OVERVIEW

Economic Analysis and Market Review Q3—2012

The last three years have, if nothing else, greatly increased our financial vocabulary—collateralized debt obligations, credit default swaps, carried interest, quantitative easing and recently, fiscal cliff. For those new to the term fiscal cliff, think of the last scene in the movie, "Thelma and Louise". Just hold hands and pray. In case fiscal cliff is new to you, it's what is expected when at the end of this year, the Bush era tax cuts expire and $1 trillion of budget cuts (from unknown sources) are mandated. In the economy we're facing today, these draconian steps would be disastrous. Congress still has time to act but not much and certainly won't before the elections on November 6. But if that's not enough to worry about, there's more:

- 1% GDP growth in the U.S.
- Euro meltdown
- China slowdown
- 8% unemployment
- Budget deficits and excessive debt

Economic growth in the U.S. is anemic and not at all where it would be if this were a "normal" recovery. At this stage of a recovery our economy should be growing at 3% plus but the recession was anything but the usual garden variety. And along with our stagnant economy, we have unemployment hovering around 8%—double what the Fed would consider full employment. Unless we can get GDP growth up to our median range of 3%, I think we're going to have to live with high unemployment.

If it was just a domestic problem, we would have a better chance of achieving a faster growth rate, but unfortunately, this is a global phenomenon. Europe, especially southern Europe, has serious problems with their deficits and debt. Greece and Spain are faced with civil unrest as they struggle to bring their economies back into alignment with European Union guidelines. Greece is a very small economy and can be bailed out, but Spain's economy, the fourth largest in the 17 country Eurozone and the 12th largest in the world would be extremely difficult for the European Union to bail out. Add to these countries and a new report indicates that the south of Italy is "heading for social and economic meltdown", citing job losses, population exodus and industrial decline. The region is not large in the context of Italy's population or economy, but nonetheless this is something to take note of.

In addition to Europe's economic distress, China is facing a slowdown as well. China's rapid growth was the engine that pulled ours and other economies along as they continued with their aggressive domestic expansion plans, but even China's growth has declined. Their slowdown was one of the reasons cited by BHP Billiton, one of the world's largest miners, for postponing two $20 billion projects: an Australian based copper mine expansion and a new Australian harbor project that would have been aimed at doubling Australia's iron ore exports to China. To be sure, other mining companies must be holding back on some of their projects as well.

One area that has tended to be a predictor of future economic activity are shipping rates since so much global trade is carried aboard ships. The Baltic Dry Freight Index has fallen by 90% to what is referred to as "post-Lehman depths" and the ClarkSea Index, another index of maritime freight rates, has halved since mid-2010 and has fallen by 80% since 2008. Other factors such as more ships available could also contribute to lower rates, but slowing global growth certainly plays a big role. German shipping companies control 40% of the world's container business and it is believed that two thirds of Germany's marine fleet is in financial distress. But there are small signs of stabilization and, perhaps, a turn-around. Germany's industrial production recently rose 0.6% in the quarter when it was expected to decline 0.5%. Germany is the engine for growth in the Eurozone. Another sign of improvement are the yields for Spain's and Italy's bonds. They've been declining which would indicate that investors believe that things are getting better and they'll be able to pay them off.

Then there's the debt problem, or rather, too much debt. If memory serves, by definition assets = liabilities so saying there's too much debt is like saying there are too many assets in the world. I don't think that too many assets in the world are holding back growth. It isn't the amount of debt outstanding that matters but the market's assessment whether the borrower can pay back the debt. Japan is a good example. Deleveraging is happening as people, businesses and countries all try to bring back their debt levels into their comfort zone where they're able to repay it in a timely fashion.

With the economies of the world facing so many headwinds, one would assume that the equity markets would be in a tailspin, approaching rock bottom. Certainly judging from the response from investors this would be the case. Equity mutual funds have lost tens of billions of dollars over the past year as investors have bailed out of stocks and bought bonds. Fully $10.5 billion was withdrawn just in the week of October 3 according to the Investment Company Institute. But the evidence proves otherwise. The stock markets performed very well in the quarter. The S&P 500 Index, an index of 500 large cap stocks, gained 6.4% in the third quarter and the Europe, Australasia, Far East Index, an index of the developed markets overseas, performed even better gaining almost 7%. As a consequence to improving markets, more companies reacted by paying dividends. The number hit 402 this year, the highest since December 1999. The payout from those companies is also expected to reach an all-time high. The amount of money paid out as dividends is expected to hit a record $275 billion in 2012, up from $241 billion in 2011 and 11% more than the previous high of $248 billion in 2008. Perhaps this response will catch on and help lead the stock market out of its current range and on to new highs. Perhaps by year end.

Market Indexes
Third Quarter, 2012

INDEX	Q3'12	YTD	12 MONTHS CHANGE
S&P 500	6.35%	16.4%	30.2%
Russell 2000	5.25%	14.2%	31.9%
Europe, Aust., Far East	6.9%	10.1%	13.8%
Barclays Agg. Bond	1.6%	3.9%	5.2%
Wilshire Real Estate	-.38%	14.5%	31.1%
Treasury Bills	0.03%	0.07%	0.07%

- 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