In a statement following their March meeting, the Federal Open Market Committee concluded that since January 2013 household spending and business fixed investment have advanced, and the housing sector has strengthened further, while fiscal policy has become somewhat more restrictive. As a result of sequestration, President Barack Obama recently volunteered to return 5% of his presidential salary to the U.S. Treasury, and other elected officials have followed suit.

Economic News

The January Barometer, a well-known stock market theory, supposes that the movement of the S&P 500 during the month of January is a good indicator of the stock market’s direction for the year. Along with some other oddball indicators—weather forecasts based on a groundhog seeing its shadow, for example—the January Barometer should be taken with a grain of salt. Theories aside, the first quarter of 2013 posted solid gains for many U.S. stock market indices, but renewed fear about the Eurozone debt crisis dampened performance at quarter end. Continued budget uncertainties and the likelihood of less government spending under the budget sequester now in place could hold overall GDP growth down in 2013. The following table highlights the average annual returns for various indices:

Index	1st Qtr	1 Year	5 Year	10 Year
S&P 500 (Composite Total Return)	10.61%	13.95%	5.81%	8.53%
Russell 2000	12.39%	16.30%	8.24%	11.52%
MSCI EAFE (Price)	4.40%	7.80%	-3.86%	6.79%
Barclays Aggregate Bond	-0.09%	2.65%	4.99%	4.79%

The S&P 500 is a commonly used measure of common stock total return performance, the Russell 2000 is a commonly used measure of small capitalization stocks, the MSCI EAFE is a commonly used measure of common stock total return performance of international markets, and the Barclays Aggregate Bond Index is a commonly used measure of the bond market. All referenced indices are unmanaged and not available for direct investment. Past performance is not a guarantee of future results.

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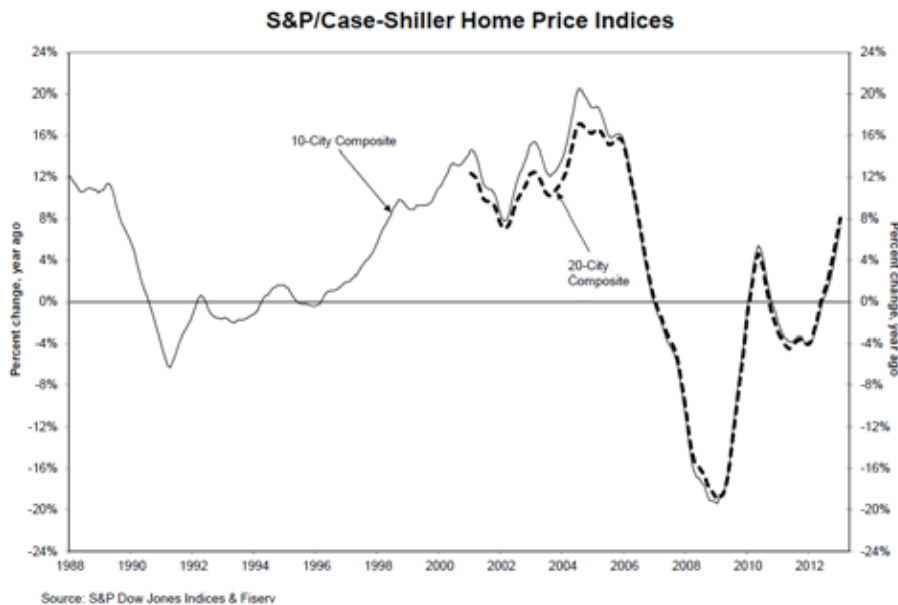
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Budget Uncertainties

