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FOURTH QUARTER 2012 INVESTMENT ADVISORY REPORT

"Curiouser and Curiouser"

The Markets put in a mixed performance last quarter. The Dow, S&P 500, and Nasdaq Composite were all down slightly, but the more volatile S&P MidCap 400 and smaller company Russell 2000 indexes both eked out gains. This incipient trend towards the reemergence of "risk on" was further evidenced by even stronger returns in the European and Emerging Markets (see table 1. below).

One notable divergent market was the Dow Jones Utility Index. According to MassMutual Retirement Services," …Utilities was (*sic*) the weakest sector and the only one to record a negative return for the year overall, losing 2.91%."[1] This sector has historically been a precursor to broader moves in interest rates. And, in fact, the 10 year US Treasury note climbed from 1.65% to 1.78% during the Fourth Quarter – a nearly 8% increase, and up from a low of 1.43% on July 25th.[2] Is this the beginning of a more significant trend in higher longer-term interest rates (lower bond prices) as investment capital, at the margin, eschews the precarious fiscal state of government balance sheets?

In his year-end commentary, Michael Aronstein of Marketfield Asset Management states;

> *"In the simplest terms, governments are being involuntarily weaned from their dependence on credit as a means of sustaining privilege. As is the case when watching waning advances in capital markets, the weakest participants give way first. It is why, at meaningful tops in price, the breadth of advance narrows as more and more of the demand is funneled to fewer and fewer high grade and seemingly impervious instruments.*
>
> *At the peak of the technology stock mania in 2000, the low quality names broke early in the year, while many of the established leaders (Cisco, Intel, IBM, Microsoft) remained at or near historic highs for another year or more.*
>
> *In the present case, governments with impaired balance sheets presiding over regions with the weakest underlying fundamentals have fallen first. Greece, Detroit, Egypt*

[1] http://wwwrs.massmutual.com/retire/pdffolder/investments/quarterly_market_review.pdf

[2] http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2012

> *and other leaders in the parade of management failure are harbingers of a more widespread problem."* [3]

Can the US Federal Reserve Bank and Treasury be far behind? Brian Jacobson summed it up nicely when commenting "We're going to boldly go where no central bank has gone before" [4] According to the most recent Federal Reserve Statistical Release, the total assets on the Fed's balance sheet were $3.036 *trillion* (and rising by close to another trillion dollars per year as a result of their most recently announced "Quantitative Easing" policies. According to a recent Seeking Alpha blog; "At the dawn of the crisis dating back to the summer of 2007, the total assets on the Fed's balance sheet stood at $867 billion"[5]). [6] However, if you look further down to section 8 of the Release, it states that the Fed's total capital is only $54.7 *billion*. [7] This means that the Fed is levered roughly 55 to 1. In August of 2007, Lehman Brothers leverage was "*only"* 44%. [8]

The US Fed is not alone in this "experiment". Barron's recently quoted Felix Zulaff who stated, "Thirty-eight countries are pursuing a zero-or negative-real-interest-rate policy. I have never seen anything like it." [9] And, in another Barron's interview, Jim Chanos states "The central banks, like any committee may get something right, and they may get something wrong. But they are not right all the time. ***And investing one's capital on the basis of where central banks are planning their policy moves is a little bit frightening*** (ed. note - emphasis added*)*." [10]

Perhaps even more frightening is that it's by no means clear that all this monetary stimulus will actually work, and result in organic economic growth. While the overall S&P 500 index was up in 2012, much of the gain came from only one stock (Apple), and according to Morgan Stanley, 88% of the incremental profits earned by the S&P components were generated by only 10 companies.[11] One outcome that typically ***<u>can</u>*** be relied upon as a result of increasing the supply of a nation's currency and pursuing ZIRP (zero interest rate policy) is the depreciation of that nation's currency. This classically increases the exports of the country due to it's now "cheaper" currency, and in fact this worked very effectively during the "Asian Contagion" crisis during the late 1990's. Their currencies crashed, inflicting severe "adjustment" to the wages and purchasing power of the domestic population. But the contraction was eventually offset by the countries increased exports and ultimately these countries thrived and today are generally running external surpluses.

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[3] Michael C. Aronstein; Marketfield Asset Management 2012 Year-End commentary, pg. 3
[4] http://www.bloomberg.com/news/2013-01-25/fed-pushes-into-uncharted-territory-with-record-assets.html
[5] http://seekingalpha.com/article/1133271-fear-and-loathing-on-wall-street
[6] http://www.federalreserve.gov/releases/h41/current/h41.htm
[7] Ibid. #6
[8] http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6143297/Lehman-Brothers-the-bank-that-bust-the-boom.html
[9] Barron's; "Here's What's cooking for 2013"; January 21, 2013; pg. S15
[10] Barron's; "A Short Story for a Long Winter's Night"; December 24, 2012; pg. 30
[11] Barron's; Where's the Crowd?", December 17, 2012; pg. 38

