2012 Year in Review and 2013 Investment Outlook

> Life is so strange
> Destination unknown
> When you don't know
> Your destination
>
> Something could change
> It's unknown
> And then you won't know
> Destination unknown
> **Missing Persons - Destination Unknown**

> "The truth, however, is that nobody on the committee, nor on our staffs at the Board of Governors and the 12 Banks, really knows what is holding back the economy. Nobody really knows what will work to get the economy back on course. And nobody—in fact, no central bank anywhere on the planet—has the experience of successfully navigating a return home from the place in which we now find ourselves. No central bank—not, at least, the Federal Reserve—has ever been on this cruise before." **- Richard Fisher, President of Dallas Federal Reserve Bank**

2012 Year in Review

New Wave L.A. rockers Missing Persons released Destination Unknown in1982, a song that aptly defined the next 30 years. The song peaked at #42 on the Billboard chart, so clearly not many were listening like they should have been to the amazing prognostication captured in the song's lyrics. Who would have known back in 1982, when interest rates were at Mr. T like pain levels, that the U.S. would embark upon on a 30 year long odyssey of lower and lower interest rates to a destination that still remains unknown.

2012 will go down in history as the Year of Central Bank Intervention. Global stock markets posted strong mid-teens returns despite tepid economic growth in the U.S., recessions in Europe, U.K., and Japan, and political dysfunction on a major scale related to addressing government debt/deficits. All major global central banks undertook unprecedented policy actions to try to stimulate economies and stop a worse case scenario outcome from happening. They were very successful with the latter but unsuccessful with the former. Mario Draghi took home the Central Banker of the Year Award as the European Central Bank's decision during the summer to backstop European sovereign debt was the most important central bank decision of the year. As global markets at the time were consumed by the potential risk of a European sovereign default, this large tail risk was taken off the table by the ECB and the "risk-on" trade, particularly in Europe, worked from that point forward.

Four years after the global financial collapse started in the Fall of 2008, central banks are still undertaking new and aggressive policy actions to find that magic elixir that will heal the global economy, drive real GDP growth higher, and create a sustainable economic recovery with improving job growth. What remains to be seen is what price will eventually be paid, if any, for these extreme policy actions. As Mr. Fisher (I'd be shocked if he is not a huge Missing Persons fan) states above, don't kid yourself into believing that the central banks have a clue about what the reversal of these extreme policy actions will mean to global economies and markets when the time comes. That's another chapter to be written in the books about this era. Destination Unknown.

Here in the U.S., the Federal Reserve increasingly placed more chips on the table in an all-in bet that they can turn the tide of weak employment and anemic economic growth. As seen in the left chart below, the Fed has dramatically expanded its balance sheet since the financial crisis began in 2008, buying large amounts of US Treasuries (and mortgage-backed bonds too) to an incomprehensible $2.9 trillion while driving longer maturity bond yields to new historical lows (right chart below). Each round of Quantitative Easing (December was QE4) has not produced the results in the economy the Fed desires so another round is engaged. The Fed's balance sheet has expanded more in the past 5 years than in the previous 93 years since it was founded as it has gone from holding less than 15% of 5+ year maturity U.S. Treasury bonds to now owning nearly 40%. Unfortunately (for U.S. taxpayers), debt is something the U.S. Treasury has in abundance for sale. U.S. debt outstanding is now north of $16 trillion and the U.S. once again finds itself up against its debt-ceiling limit that was raised less than a year and a half ago. The last time the U.S. had a debt ceiling crisis showdown in August 2011, the stock market cratered 20% and the U.S. lost its AAA rating. Mark mid February on your calendar as the next debt ceiling showdown looms. Based on the political shenanigans of the past several years, one thing is certain. The Administration and Congress will turn it into another crisis that comes down to the wire to get resolved.

