Quarterly Market Update

December 31, 2012

In spite of all the political shrillness during the fourth quarter, investment returns were remarkably benign. From the end of September through the closing on Election Day, the S&P 500 declined by 0.85%, hardly the cataclysm forecast by both Republicans and Democrats if their side did not prevail. From Election Day through the end of 2012 the S&P 500 declined by 0.15%, again hardly the dire consequence forecast if a "fiscal cliff deal" was not struck in time.

Meanwhile, many companies decided to pay dividends in December so that shareholders would receive income subject to 15% tax rates rather than 20% (if their income exceeds $400,000 or $450,000 depending on their tax filing status). Also, a number of companies were sold at the end of 2012 before capital gains rates increased from 15% to 20%. To the extent that such transactions were going to occur anyway, completing them in 2012 made sense. However, it is also an investment truism that hastening to make investment decisions based on tax consequences is rarely beneficial to the investor.

During the fourth quarter the Federal Reserve announced its intention to purchase U.S. Treasury securities and mortgage backed securities at the rate of approximately $85 billion a month until the unemployment rate drops below 6.5% or inflation increases to 2.5% or higher on a sustained basis. The Federal Reserve's dual mandate for both monetary stability and full employment has taken a decided turn towards monetary stimulus to help foster economic growth and hopefully a reduction in the unemployment rate. The reaction in the bond market has been much less benign than in the equity market.

With all the buying by the Federal Reserve one would expect interest rate levels to remain low, and they ended the year at historically low levels. However, the direction of interest rates on 10 year US Treasuries has been upward, and that is unsettling. The yield on a 10 year US Treasury was 1.63% on September 30 and 1.76% on December 31, implying an investment return of -1.0% for the quarter, almost the same as for the equity market overall. Within the first three trading days of 2013 however, the yield on the 10 year Treasury has climbed to 1.96%, a significant change. It may well be a reaction to the lack of spending restraint in the "deal" to avert the fiscal cliff, but it also indicates the fiscal problems facing America are overwhelming the liquidity provided by the Federal Reserve through its bond purchase program.

The outlook for 2013 is one of a series of political conflicts over raising the debt limit, avoiding the consequences of sequestration and converting the continuing resolution to fund government operations into real budget authorizations. It is enough to give any observer, much less a participant, a severe case of "battle fatigue."

Nevertheless, the state of the economy overall is slightly better than a year ago and valuations on equities generally are still at historically low levels and represent a much better investment opportunity than fixed income securities. We anticipate another year of above average equity returns, marking the fifth consecutive year of positive results following the market break in 2008.

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