Fourth Quarter, 2012

Summary

For 2012, the S&P 500 Index advanced 16.0%, and the S&P 600 Index returned 16.3%. The MSCI All-Country World Index, ex-US, had a net total return of 16.8%. Fixed income markets also gained as interest rates declined to unprecedented lows. The Barclays Capital Intermediate Treasury Index returned 1.7% on a total return basis.

Although Washington remained dysfunctional, consumers and corporations largely did their part to advance the U.S. economy and markets during 2012. The traditional early cycle combination of domestic auto, housing, and retail, which had lagged the export-driven manufacturing sector since 2009, finally seems to be gathering momentum. Through the third quarter, U.S. corporate after-tax profits had increased 17.9%, year-over-year, rising to an all-time high.

U.S. government borrowing exceeds 100% of GDP for the first time since the late 1940's, according to government data. The Fed appears driven to "monetize" this deficit and the national debt. Over the last year, virtually every central bank around the globe has reduced interest rates and/or provided fiscal stimulus in an attempt to foster growth in an environment of excess labor, industrial capacity, and capital.

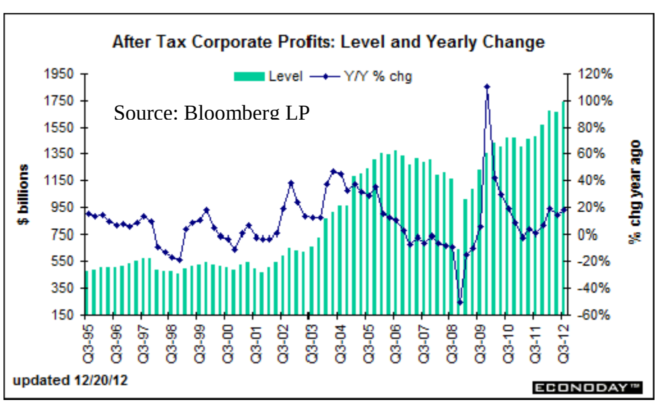
We anticipate that political dithering over deficits, debts, and muted GDP growth may create angst and disruption near-term. Despite these concerns, global markets seem to be stabilizing if not strengthening. Corporations generally remain healthy with a record $1.03 trillion of cash on the balance sheets. Although growth is tepid versus earlier historical data series, we have growth.

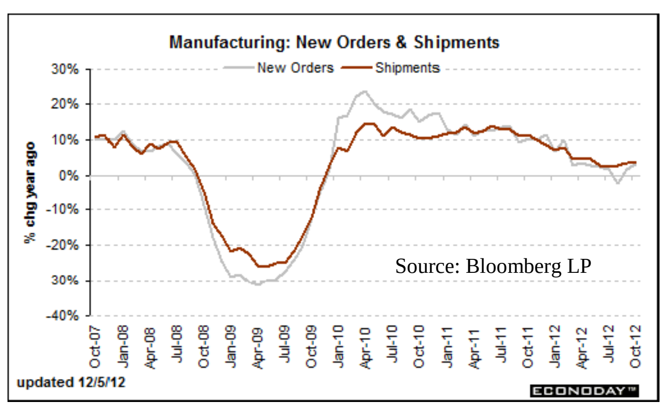
Behind The Cliff

In the final hours of 2012, political drama held center stage. U.S. lawmakers, in both the House and Senate, jousted acrimoniously over the crafting of a resolution to the "fiscal cliff", the series of automatic tax hikes and spending cuts that would have occurred absent a bill's passage. In the end, a deal was struck that raised taxes, mostly on the wealthy, and identified some spending cuts – but failed to include a framework and plan for a) bringing this country's spending in line with its revenues and b) beginning to chip away at the exponentially mounting national debt. As we approach the U.S. debt ceiling limits within the next few months, we anticipate a vigorous renewal of the debate over these issues.

Although Washington remained dysfunctional, consumers and corporations largely did their part to advance the U.S. economy and markets during 2012. Early last year, improvements in the housing and construction markets began to bolster optimism that had started with advances in retail and automobile sales. The traditional early cycle combination of domestic auto, housing, and retail, which had lagged the export-driven manufacturing sector since 2009, finally seems to be gathering momentum. As seen in the chart below, through the third quarter, U.S. corporate after-tax profits had increased 17.9%, year-over-year, rising to an all-time high. Not to be confused with S&P 500 Index earnings, corporate profits are reported by the Bureau of Economic Analysis as the income of all corporations in the national income and product accounts (NIPA).

Offsetting these improvements in domestically driven strength were weakening trends among U.S. manufacturers, as export demand began to slow (see chart below). With roughly one third of S&P 500 company profits now being derived from Europe, the Eurozone's mounting financial crisis and series of recessions weighed heavily on large multi-national companies' order backlogs and earnings. Asian-Pacific demand could not absorb all the slack, especially as that region's export opportunities suffered as Europe weakened. According to the World Trade Organization, the members of the 21-country Emerging Market Index (EM) send thirty-percent of their exports to the European Union.