Missing Persons releases
Destination Unknown in 1982

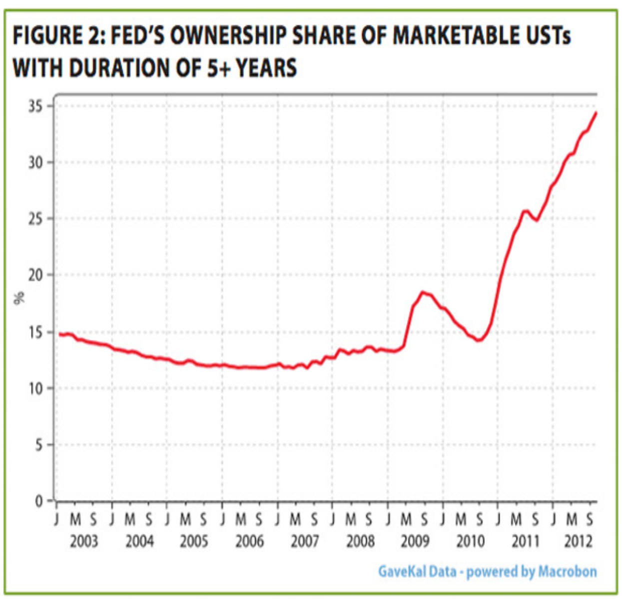


FIGURE 2: FED'S OWNERSHIP SHARE OF MARKETABLE USTs WITH DURATION OF 5+ YEARS

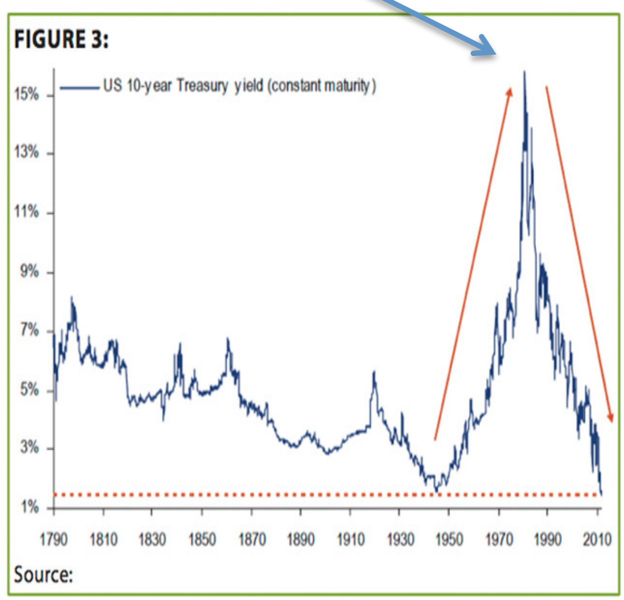


FIGURE 3:

Source: Evergreen Virtual Advisors, GaveKal

In its latest policy decision made in December, the Fed has now tied the end or reversal of its current monetary policy position to the unemployment rate declining to 6.5% (today it's 7.8%, wink, wink, nudge, nudge) or inflation exceeding 2.5%. If monthly employment growth were to stay in the 150,000 to 200,000 range (Dec 2012 was 155,000), and inflation does not move consistently above 2.5%, it is plausible the current policy could be in place well into 2016. If that were to happen, these extraordinary policy actions would be in place eight years after the global financial collapse began. That's 56 dog years. Any way you look at it, it is an extremely long period of time to have unprecedented policy measures in place to restore an economy to health. Such an extreme policy in place for such a long time is going to create other unintended consequences.

Despite large macro risks that went largely unresolved, and political dysfunction that caused a high degree of uncertainty in the private sector and negatively impacted economic growth, global financial markets viewed the world through rose colored glasses during 2012. Except for the second quarter's strong pullback, goods news was good news and bad news was good news for most of the year. Despite weak macro data throughout the year, the substantial infusion of liquidity by central banks into the global financial system eventually found a home and financial assets and stock markets in particular were the major beneficiary. All major asset classes had positive returns during 2012 as shown in the table below.

