OVERVIEW

Economic Analysis and Market Review

Q1 — 2012

The French have a saying "Plus ca change, plus c'est la meme chose" which loosely translates to "the more things change, the more things stay the same" and that sums up the markets' activity thus far. As the year unfolded, it appeared that the U.S. recovery was gaining traction as each economic data point —GDP growth, inflation, manufacturing, jobs, housing—was a distinct improvement over the previous mark from a year ago or a quarter ago. This in turn fueled a resurging stock market into double digit gains. But as I write this the market has given back all the gains since February. Frustrating and confusing to say the least, but the year isn't over yet and as the saying goes, "As the S&P goes in January, so goes the year." Since 1950, this theory has worked 86% of the time.

Over all, the outlook from here appears to be promising. The U.S. economy appears to be on track to grow by about 2.5% in 2012. This is a step up from the 1.7% gain last year but not near to where we should be in a 3–year old recovery. But there are real signs of a turn-around. Housing, one of the hardest hit sectors of the economy is showing steady improvement. Inventories of unsold new homes are approaching what might be normal levels and sales of existing homes are on a steady rise. There is still a large overhang of distressed property to come to market which is holding price gains down. And finally, the Conference Board's index of leading economic indicators (LEI) edged up by 0.7% in February which would indicate that the current growth trend could continue for some time. Along with this, the unemployment picture shows signs of improvement as first time jobless claims declined by 5000 against expectations of a rise of 4000. This showing is a new 4– year low. Unemployment now stands at 8.2%, down from over 9% three years ago. Good news from the Fed's Beige Book survey showed an economy that is firing on all 12 Fed regions as manufacturing, hiring and retail sales showed signs of strength – and this in the face of punishing fuel prices that would ordinarily damage unnecessary trips in the car. Add all of this up and it is unlikely that the Fed will feel the need to re-stimulate the economy with a third round of "quantitative easing". In his last outing to the halls of Congress, Fed Chairman Bernanke basically said as much; however, he did leave the door open for a QE3 if conditions would warrant. Plus ca change...

And they may warrant because one of the darkest clouds hanging over our recovery is the sovereign debt problems in Europe. Greece was in the headlines as they dealt with their financial quagmire. After two bailouts, they're still not out of the woods — far from it. Greece faces unfunded liabilities in the future of nearly 800% of GDP. The austerity measures recently enacted will cripple growth and unemployment is over 20%. Next in line could be Spain or any of the other Mediterranean countries. Spain's three largest banks have $2.7 trillion in assets and are on the verge of failing. Unemployment in Spain is also over 20% with youth unemployment (those under 30) at over 50%!

Europe will have to develop a plan to contain their sovereign debt problem over the course of the year. The European Central Bank, the International Monetary Fund, the European Financial Stability Facility and the European Union along with our Fed and possibly the Chinese, will all be involved. We won't stand by idly. The problems are too large to be dealt with by the Europeans alone. The ECB's balance sheet is already larger than the GDP of Germany. With all that needs to be done financially, the most important is structural change and that is slow and hard — witness the riots in Athens and Madrid.

Stock markets will, of course, respond to the turmoil with great volatility as they have recently. In our stock market, the "earnings season" has just begun and analysts are expecting lower earnings. They might be correct because many companies are lowering their expectations with more conservative "pre-earnings estimates". S&P expects the first quarter to have produced an earnings gain of just 0.5%, not much to get excited about. Analysts cite slow growth in the U.S. and Europe as the reason for a lack of optimism. Should this lack of optimism have a negative impact on our market? Maybe not. The stock market is a "discounting mechanism" which means that activity today is reflective of the outlook six to nine months out. So the market's performance now is reflective of the outlook last summer and fall. This being the case, we should see a market on the rise as the third and fourth quarters of 2012 are expected to be strong. Business balance sheets are in excellent shape and that removes one risk from the equation but profit margins on the other hand, could be squeezed due to rising costs and sluggish demand.

The bond market should continue in its current range as the Fed has stated that it intends to hold interest rates low until 2014. Interest rates to banks are currently at 0 – .25%. These low rates have enabled the banks to fortify their balance sheets and regain profitability. Once these rates start to rise, perhaps in late 2013 or early 2014, a bear market in bonds will begin. Of course, with the yield on the 10–year Treasury at 2.0% and inflation at 3%+, one could make the argument that we're already in a bear market. Be prepared. No one expected this to be easy.

INDEX	Q1'12	YTD
S&P 500	12.59%	12.59%
Russell 2000	12.44%	12.44%
Europe, Aust., Far East	10.86%	10.86%
Barclays Agg. Bond	.30%	.30%
Wilshire Real Estate	10.76%	10.76%
Treasury Bills	0.01%	0.01%

- The S&P 500 is an index of 500 large, well-established companies
- The Russell 2000 is an index of 2000 small companies
- The Europe, Australasia, Far East Index (EAFE) is an index of the developed countries around the world
- Barclays Aggregate Bond Index is an index composed of investment grade bonds
- Wilshire Real Estate Index is an index of commercial real estate properties