Amidst these concerns, the back half of the year reflected signs of stabilization and optimism, particularly in Europe. Specifically, German business confidence rose more than had been forecast, and Italian 10-Year bond rates fell from the alarming 7% level of a year ago to slightly over 4%. China also recently mounted a string of positive indicators, suggesting that growth picked up in the fourth quarter. Collectively, these and other improvements fueled optimism in global markets. Between June 4th and year-end, the Stoxx Europe 600 Index gained 19%, with banks leading the rally. For the full year, the MSCI All-Country World Index, ex-US, had a total return (net of foreign withholdings) of 16.8%.

Here at home, despite the fact that S&P 500 earnings for 2012 are expected to come in roughly flat versus 2011's, equity markets also performed well in 2012, albeit with episodes of great volatility. For the year, the S&P 500 Index advanced 16.0% and the S&P 600 Index returned 16.3% (total return basis for both). Fixed income markets also gained ground as interest rates declined to unprecedented lows. The Barclays Capital Intermediate Treasury Index returned 1.7% on a total return basis.

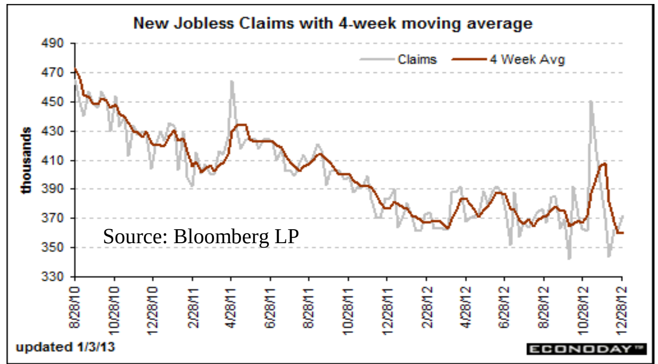
Current Economic Trends

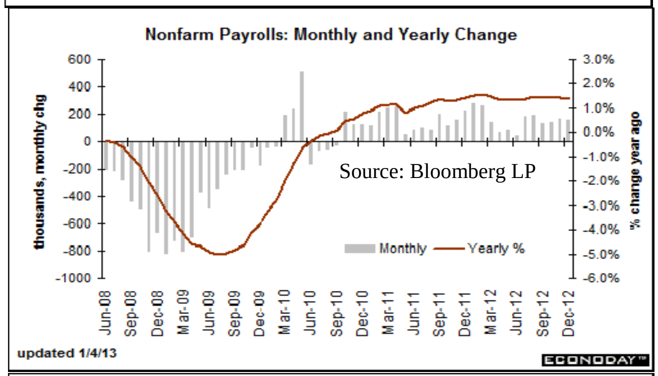
Notwithstanding optimism in the markets, real inflation-adjusted U.S. GDP growth is expected to continue to follow its below average trend, in the 1%-2% range. In fact, growth likely weakened during the fourth quarter of 2012, as political wrangling in December may have damaged consumer and corporate confidence and spending. Without credible plans for addressing the deficit and debt, and with higher taxes and high odds for increasing levels of corporate regulations (especially in banking), business executives may remain tight-fisted. Additionally, everyone awaits the articulation of concrete plans for stimulating growth. Presently, although the magnitude of growth appears to be sparse, the trends, in most cases, appear constructive (see charts to the right).

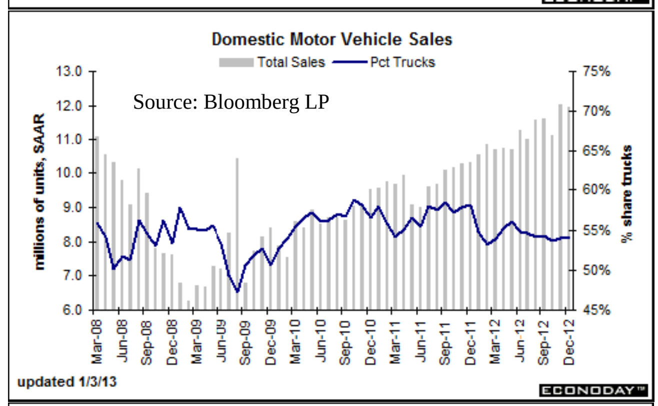
Financial Conditions/Monetary Trends

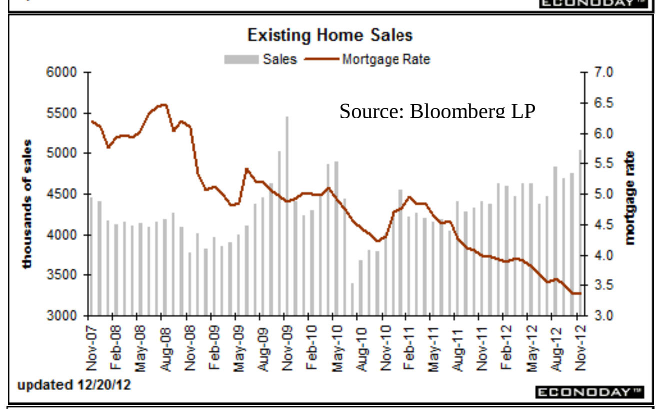
U.S. government borrowing exceeds 100% of GDP for the first time since the late 1940's, according to public government data. At that time, the debt-to-GDP ratio peaked at 121%. What followed were excess labor and industrial capacity, recession, and declining asset prices. Under President Truman, the Fed attempted to "monetize" the deficit, holding interest rates low, driving asset prices higher, and creating the conditions (inflation) for paying back the debt with devalued currency. Presently, Fed Chairman Bernanke appears to be following the same playbook. Similar actions have been taken by ECB President Mario Draghi, an MIT trained economist, in his attempt to stabilize European markets. Over the last year, virtually every central bank around the globe has reduced interest rates and/or provided fiscal stimulus in an attempt to foster growth in an environment of excess labor, industrial capacity, and capital. Collectively, these programs appear to have yielded limited, but positive, results.