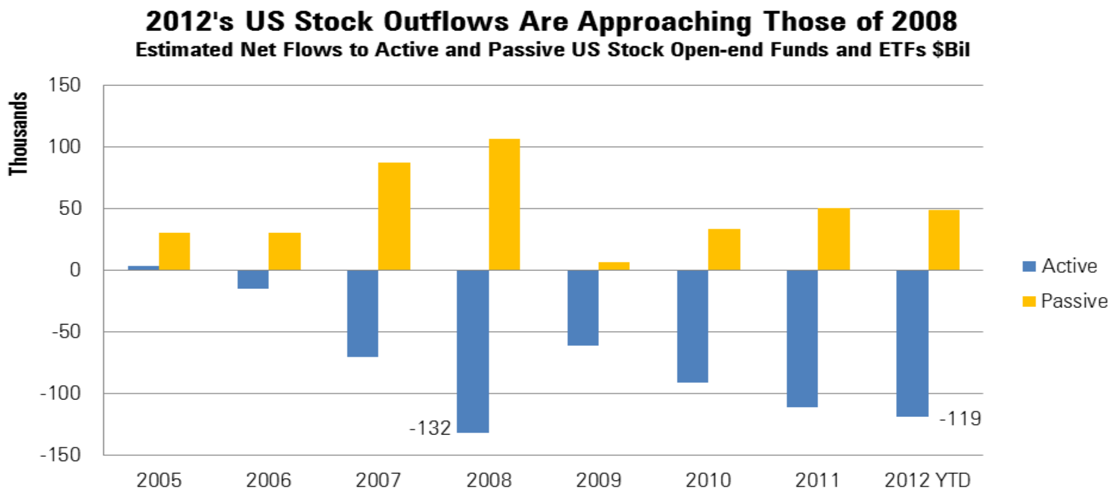
Index	Return
S&P 500 Index (large cap U.S. stocks)	16.0%
Russell 2000 Index (small cap U.S. stocks)	16.4%
MSCI EAFE Index (developed int'l mkts)	17.3%
MSCI EM Index (emerging int'l mkts)	18.2%
Barclays Aggregate Bond Index (invt. grade)	4.2%
Barclays High Yield Bond Index (below invt. grade)	15.8%
Barclays Short-term Treasury bills (cash)	0.1%
Gold	12.7%
Brent Crude Oil	3.5%

The poor visibility brought on by the current global economic environment, uncertain fiscal policies, and massive central bank intervention continued to confound professional investors. As was the case in 2011, active manager underperformance against broad benchmarks continued during 2012. The table below shows the average fund return in each major mutual fund category compared to its respective benchmark return for 2012. For U.S. Large Cap, only 39% of managers beat the S&P 500 Index. The average international stock fund and taxable bond fund achieved decent outperformance during 2012. Hedge funds, where the best and brightest in the business are supposed to reside, had one of its worst years since hedge funds became a mainstay in the investment business.

Fund Category	Avg. Fund Return*	Benchmark Return
Large Cap US	15.1%	16.0%
Small Cap US	14.7%	16.4%
Large Cap Int'l	18.2%	17.3%
Balanced	11.3%	11.3%
General Taxable Bond	8.8%	4.2%
Diversified Hedge Funds	3.2%	NA

*** Average Fund Return Data from Lipper**

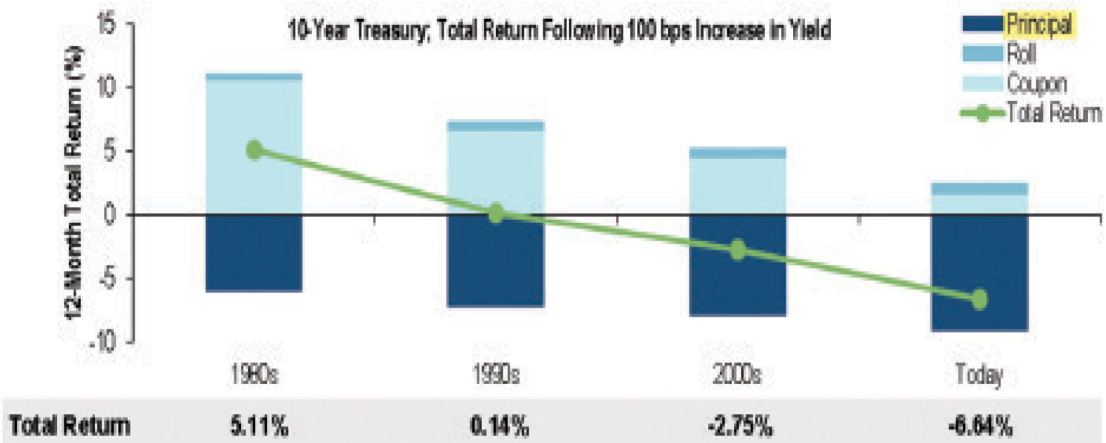
Even as the Fed punished savers with its Zero Interest Rate policy and bond yields remained near historical lows, one of the more interesting aspects of 2012 was that fewer retail investors enjoyed the positive stock market returns as they remain hunkered down and risk averse. More likely, they have no excess cash available to save and invest or are withdrawing money to supplement their income needs or pay down debt. As shown in the next chart, active stock mutual fund outflows during 2012 have continued a multi-year negative trend with bond funds (not shown) the major recipient of the outflows. 2012 active stock fund outflows were as bad as 2008, the year the stock market plunged 35%.