This did not work quite as well though, during the years following the 1929 market crash and the ensuing depression. In that instance, the entire world simultaneously weakened their currencies in what became known as "beggar thy neighbor policies - an essentially zero-sum attempt to boost exports. And, with Japan recently joining the party – announcing that they would depreciate the Yen until inflation was running at 2% - it's becoming eerily reminiscent of the '30's. A front page headline in the Financial Times – "Central Bankers Hit Out at Yen Policy" – outlined such concern.[12] Equity markets worldwide are rising in the face of all this liquidity, but it's still hard to see where the economic growth will come from. Copper is a commodity that's highly sensitive to signs of economic growth and increased demand, but as the chart below indicates, it's essentially going sideways. [13]

1 Year Copper Prices and Price Charts

Copper Price 3.65 USD/lb (8,036 USD/t | 5,972 EUR/t) 24 Jan 2013 - 52 Week Low 3.29 USD/lb 52 Week High 3.93 USD/lb

[12] Financial Times USA, "Central Bankers Hit Out at Yen Policy"; Thursday, January 24, 2012, pg. 1
[13] http://www.infomine.com/investment/metal-prices/copper/1-year/

Possibly the stock markets have it wrong. As Michael Aronstein so eloquently explains, "Markets are accurate expressions of established facts and expectations, even when the latter are wrong. As is the case of markets for goods and services in a free society, people buy and sell according to rational expectations of what they believe will benefit their circumstances. Often times they turn out to be wrong. ***That does not illustrate the frailty of free markets, but of we humans***. (emphasis added)"[14]

So, as with Alice's perception of her surroundings, the world *does* seem to be becoming "curiouser and curiouser". However, directly underneath the front page article in the FT on Japan's new Yen policy and the global angst it's causing the other central banks in the world, there is another, rather astounding article entitled "How the Secret of Data Storage Might Lie in a Small Cup of DNA". It describes the accomplishments of a team of scientists who have "demonstrated a working DNA storage and retrieval system" for data. [15] The following day's FT issue, also on the front page, proclaims, "IBM Mixes Computing and Health with Gel to Zap Hospital Superbugs"[16]

Thus, perhaps the markets are portending a brighter future. Perhaps not this year or the next several… and perhaps, for the markets, not in a straight line. However, we believe that, there ***is*** value in the growth sectors such as the industrials, biotech and technology, and very little value to be found in bonds and fixed income proxies such as utilities. Rising interest rates in and of themselves remain arguably the biggest threat to any cyclical growth scenario, and we are watching the yield curve closely. But, for the present, in our Balanced models we are overweighting equities and underweighting fixed income and to a lesser extent, cash.

The other related, and not insignificant risk, is what happens when the liquidity recedes. It is unimaginable that this will be painless and without consequence – and will probably be playing out over a longer time period than we imagine. But, that will have to wait for a future Quarterly Report. For now, we are eagerly awaiting the arrival of Spring – both meteorologically and figuratively in terms of a healing economy. In the meanwhile, we hope you're all staying warm and productive.

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[14] Op. cit. #3, pg. 4
[15] Financial Times USA, "How the Secret of Data Storage Might Lie in a Small Cup of DNA"; Thursday, January 24, 2012, pg. 1
[16] Financial Times USA, "IBM Mixes Computing and Health With Gel to Zap Hospital Superbugs"; Friday, January 25, 2012, pg. 1

Table 1.

U.S. Stocks

Index[2]	Total Return[1] Fourth Quarter 2012	Year-to-Date
DJIA	-1.74%	10.24%
S&P 500	-0.38	16.00
Nasdaq Composite	-3.10	15.91
S&P MidCap 400	3.61	17.88
Russell 2000	1.85	16.35

Total Returns

Index[1]	Fourth Quarter 2012	Year-to-Date
Barclays Capital U.S. Aggregate Bond Index	0.21%	4.21%
Credit Suisse High Yield Index	3.14	14.71
Barclays Capital Municipal Bond Index	0.67	6.78
Barclays Capital Global Aggregate Ex-U.S. Dollar Government Bond Index	-1.04	4.09
J.P. Morgan Emerging Markets Index Plus	3.24	18.04

International Averages

MSCI Index[1]	Total Return Fourth Quarter 2012	Year-to-Date
EAFE (Europe, Australasia, Far East)	6.60%	17.90%
All Country World ex-U.S.	5.89	17.39
Europe	7.06	19.93
Japan	5.79	8.36
All Country Asia Ex-Japan	5.70	22.70
EM (Emerging Markets)	5.61	18.63

International Averages

MSCI Index[1]	Total Return Fourth Quarter 2012	Year-to-Date
Emerging Markets (EM)	5.61%	18.63%
EM—Asia	5.93	21.24
EM—Europe, Middle East, and Africa (EMEA)	5.95	22.45
EM—Latin America	4.36	8.90

[17]

[17] http://individual.troweprice.com/public/Retail/Planning-%26-Research/T.-Rowe-Price-Insights/Market-Analysis/Quarterly-Wrap-Ups?WTARank=10&WTARankPhrase=Quarterly Wrap ups