With the U.S. government’s failure to reach a compromise on deficit reduction, a group of federal spending cuts, known as the sequester, went into effect on March 1, 2013. Originating from the Budget Control Act of 2011, the automatic spending cuts were designed to reduce the deficit by approximately \$1.5 trillion over the next 10 years. The Congressional Budget Office (CBO) projects that these spending cuts, together with the expiration of Bush era tax cuts and a decrease in payroll tax revenue, will slow U.S. economic growth by 1.25 percent. The sequester divides cuts evenly between discretionary defense, mandatory domestic, and discretionary domestic programs, projects, and activities. The CBO reports \$85 billion in automatic budget cuts for the 2013 fiscal year, though estimates for real reduction in cash disbursement stands at \$42 billion due to the multi-year nature of contracts and orders. Defense spending cuts reduce weapons purchases, base operations and construction activities. While \$28.7 billion of the \$42.7 billion in domestic cuts are discretionary, programs such as Medicaid, Social Security, and numerous low-income services remain untouched. Since agency heads have limited flexibility implementing the cuts, furloughs and job loss are beginning to take effect. The long-term effects of the sequester remain unclear. While the deficit as a percentage of GDP is projected to drop from 7.0 percent to 2.4 percent by fiscal year 2015, the same metric grows again during the second half of the decade. In January 2013, two major credit ratings agencies (Moody’s and Fitch) issued warnings about the long-term sustainability of the U.S.’ credit rating, with Fitch reiterating its concerns one month later.

Housing

The continued increase in home prices and existing home sales has brightened the outlook for the housing sector. According to the National Association of Realtors, home sales have been above previous-year levels for 20 consecutive months, while prices show 12 consecutive months of year-over-year price increases. The S&P/Case-Shiller 20-City Composite Home Price Index, which is the most widely followed measure of home prices, showed a year-over-year home price increase at approximately 8.1 percent through January 2013. The 20-City Composite is a value-weighted average of 20 metro area indices. All 20 metro areas showed a positive gain year-over-year in January.



Total housing inventory at the end of February represented a 4.7-month supply, down 27 percent from the same time in the previous year, but up slightly from the previous month—housing inventory tends to climb during the spring, which is generally considered to be the best time to sell a home. The median time on market for all homes was 74 days in February 2013, compared to 97 days in February 2012. The housing market still faces certain challenges in the year to come, such as tight mortgage lending standards which might prevent some buyers from qualifying for a loan. Some real estate intelligence firms believe that the housing market is on an upward trajectory, but that it is not out of the woods yet. Although down from its peak, shadow inventory of delinquent or foreclosed homes remains high.

Cyprus

Turmoil surrounding the European Union's financial stability continued to mount in 2012 as significant attention shifted to the Republic of Cyprus, whose banks had long since served as an offshore haven for neighboring countries. The country's economy relied heavily on the financial sector, comprising approximately 45 percent of its GDP. This figure is all the more significant considering Cypriot banks' overexposure to Greek debt. Following a Greek debt "haircut" in 2012,

Cypriot banks lost an amount equal to 25 percent of their nation's GDP. Cyprus requested 17 billion euros in rescue funding from the European Stability Mechanism (ESM) on June 25, 2012. By the first quarter of 2013, it appeared that the nation's future in the European Union was contingent upon their receipt of a successful rescue package.

After nearly six months of indecision on the topic of a Cypriot banking bailout, Eurogroup President Jean-Claude Juncker resigned his position on January 21, 2013, announcing that the decision on the requested rescue package would be made no earlier than March. By mid-March, depositors of Cypriot banks feared for the safety of their deposits which were only insured up to 100,000 euros. When the country announced that a tax on bank savings may be part of a deal to obtain rescue funding, Cypriots rushed to access their funds before the levy was enforced. With ATMs cashless, banks were forced to close their doors beginning March 16. Rescue funding negotiations were completed on March 25; however, banks remained closed until March 28 as the country adjusted to the terms of the bailout.

Cyprus accepted 10 billion euros from the ESM, committed to raise an additional 5.8 billion euros through bank restructuring, and agreed to close Cyprus Popular, its second-largest bank. The bank's deposits of less than 100,000 euros will be transferred to the Bank of Cyprus, while deposits above the insurable threshold will be frozen until the restructuring of the banks is completed. These deposits will be used to pay Cyprus Popular's debts and recapitalize the Bank of Cyprus. Although these uninsured deposits will eventually be converted to shares of the bank, losses may be as high as 30 percent.

Cyprus once again brought into question the practicality of a single-currency Eurobloc. Eurozone ministers closed the quarter by announcing a 500 billion euro increase to the ESM on March 30. The funds are intended to alleviate concerns that the currency's future is unprotected and, even worse, uncertain.

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