Source: Morningstar

Investors continued to pile into bond funds in a desperate search for yield (any yield, please!) in this era of repressive central bank policies. The Ben Bernanke lead Fed is pile driving (one of the nastier "professional" wrestling moves) U.S. savers and risk averse investors with a bias towards low risk, income producing assets. With the Fed a large, unnatural buyer of bonds in the market, bond volatility and yields are artificially depressed and make bonds appear to be an attractive risk/reward investment vehicle. What happens when and if the Fed declares victory and begins to reverse its current policy position? If the Fed is successful and the economy gains traction and unemployment falls such that the Fed can claim victory (Pyrrhic?) and disengages from QE Infinity, bonds are a far riskier proposition than most investors can comprehend.

The following chart shows what a 100 basis point (1.00%) move higher in the 10 year U.S. Treasury bond would do to total return of the bond starting to today's low yield levels. With the current 10 year U.S. Treasury bond yield at 1.8%, this would mean a move up to 2.8% yield. The total return for an investor would be -6.5% should such a scenario occur and even worse for bonds with longer maturities. The risk/reward profile for a long maturity U.S. Treasury bond is akin to picking up pennies in front of a steamroller. For most bonds today, except those with much higher credit risk and thus higher yields, the real return (current yield-inflation rate) is already close to 0% or negative. Of course, with a massive buyer like the Fed in the market buying bonds, unless the QE policy is halted or reversed, or U.S. economic growth is stronger than expected (Do you believe in miracles, Yes!!), it is hard to see how bond yields are going to jump aggressively higher.



Source: Soberlook

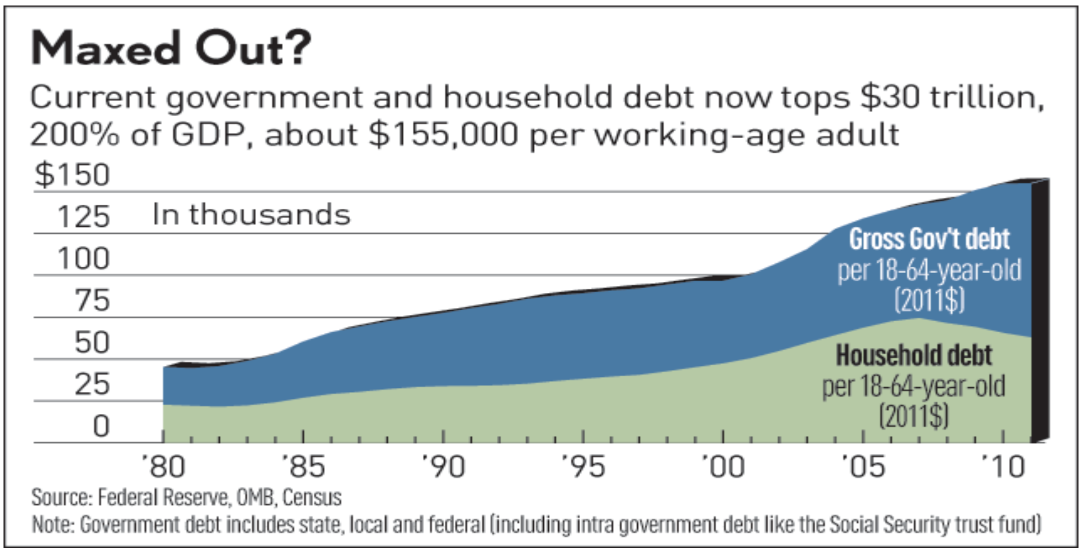
Summarizing 2012, deteriorating economic and earnings growth as the year progressed was more than offset by the impact of massive central bank intervention moves. Large tail risks, at least in the short term, were reduced by central banks. Massive liquidity injections benefited financial markets and risk assets such as stocks saw strong performance. Have any of the underlying, large macro problems that existed at the beginning of 2012 gone away? Not meaningfully.

2013 Investment Outlook

In last year's Investment Outlook, I highlighted several potential downside risk scenarios, none of which came to fruition. I also highlighted several upside risk scenarios, none of which came to fruition. OK, the Great and Merciful Oz, I am not. That being said, and in a self congratulatory move I did also say the most important factor on investment returns in 2012 would be correctly predicting what politicians and central bankers would do, particularly in Europe (my self boasting is brought on by reading Stewart Smalley's *You're Good Enough, You're Smart Enough, and Doggone It, People Like You*). As shown in the returns of professional investors the past several years, this type of backdrop is not the best for most stock jockeys to perform well. If an economy is struggling, and earnings growth muted, the fundamentals suggest a defensive posture is prudent. However, with Ben Bernanke and Mario Draghi continuing to redefine the role and policy actions central bankers are willing to take to support economies and financial markets, 2013 is still not a great setup for fundamentally based investors to thrive.

