401KVentures

OVERVIEW

Economic Analysis and Market Review

Q4—2012

- In the U.S. economy, only one bright spot — housing
- Fiscal Cliff Act 2 — The battle over the debt ceiling and the national debt is the next reality show from D.C.
- The European Union agreed to give the European Central Bank (ECB) the authority to directly supervise the Eurozone's largest banks
- China is experiencing its own set of problems with inflation and decelerating growth.

We entered the fourth quarter with two strikes against us — the U. S. economy chugging along in the slowest recovery of the post-war era and Europe struggling to get a handle on their debt crisis and keep the euro currency from collapse — two lingering problems with no easy remedy in sight. And the next pitch — a possible third strike, the "fiscal cliff".

In the U.S. economy, only one bright spot — housing — seemed to be responding to the Fed's quantitative easing measures. With current mortgage rates slightly above 3%, home sales and prices are improving and mortgage delinquency rates have also come down from a peak of 11% to 7% now. In some parts of the country, home prices have almost returned to 2006 levels and in some of the hardest hit areas like Michigan, there are signs of life. Manufacturing and corporate capital spending, two sectors that could help considerably to reduce the high unemployment numbers remain stuck in low gear. GDP growth in the third quarter expanded around 3% and the outlook for this quarter and subsequent quarters in the year ahead is for roughly half that. Current forecasts are for the economy to begin to pick up the pace in the second half of the year. I'm not sure exactly how that can happen if any significant austerity measures that deal with our growing debt and deficit problem come out of "Fiscal Cliff Act 2". The battle over the debt ceiling and the national debt is the next reality show from D.C.. If Congress does not act, the U.S. government will soon not be able to borrow any additional money. This story will dominate the headlines over the next few months. The Democrats had their way over the tax fight, now the leverage will shift over to the Republicans for the next round.

The economic picture isn't any brighter in Europe, either, although the euro is still intact and that wasn't a certainty at the beginning of the year, Greece is still a member of the Eurozone and Spain hasn't requested a bailout yet. But a report out in December said that Italy's industrial production continued to decline in October from September, and their industrial production index was 6.2% lower than a year ago. Italy is the 4th largest economy in the 27- country

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European Union, and the 3rd largest in the 17- country Eurozone after Germany and Spain. It's possible that Italy could follow in the footsteps of Spain, so I'll be watching for reports of "contagion" and related economic concerns about Italy. It's certain that, if Italy's economy deteriorates from here it will have an impact on European financial markets, the euro exchange rate and, very possibly, the global financial markets. One positive in all this is that following months of negotiations, the 27 countries that comprise the European Union agreed to give the European Central Bank (ECB) the authority to directly supervise the Eurozone's largest banks, and intervene where smaller Eurozone banks appear to be in financial difficulty. This agreement is said to give the ECB direct control of 200 of the approximately 6,000 Eurozone country banks. One of the problems in the creation of the European Union is that there was no unification of the various financial systems. This move is one of the biggest overhauls of any European banking system since the financial crisis began. It also signals that the EU's problems will be dealt with as a unified bloc.

On the other side of the world, China is experiencing its own set of problems with inflation and decelerating growth. China's economy is driven by exports and as the U.S. and Europe have seen their imports contract, it has affected China's economy in a big way. Whereas their economy was growing at a double-digit rate near 11%, it now appears more likely to grow at 7% to 8%. Even that seems a bit ambitious without domestic consumption becoming a bigger piece of the economy. China's growth was considered the engine that was going to pull us all out of recession and it may yet, but it will take more time.

Yet with all the global economic malaise, the financial markets remained buoyed by almost exuberant optimism. Share prices this year survived the potential death of a major currency and the very real threat of slipping into another domestic recession, all of which, if they occurred, would have been calamitous to investors' wealth. The U.S. stock market as measured by the S&P 500, had an excellent year gaining 16% including dividends. Barclay's aggregate bond index posted a 4.2% return, and even TIPS — bonds designed to help investors keep up with inflation — gained almost 7% for the year. All this occurred in a 2% inflationary environment. Looking ahead, the market as a whole may not perform as well but certain sectors should outperform: financials, energy exploration and transportation, medical supplies and home builders. In Europe where a Lehman-scale event seems to be around the next corner, the stock markets did even better. The Morgan Stanley Capital International (MSCI) Europe Index gained over 17% helped by Germany's whopping 30.9%. Even after these stellar returns European markets still appear to be cheap.

Cheap they may be but many things have to go right for the markets to continue on this trajectory and that's a lot to ask or expect when it's events and not fundamentals driving them.

Market Indexes
Fourth Quarter, 2012

INDEX	Q4'12	YTD	3 YEAR RET.	5 YEAR RET.
S&P 500	-0.38%	16.00%	10.87%	1.66%
Russell 2000	1.85%	16.35%	12.25%	3.55%
Europe, Aust., Far East	6.57%	17.32%	3.56%	-3.69%
Barclays Agg. Bond	0.21%	4.21%	6.19%	5.94%
Dow Jones Real Estate	2.31%	17.12%	17.94%	5.08%

- Multiple years' returns are annualized
- The S&P 500 is an index of 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
- Dow Jones Real Estate Index is an index of commercial real estate properties