Market Commentary

Third Quarter 2012

C. Angus Schaal, CFP®
Managing Director

we'll get there together

The third quarter of 2012 saw a further rise in the equity markets. The benchmark S&P 500 index rose by 6.3% during the quarter on a total return basis. This brought the year-to-date return in the S&P 500 index to 16.4%. Going back to the early October 2011 lows, the S&P 500 has returned 33.9% in just under 12 months. After gains like these, we believe the likelihood of equity markets "marking time" is likely over the next few months as they consolidate the gains of the past year.

Fixed income markets are showing the effects of a Federal Reserve doing everything in its power to jump-start the US economy. The benchmark 10-year note ended the quarter with a yield of 1.65%, essentially where it traded three months earlier. We continue to question the logic of investors accepting negative real returns in US Treasuries, particularly in durations of 10 years or longer. The Federal Reserve is trying to do what it can to improve growth in the economy by purchasing fixed income securities. The past several quarters of lackluster economic growth has built up significant excess capacity in the economy and is the primary reason inflationary pressures are being kept at bay. While the Fed's stated long-term inflationary target is 2%, we believe at this point they would far prefer 4% inflation to 0%. They are willing to risk higher inflation if they think it will spur economic growth in the short-term.

We have seen and heard a lot of talk regarding the coming "fiscal cliff" on January 1, 2013. In summary, this is a combination of mandated spending cuts along with significant tax increases hitting at the same time. Clearly, if tax rates move back to pre-Bush tax cut levels in January 2013, there is no doubt the economy goes back into a recession—possibly a severe one. This is not our prediction, since we do not think Congress or the President is going to play chicken with the American economy and have that happen. The best outcome would be a long-term permanent deal. This would be very bullish, although it would not postpone the secular deleveraging and deflationary forces in the economy. A temporary deal would likely result in continued economic paralysis, much like what we've seen over the past two years. Corporations simply cannot invest and hire when economic and tax policy is subject to continued six to twelve month resolutions. We need to know what the fiscal and regulatory environment will be over the next five to ten years to enable people to be willing to invest in plants as well as people. We believe a tax cut to corporations, along with maintaining the present tax system for consumers, would be a long-run positive and a step in reducing the government's role in the economy, which has been enormous over the past four years. US companies are not sitting on $2 trillion in cash because they cannot think of any productive uses for it. They fully understand they are getting negative returns after inflation and lowering their return on equity. Were they to open their wallets to invest in hiring along with capital expenditures, the seeds of a sustainable recovery would be sown. Certainty on policy is what they crave.

We are concerned that the Fed has made itself the only natural buyer of Treasuries during the past 18 months. During the second round of quantitative easing (QE2) they were 61% of the market. At the peak of the housing bubble, foreigners absorbed 82% of Treasury issuance; today, they are only 26%. The Fed

Tandem Wealth Advisors LLC
www.tandemwealth.com

1 East Camelback, Suite 550
Phoenix, AZ 85012
Tel 602-297-8600
Fax 602-297-8601

announced QE3 in mid-September, announcing that it would buy $40 billion in mortgage securities each month until it sees improvement in the economy. This is the first time they announced an open-ended round of bond-buying. In essence, the Fed stated it would print money and buy bonds every month until it sees clear signs of stronger economic growth.

Our Outlook

The economy continues to sputter in fits and starts. We do not currently see a path to sustained growth much above 2% annually until the fiscal and monetary issues discussed above are set for the long term. Housing seems to have finally bottomed with many regions across the country noting increases in both the number of sales along with average selling prices. Inflation, while potentially a large headache, remains quite muted despite the heavy Fed intervention. Europe continues to make headlines but this is already well known and the declaration that the European Central Bank would do "whatever it takes" to keep the Euro intact seems to have calmed many nervous investors and institutions.

Portfolio Positioning

Client equity portfolios remain positioned for the slow and uneven growth we project for the US economy. We continue to look for signs of increasing growth in the US economy, although these are scant at the current time. When we see stronger growth become entrenched in the economy, we would move further out on the risk spectrum. The unexpected stock market rally during the summer months was a strong example of why we do not believe in market timing. After clear signs that Europe was headed into a recession and the US was seeing slower growth, many investors headed for the sidelines in April and May. After a modest decline of about 7% during those two months, stocks reversed course and ran up more than 10.7% in the following four months. Some of those investors grudgingly got reinvested as the market strength continued. We continue to favor larger companies with stronger balance sheets, international presence, and the ability to maneuver through the uneven economic growth.

Conclusion

As we close in on the election, the expected results will likely begin to effect markets, although the degree of movement is uncertain. Continued coverage of the impending "fiscal cliff" will cause some angst among investors, but we believe this will be settled before the end of the year. Despite the potential risks, equities continue as the cheapest of the easily investible asset classes. Please call or email us if you have any questions or comments.

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Tandem Wealth Advisors LLC
www.tandemwealth.com

1 East Camelback, Suite 550
Phoenix, AZ 85012
Tel 602-297-8600
Fax 602-297-8601