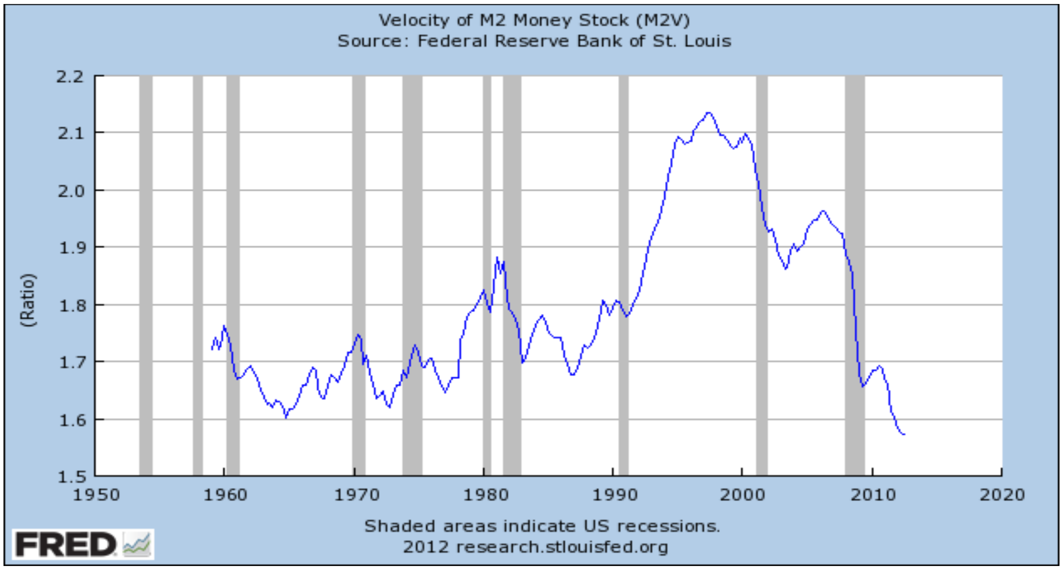
Perhaps it's not surprising that the U.S. economy struggles to get back to "normal" as the U.S. problem (and global as well) from the start of the crisis was an economy drowning in debt that had been accumulated over a long period of time. As can be seen the next chart, personal debt levels peaked in 2007 and are now on a downward trend. U.S. households are taking their medicine and are doing a good job of reducing debt. Importantly, household debt service and financial obligations as a percent of disposable personal income are now back to 1993 levels, meaning consumer balance sheets are in much better shape after five years of belt tightening. The same is also generally true of corporate America, where trillions of dollars sit on the balance sheets earning nearly 0% (and negative real rates) because there is limited confidence in the economic outlook.

Unfortunately, the same can't be said about the aggregate U.S. debt problem. The next chart also shows that the aggregate debt problem has continued to grow as debt has simply been transferred from households to the government. U.S. government debt outstanding has ballooned to over $16 trillion and a crafting a sound plan to get the U.S. back on the right track towards fiscal sanity has eluded politicians, even with the fiscal cliff deal that passed just after the stroke of midnight on January 1, 2013 (I could have put in a Cinderella/pumpkin line here but I am reaching my self imposed limit on obscure pop culture references). And don't we as citizens ultimately own the government debt? Of course, which explains why U.S. consumers remain cautious and GDP growth remains tepid because most people understand that the bill is coming via higher taxes.