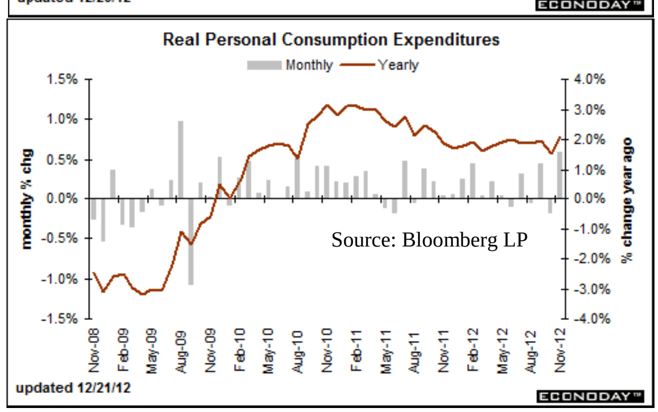
In an interesting shift, the most recent Federal Open Market Committee (FOMC) interest rate policy announcement reflects a move from date-based targets to specific labor market and











inflation data triggers. Now, the Fed says that exceptionally low rates "*will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored.*" Regression analysis of the 10-Year U.S. Treasury yield versus actual inflation levels reveals that, were the yield on the 10-Year U.S. Treasury allowed to normalize, it should be approximately 4.8% today – a figure that should give pause to fixed income investors, who along with the Fed have pushed that rate and others through the sub-floor. We would note that, perhaps in signs of things to come, the 10-Year Treasury yield has moved from 1.47% to 1.76%, between the end of July and year-end.

Sentiment Indicators/Market Trends

After correcting from last September's high readings, sentiment and market trends do not suggest overly aggressive market enthusiasm. Several measures give us some hesitation and a neutral view on the short-term. However, the longer-term trends appear reasonably healthy and intact at this time.

Equity Market Valuations & Earnings

2012 earnings for the S&P 500 Index are on target to be flat with 2011's record level. Slow global growth, extreme currency headwinds, and tough comparisons versus the historically high, year-ago margins were the primary culprits. For 2013, earnings are penciled in with an expected mid-to-upper single-digit growth rate. Currency translation adjustment (the process of reflecting foreign earnings in terms of U.S. currency) was particularly brutal on multinational earnings during 2012, perhaps having a negative impact in the range of 4%-8% on the statement of foreign revenues. When the currencies of our trading partners find firmer footing, that trend ought to reverse. Many small and mid-sized U.S. companies, who gathered a higher percentage of earnings domestically, were not similarly affected; generally, these companies posted more robust earnings than many of their larger, multinational brethren.

With the S&P 500 Index trading at 13.9x trailing earnings and 13.4x forward earnings as of 12/31/2012, valuations appear reasonably attractive. According to Bloomberg, the six-decade average market multiple is 16.4x earnings, and stock multiples have been stuck below the long-term average for the longest period since Richard Nixon was president. By comparison, interest rates are the lowest (meaning that enthusiasm for bonds is the highest) since the early 1950s.

Investment flows data suggest that many investors have missed out on the market's recovery since 2009 and that a number of those who remained have been liquidating amidst recent political strife. The Investment Company Institute (ICI) reports that household ownership of equity mutual funds has dropped every year since 2008 to the second lowest level since 1997. Ironically, stock ownership (versus other asset classes) in 401(k) and IRA accounts peaked at around 90% in 2000, when valuation levels where more than twice as rich as today. ICI also reports that recent stock ownership has dropped to 72% in individual retirement plans, lower than the 77% measure of the 1992 recession era. These data, coupled with the fact that the S&P 500's dividend yield exceeds the yield on the 10-Year U.S. Treasury, cause us to be optimistic on stocks longer-term.

Conclusion

Near-term, we anticipate that political dithering over deficits, debts, and muted GDP growth may create angst and disruption. Despite these concerns, global markets seem to be stabilizing if not strengthening. In the U.S., housing and construction, auto, and retail markets show signs of progress. Corporations generally remain healthy with a record $1.03 trillion of cash on the balance sheets. Although growth is tepid versus other historical data series, we have growth. Moreover, valuations remain reasonable, and earnings – absent exogenous shocks or self-inflicted wounds – appear poised to advance.

For an in depth review of our Market Pillars and Charts, visit: http://www.imva.net/market-pillars/.

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