Market Commentary

First Quarter 2012

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we'll get there together

The first quarter of 2012 continued the strong upward move in equity markets that began in early October 2011. The benchmark S&P 500 index increased by 12.6% during the quarter on a total return basis. This brought the cumulative increase in the benchmark S&P 500 index to 29.6% from the fourth quarter lows. After such a rapid increase, it would be unwise not to expect a short-term period of backing and filling while earnings growth catches up to stock prices. We also note that in the previous eight instances that the S&P 500 has gained more than 10% in the first quarter of a year, it has averaged an additional gain of 3.3% in the second quarter. We are not saying the stock market is overvalued at current levels, but merely that after the six-month rally a trading range could be expected to consolidate the gains in equity markets.

Activity in fixed income markets during the quarter unequivocally demonstrated our reasons for remaining with very short-term and very high-quality debt instruments. We have held these beliefs for most of the past three years as rates have remained near multi-decade lows. The Federal Reserve is artificially keeping rates low in an attempt to rebuild the banking sector, but this distorts interest rates and makes them susceptible to rapid swings. During a single week in March, the interest rate on the 10-year Treasury note jumped from 2.03% to 2.38%. While this may not seem like a large move in rates, investors lost 3.5% of their principal in just five trading days. With rates as low as they are, this 3.5% principal loss wiped out **18 months** of interest payments. We believe the Federal Reserve will eventually have to reverse course on their quantitative easing and when they do, interest rates could rise faster and farther than most investors expect. For these reasons, we continue to invest in bonds that have solid credit qualities and very short maturities to protect against large principal losses. Buying a 10-year Treasury with a 2.25% yield almost guarantees a negative real return for investors.

Our Outlook

Despite the rapid move upwards in equity markets, there remain a number of issues that may curtail this current rise in equity prices. There are four major issues that bear watching as we progress through 2012. A positive resolution to some of these issues could lead to higher markets, while negative resolutions would have the opposite effect. Specifically, we are watching the European economic situation, the potential for armed conflict with Iran, rising oil prices, and the slowly reviving US economy. While we believe all four could be neutral to positive for the markets during 2012, there is a fifth issue that could override the other four – the Presidential and congressional elections and their effect on economic policy. There are a large number of economic and tax issues that remain unsettled for next year. These include the expiration of all Bush tax cuts, the future of the "temporary" Social Security tax cut, across-the-board budget cuts in domestic and military spending, and the federal debt limit being reached. The likelihood of resolving these in an election year are slim at best, and thus it may be well into the holiday season before we get a sense of what tax rates will be for 2013 and beyond. At this point, we don't see anything being accomplished in Congress as members of the House and Senate focus on the November elections. Neither party will want to negotiate with the opposing party if they believe they will gain seats in the November elections. Even following the election, the most likely scenario is a further delay in any painful choices by kicking the can down the road again with a bi-partisan agreement to extend current rules temporarily.

While concerns over a second US recession have subsided, there are still many concerns over the sustainability of the US economy. Many economists believe if the Federal Reserve were to move from its zero interest rate policy, or if the temporary cut in the Social Security tax were to be removed, the economy would stop growing.

Portfolio Positioning

Client equity portfolios have seen some changes during the past quarter as we fine-tuned portfolios for the slow and uneven growth we project for the US economy. While it is clearly evident that economic growth has picked up in recent months, the US economy is still far below its potential output and this sub-par growth is likely to continue for several more quarters. Large-cap, well established companies with solid cash flows and strong balance sheets should be among the best performers at this point in the economic cycle. Speculative companies have already made large moves and many have had rapid descents after missing a quarterly estimate or delaying a new product. We believe investing is not speculating, and therefore we focus on strong companies with the financial strength to not only survive difficult economic periods, but to continue to grow through them.

Looking at individual sectors, we observe that significant investor cash flows into traditionally conservative stocks have pushed valuations up for many of these companies. The most expensive sectors currently are Consumer Staples, Telecommunications, and Utilities. The rush into these stocks over the past 30 months has driven valuations to well above normal levels. In contrast, Energy, Healthcare and Technology are selling well below historical valuations and are the least expensive sectors currently.

With economic growth expected to be muted for the next few years, we are looking at dividend payers and more specifically those companies that grow their dividends year after year. If growth in earnings declines to the 5% range, as many expect, an extra two to three percentage points in dividend yield can significantly boost overall returns in client portfolios. As stated earlier in this commentary, fixed income portfolios remain short in duration and focused on high-quality credits as they have been for most of the past two years. We do not believe in taking risk with the fixed income portion of client portfolios.

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Conclusion

We see 2012 shaping up to be a year with a number of cross-currents that could potentially affect markets. The Presidential election, the risk of armed conflict with Iran, rising energy prices, and a domestic economy that continues to grow well below its potential are among the principal exogenous factors we are monitoring. In spite of these outside risks, equities continue to be reasonably priced, and in the case of the largest companies by market capitalization, meaningfully undervalued versus historical valuations. We believe that the move towards larger, financially strong companies that began in 2011 will continue through 2012 and this could be another catalyst in leading the equity markets higher during the year. Price/earnings ratios remain below historical averages of the past 40 years.

Additionally, fund-flow data shows that investors continue to withdraw money from equity funds and place it in bond funds even though stocks are cheaper than bonds. After a rapid move upwards of almost 30% from the October 2011 lows, we believe equity markets may take a breather until later in 2012 when some of the uncertainties begin to be resolved. With equities near fair pricing, we forecast returns over the next 12-18 months approximating the long-term average for equities of about 10-12%, with the caveat that sustained higher oil prices would further crimp consumer demand. In conclusion, with bond yields at multi-generation lows, we believe equities offer investors a very strong investment alternative. Stocks have yields similar to bonds, yet stocks traditionally grow both their earnings and their dividends each year. Finally, although investors have been a bit shell-shocked during the past few years, we point out that as measured by the S&P 500 Index, the stock market has only declined in one of the past nine years.

As always, please do not hesitate to call or email if you have any questions or comments.

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