Market Commentary

Second Quarter 2012

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we'll get there together

The second quarter of 2012 was a period of small moves higher and lower for the equity markets after the very powerful upward move that began in October 2011. The benchmark S&P 500 index declined by 2.8% during the quarter on a total return basis. This brought the year-to-date return in the S&P 500 index to 9.5%. After such a rapid increase in six months, the slight pullback during the quarter was not only probable but also healthy. The market has continued to show rapid moves in both directions as the period of mini-cycles that began in 2009 continues.

Fixed income markets benefited from a further flight to quality during the quarter with yields on the 10-year US Treasury bumping against all-time record lows. The benchmark 10-year note finished the quarter with a yield of 1.66%. Investors across most of the US Treasury yield spectrum are accepting negative real returns due to fear of principal losses in other asset classes. As the Federal Reserve continues to keep interest rates artificially low, we are astounded by calls for more Fed easing. The US economy is suffering from a lack of demand, not a lack of liquidity. Businesses and consumers are paralyzed by uncertain fiscal and tax policies. While any further Fed action might cause a relief rally due to the Fed "doing something", we do not believe further Fed action is needed or desired.

Investors continue to shun stocks as they flee risk assets. During the second quarter, investors pulled approximately $44 billion from equity mutual funds and invested about $71 billion in fixed income funds. This continues a trend that began in 2007. Since the start of 2007, investors have redeemed over $350 billion from equity funds while investing over $1 trillion in fixed income funds. We don't know when this trend will end, but we can be sure that when it reverses, equities will gain an additional boost. One reason for the huge move into bonds is their outperformance over equities since 2000 – the first extended period of bonds outperforming stocks since the Great Depression. This will reverse course at some point, with current interest yields near multi-generation lows.

Our Outlook

In our last commentary, we mentioned four major issues to watch during 2012. These issues were Europe, oil prices, Iran, and the US economy. Through numerous fits and starts, we believe we are closer to the resolution of the European fiscal crisis than we were several months ago. Although markets have been held captive to issues in Greece, Spain and elsewhere on the continent, the European nations appear to be edging towards a solution to the multi-year crisis. Oil prices have declined significantly during the past three months. Lower gasoline prices will add to consumer purchasing power and provide support to consumer spending growth over the next few months. Each penny decline in fuel prices adds $1 billion to consumers' purchasing power. The situation with Iran remains fluid but we do not see any signs of an armed conflict in the upcoming months. That leaves the US economy as the biggest swing factor.

While mild winter weather boosted payroll growth in January and February, this borrowed from traditional seasonal strength in the April to June time period. 2012 continues to be a year in which macro events

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overshadow the relative merits of companies, sectors, and market segments. This is the third consecutive year to see the equity markets pull back in the spring / early summer on fears of a US recession. We do not expect a recession this year which sets the stage for a stronger market later in the year.

Portfolio Positioning

Client equity portfolios have been positioned for the slow and uneven growth we project for the US economy. We continue to look for signs the US economy will approach its potential output at which point we would become more comfortable increasing our exposure to riskier assets. In the meantime, we remain content to stay near our benchmark asset allocation weightings. Within equities, we believe larger companies, with the ability to grow through the uneven economic cycle, will do best. We do not mind missing out on the occasional speculative winner, when we know the penalty for getting it wrong is so severe. Witness the Facebook IPO – the most heralded IPO in a decade. The frenzy to buy shares in the IPO was headline news for several weeks. Nobody seemed to care or worry about the valuation. Within three weeks of the offering, investors who bought at the IPO were down 32%. Instead of stories about all the new millionaires, we got news about investor lawsuits. There is always a style of investing that will excel during a certain type of market or economic period. At Tandem Wealth, we strive to do well in the up cycles while fiercely protecting client assets when the inevitable downturn occurs. This is where we believe most investors are lacking – they fail to protect their downside when the market quickly turns lower. We have seen sharp, rapid declines several times during the past decade in this period of mini-cycles. Risk control is paramount among our duties to our clients.

While equities continue to look cheap when compared to fixed income securities, there is concern that continued lackluster economic growth could hurt both asset classes. Interest rates remain very low for the fourth consecutive year because there are no signs of strong economic growth at any point in the next several quarters. If this holds true, it will be difficult for corporations to see much in the way of revenue or earnings growth from here. With profit margins at historic highs and most companies having undergone several rounds of cost-cutting, further earnings gains must come from higher revenues.

Conclusion

As we move closer to November, the Presidential election will grow in importance and markets will begin to price in a victory by one of the two candidates. There is a lot of chatter about the coming "fiscal cliff" in early 2013. While the risks of doing nothing are too great for even our fractured Congress to ignore, we still believe they will wait until the very end of 2012 before acting. We saw similar behavior in late 2010 when Congress waited until after the November elections before voting to extend the Bush tax cuts for another two years. Markets may get very volatile as the media increasingly beats the "fiscal cliff" drums, but nobody on either side believes it is prudent to enact a tax increase of between 2-3% of GDP while the economy is already on a tenuous track. Despite the potential risks, equities continue to be slightly undervalued, especially when compared to other asset classes. As always, we encourage dialogue with our clients. Do not hesitate to call or email if you have any questions or comments.

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