Market Commentary

Fourth Quarter 2012

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we'll get there together

The fourth quarter of 2012 saw a modest decline in the equity markets. The benchmark S&P 500 index fell by 0.4% during the quarter on a total return basis. This brought the full year return for 2012 to 16.0%. Fixed income markets were more volatile than usual during the quarter as economic and political events moved rates more than would be expected. The benchmark 10-year note ended 2012 with a yield of 1.78%, up from 1.65% three months earlier, but still the lowest year-end yield on record. With the Federal Reserve stating that it would like inflation in the 2.0-2.5% range, owning a 10-year note paying less than 2% defies wisdom. Despite the strong equity returns in 2012, investors continue to favor ultra-safe instruments like US Treasuries and shun riskier assets like equities and commodities as evidenced by continued monthly outflows from equity funds into fixed income funds. In an environment of rising inflation – where the Fed is trying to move us, Treasuries would decline in value and commodities and stocks would likely increase. We conclude from this that investors believe the Fed will fail in its mission to spur economic growth and reduce unemployment.

With the Federal Reserve having committed to buying approximately $85 billion in fixed income securities per month, their mission is clear – to do everything in their power to inflate asset prices and spur economic growth. Currently at $2.9 trillion, the Fed could see its balance sheet surpass $4 trillion in assets by the end of 2013 if it continues purchasing securities at the current rate. We agree with many who say the Fed has often been the only "game" in Washington during the past two years. Congress and the President would rather spew vitriol towards the other side instead of working together towards solidifying economic growth.

Our Outlook

Clearly, the past three months have been dominated by chatter over the "fiscal cliff" which was to arrive on January 1, 2013. We had written in our last commentary that we did not think Congress or the President would allow the economy to face these huge tax increases along with significant budget cuts. We were correct on this prediction. We also wrote that we preferred a long-term permanent deal that reduced spending, set long-term tax policy and dealt with entitlement reform. Clearly, we did not get anything close to that. In fact, Congress effectively transformed this fiscal cliff into three "mini-cliffs" that will be reached in the next three months. Before the end of March, Congress has to deal with three major budgetary issues. In late February, the Treasury will be unable to pay its bills unless the debt limit is increased. On March 1, the mandated spending cuts strike, having been punted two months during the recent budget agreement. Finally, on March 27, we face a potential government shutdown unless Congress approves funding for the remainder of the fiscal year. This piecemeal governing is neither conducive to long-term strategic planning, nor investing. While the tax rates have been settled, little has been done on reducing spending or trying to control deficits. It seems that only in America can we read that Congress raised taxes on nearly 80% of Americans, and in doing so, raised the projected deficits by $4 trillion over the next decade.

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The economy continues to show more signs of sustained growth, albeit at well below potential output levels. Job growth remains steady but at insufficient levels to dramatically reduce the unemployment rate.

We are still concerned that the recent "fiscal cliff" deal does nothing to address the major economic issues of the past few years. There is no short-term stimulus to try to get the economy back to full employment. Nor is there a strategy to attempt to reduce the budget deficit over the longer-term. Congress has set up another trio of arbitrary deadlines that need to be addressed during the current quarter. This is likely to lead to increased financial market volatility, at least during the short term.

Portfolio Positioning

Client equity portfolios have been positioned for the sub-par economic growth of the past several quarters. We see early signs of a better economy, particularly in the housing and automotive markets, but not enough to make us increase the overall risk of portfolios at the current time. We continue to counsel prudent asset allocation and remaining invested through turbulent times. Investors who grew disenchanted following the Presidential election felt emboldened to sell equities as evidenced by the 6.1% decline during the quarter. However, from the equity market bottom on November 15, the S&P 500 rallied 6.5% through year end and an additional 2.5% on the first trading day of 2013. These quick movements in each direction are difficult to capture and provide the basis for our counseling patience in investing. With profit margin growth well above historic levels, we believe top-line revenue growth will be the key to better earnings. We continue to favor companies and sectors with stronger balance sheets, international presence, and the ability to grow their revenues each year. As always, risk control is our paramount goal for client portfolios. Our unique blend of different investment styles continues to garner solid relative performance across a variety of market cycles.

Conclusion

As we begin 2013, with the Presidential election behind us, investment returns will again be determined by economic growth prospects. While the next few months promise more uncertainty and headlines, we do see concrete evidence of a slowly improving economy. We believe with the poisonous effects of the election in the past, Congress may finally begin to work on putting the US on a path to more fiscal stability. Equities are not the safest of investments, but they do remain one of the most inexpensive relative to both historical valuations and competing asset classes.

Finally we wish everyone a healthy, happy and successful New Year in 2013. We continue to strive to earn your trust and loyalty every day. As always, please contact us if you have questions or if we can provide any assistance to you with your investments.

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