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Investment Review and Outlook

Investors confronted a bevy of discomfiting events in the fourth quarter of 2012 including: a contentious and polarizing presidential election, an unprecedented and devastating hurricane in the Northeast, and the threat of falling off the "fiscal cliff." But none of these headwinds were able to shake the convictions of the market faithful. Investors were able to look past these events and the stock market ended 2012 scoring solid gains.

Last year at this time we were rather optimistic about the prospects for equities. The premise of our optimism was based partly on the expectation of positive steps in Washington to restore fiscal discipline. But, alas, we were let down by our elected officials once again….no surprise there!

Not wanting to throw a wet blanket on the recent stock market rally that followed the "resolution" of the self-inflicted "fiscal cliff" crisis, the agreement represents a Pyrrhic victory at best. While it is debatable whether the ultra-rich are now paying their fair share of taxes, what is indisputable is that the Federal government has a chronic spending problem. And it will likely get much worse as the baby boom generation retires and the demand for entitlement programs such as Social Security and Medicare grow exponentially.

The unpalatable truth is that bringing the federal deficit under control will be a monumental task. Politicians are especially loath to take the scalpel to entitlement programs. Thus, the road to fiscal responsibility will undoubtedly be tortuous. Therefore, we expect volatility in the financial markets to surface sporadically as Washington attempts to make progress. But volatility will surely yield new opportunities, and we will continue to endeavor to take advantage of market dislocations as the saga continues.

RIP - US Bond Market Rally (1981-2012)

In July 1981, Merrill Lynch trumpeted the "The Dawn of a New Bull Market" for the bond market in newspapers across the country. One of the most prescient and timely predictions ever made on Wall Street, it occurred at a time when the bond market was in disarray, as high inflation and Federal Reserve austerity measures caused bond investor to shudder. Merrill analysts pointed out that the bond market was on the verge of a major secular rally because inflation-adjusted yields on bonds were becoming very favorable and policy makers were making meaningful progress on restoring our economy. They noted that even a small decline in bond yields would push bond prices significantly higher. And the rest is history – the bond market entered a 30 year period of outstanding returns.

The following excerpts of the Merrill advertisement portray a stark contrast between 1981 and today:

"Interest rates are extraordinarily high. Even after adjusting for high inflation, bonds offer the most generous returns in over 30 years."

"What makes Merrill Lynch so confident?

We have several reasons, ranging from change in government policies to more effective Federal Reserve procedures to fight inflation."

This sounds distinctly different than the environment we are facing today. Inflation is low but inflation-adjusted returns on bonds are in some cases negative. Bonds offer the lowest returns in many decades. Federal government fiscal responsibility is non-existent and the Federal Reserve remains resolute in its unprecedented easy monetary policy.

Are we at the "dawn of a new bear market" for bonds? We are not certain. But we do not believe this is a propitious time to be betting the ranch on US bonds.

04-Jun-12 CNBC

Professor Jeremy Siegel says ECB should insure all deposits in Eurozone banks, similar to what Bernanke did in 2008, and that will stabilize the markets.

Marc Faber says he is convinced that Europe is already in recession and that China is growing substantially slower than the official statistics suggest, perhaps no growth at all. This will slow down demand for commodities create a vicious spiral throughout the global economy. This means that corporate profits across the globe are set to disappoint. Demand for iron ore and copper frok China is weak**. At the same time, Faber believes that stocks like J&J will outperform US Treasuries over the next 10 years.**

Siegel says it is the first time in 60 years that the dividend yields on stocks exceeds long term interest rates. You do not need stock prices to rise to outperform Treasurys. Siegel also says that lower commodity prices will benefit the US economy in the second half of the year, thus cushioning the downturn in the US. He sees slow growth but no recession. Earnings could be flat but dividend coverage is solid. Even European stocks are historically cheap, tading at 8-9 times earnings.

Detroit on the Comeback

No matter what your position is on government bailouts, there is no doubt that the prospects for the auto industry have improved dramatically since 2008. Ford Motor Company **(F $10)** was able to save the company on its own, having begun a painful restructuring process two years before the industry downturn. **General Motors (GM $22)** was in terrible shape and needed the heavy hand (and deep pockets) of the federal government to reshape the company and effectively rid itself of most of its massive debt load. In fact both companies have very solid balance sheets with plenty of cash, far exceeding their debt.

More importantly, despite the tepid growth in the US economy, sales have been increasing at a healthy pace and profits in their North American operations have been rather strong. How is that possible? We believe that sales are still benefiting from the 2005-2009 downturn when sales plummeted from an all time of over 17.4 million vehicles in 2005 to a low of 10.6 million vehicles in 2009. The average age of vehicles on the road has risen sharply and is currently at a record 10.8 years. So it is likely that sales could have an extended upturn over the next few years.

Other good news for the company are the upgrade of its credit rating by Moody's? last October? Which has allowed the company to begin paying a dividend. While General Motors trades at a discount to Ford on a number of metrics, we believe that Ford warrants the premium. First, Ford has a proven track record of building the product customers covet. And that is critical to long term success. Just ask the folks at Nokia abd Research in Motion. But the main reason is that the US Government still holds a large equity position in GM. When the government divests its stake, we will reconsider our position. Until then, we will motor ahead with Ford.