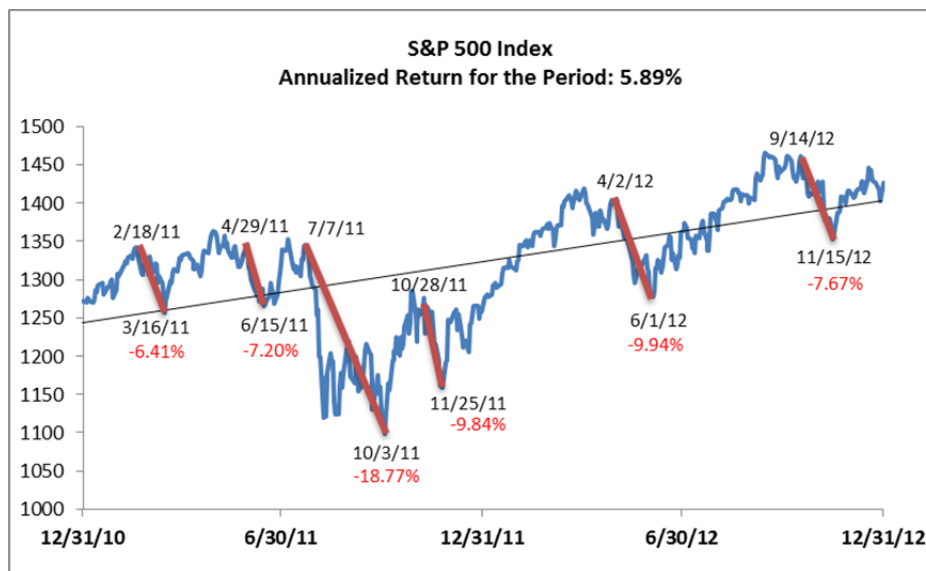


Financial Markets Perspective

January 2013

Prudence and Patience

The dominant theme in the global economy for the past two years could be entitled: “backlash to austerity” whereby the malaise induced by individual European governments to combat budget deficits (reduced spending and higher taxes) was countered by the emergence of new monetary policies by the European Central Bank that effectively emulated the Federal Reserve’s efforts to keep interest rates low in the United States. These “safety net” policies provided surprising support for equity markets giving stocks a strong rally in late 2011 and early 2012. Unfortunately, intermittent financial scares regarding a bankruptcy of one or more European countries and the uncertainty surrounding the fiscal cliff drove the stock market down by almost 10% twice last year and by 19% during 2011. As you can see in the chart below, volatility was especially high over the past two years as a result of Japanese earthquakes and tsunamis, Thai floods and the above-mentioned Euro crisis and fiscal issues in the United States. For the past two years the S&P 500 index has had an annualized return of less than 6% and only a 2.3% return per year since the peak on October 9, 2007.



Despite moving up and down for most of last year, domestic stocks finished up as measured by the S&P 500 index that rose 16% while the more popular Dow Jones Industrial Average gained 7.3%. Virtually all major foreign stock markets did well in 2012 with the exception of Greece, Portugal and Spain where persistent economic problems prevailed.

Long-term U.S. Treasury bonds returned a paltry 2% last year. This gain is far below the 8% annualized return that investors have enjoyed over the past thirty years! This rally in Treasuries has been fed by FEAR as investors tried to avoid volatility in the stock market. With continued low interest rates, corporations issued a record number of bonds last year. For example, Texas Instruments recently sold bonds with yields below ½%! Many professionals see a surprising upturn in the economy as the pin to deflate the bond market bubble. The concern is not so much that investors will lose principal by owning these bonds but rather that low returns will remain a non-rewarding investment relative to stocks. Conservative investors who chose money market accounts as a safe-haven from stocks have experienced almost five years of zero returns while inflation has eroded their principal.

The decision during the fourth quarter by the Federal Reserve to target the unemployment rate rather than inflation was another landmark move in the conduct of monetary policy. The Fed's prior commitment to keep interest rates low until mid-2015 gave market participants some leeway in planning the future knowing when rates would rise. This second commitment by the Fed to keep interest rates at record lows as long as unemployment stays above 6.5% suggests many more years of low interest rates—unless the economy grows unexpectedly. Given the recent fiscal tightening and low interest rates for the foreseeable future, corporations that are sensitive to interest rate spreads will thrive.

Low inflation, low interest rates and an improving private sector are finally giving a lift to the economy while continued political battles encourage greater uncertainty about the future. The collision of these trends has produced unusual stock market volatility but a better than average year for stocks.

[Where Do We Go From Here? : A Narrative for 2013](#)

We look forward to a year that will likely bring a higher stock market accompanied by continued ups and downs as a result of event-driven volatility. Political indecision and macroeconomic results will influence financial markets for the year. Sound familiar?

The recent agreement reached by politicians to avoid the fiscal cliff resulted in a tax increase on the “wealthy” (individuals making over \$400,000 and couples making over \$450,000) and a sizeable percentage boost in the payroll tax rate (from 4.2% to 6.2%). In addition to the known tax increases, there will be a growing tax payment due on the implementation of the Affordable Care Act otherwise known as Obamacare. All of these tax increases will slow economic activity. The agreement postponed the imposition of massive sequestration of funds that would have been spent by the government on defense and social programs. The postponement is only for two months so we will be back in the heat of political battles before Spring. Then there is the self-imposed issue of the federal debt ceiling that could produce a temporary shutdown of the federal government—slowing spending even further. Lastly, corporate America did accelerate economic decisions into last year that would have contributed to growth this year.

As mentioned earlier, there is continued good news coming from the private sector. The labor market is gradually improving as jobs have been growing at a reasonable pace. The household debt service burden is near all-time record lows and household net worth has almost fully recovered from the 2008 recession. More positive data has come from the housing market as home prices have finally been steadily improving. Corporate earnings and wealth are at record levels providing the basis for share repurchase programs, increased dividends, company acquisitions and related higher stock prices. The Federal Reserve's commitment to low interest rates and support for the financial markets increases confidence that another financial meltdown is unlikely. The combination of similar policies being implemented by central banks around the world and new initiatives by both China and Japan are likely to invigorate the trade picture that will propel global growth in 2013 and beyond.

The dramatic reversal in our energy fortunes due primarily to an explosion in domestic oil and gas production provides another source for optimism. According to Investor's Business Daily, oil output in the U.S. last year was 7 million barrels a day, the highest level since 1993. As a result, the U.S. met 83% of its energy needs. The U.S. imported 7.9 million barrels a day in 2012, 16% below the level of imports in 2011. The Energy Department estimates that the U.S. will produce 7.3 million barrels per day this year and 7.9 million barrels per day next year. This increase in domestic supply signals that energy independence is not far away.

Economic history is replete with examples of the business cycle where a recovery from an economic downturn is followed by a phase of normal sustainable growth rates assuming no unusual events occur. Since the Crash of 2008, the U.S. economy has been experiencing slower 2% growth rather than a 3-4% rate that should occur given the average of prior recoveries. This slow growth suggests there is a long way to go to achieve full employment and full capacity utilization—a time when inflation begins to accelerate. Investors are still wary about the ability of a bull market to be sustained as indicated by substantial withdrawals from equity mutual funds and contributions to bond mutual funds over the past two years. History also tells us that the third phase of a stock market advance is characterized by investment euphoria, surging stock prices and the ability of just about anyone to make money. Back at the highs of 1999, market commentators forecasted a Dow Jones Industrial Average of 36,000. The highest forecast for the DJIA that we have seen lately is from Jeremy Siegel who is calling for 15,000—some 13 years after the 36,000 forecast was made and a 14% or so return from today's level that is far from euphoric.

The primary risks to positive stock market returns continue to be political. Solving the fiscal cliff could have been much worse if the Bush tax cuts expired and sequestration proceeded on plan. Fears over a growing federal debt due to record budget deficits continue to spook the financial markets but any serious efforts to cut that deficit will have a negative economic impact as one government's spending is another person's income. A similar story can be told about the sequestration of funds—another way to get the federal government to spend

less. Yet there are no apparent problems caused by currently large deficits that bolster the general economy until private sector spending gets back on track. Each time the politicians address these problems and come up with non-solutions, financial markets shudder. History teaches us that a strong stock market presages a strong economy. The resolution of the fiscal cliff—at least partially deferring tax increases and spending cuts—could produce sufficient optimism in consumers and businesses that we get an acceleration in economic activity this year.

Our investment strategy is founded in the belief that common stocks are the best way to grow wealth given a long-term perspective and a willingness to make changes as the economic and investment landscape becomes uncertain. As with the last two years, we may be confronted with events that lead to sharp market corrections in 2013. Our plan is to invest carefully and prudently knowing that patience will win in the long-term. We are hopeful that U.S. politicians will opt for a private sector growth solution instead of continued shenanigans that inhibit pro-capitalist programs.

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