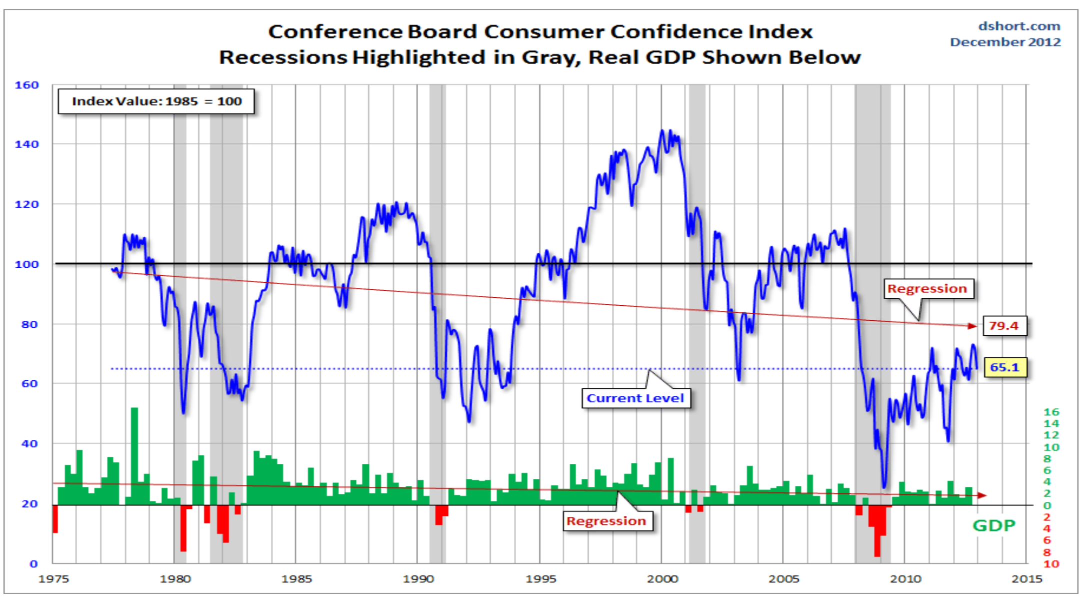
Until the overall debt problem gets resolved, real GDP growth will remain subpar because reduced spending, whether through consumer belt tightening or government austerity, means GDP growth will remain constrained.

As the old adage says, you can lead a horse to water but you can't make him drink. Even with the cost of borrowing at historical lows, extreme monetary policies can only go so far in driving GDP growth higher in an era of excessive debt. Despite the Fed's best efforts to flood liquidity into the system, the velocity of money remains mired in a downward path. The next chart shows that the money being pumped into the system by the Fed is not being turned around and transacted, but is mostly being hoarded as individuals and corporations hunker down.



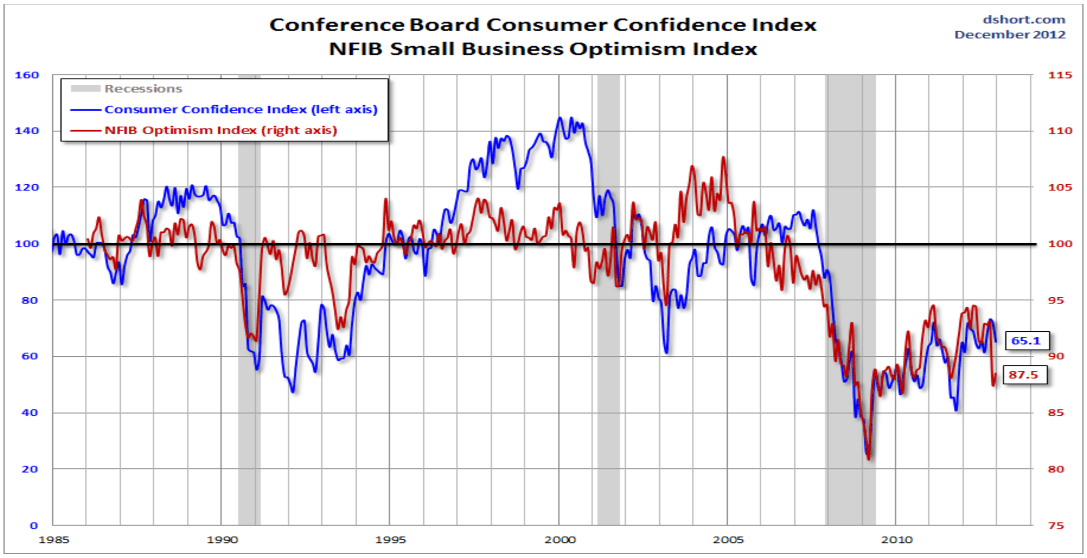
Source: St. Louis Federal Reserve Bank

The massive U.S. debt overhang and how it gets paid off is high on the minds of Americans. The Conference Board reading of Consumer Confidence, despite being above 2009 recession lows, remains constrained and at levels that defined the early 80's and 90's recessions.



Source: Conference Board

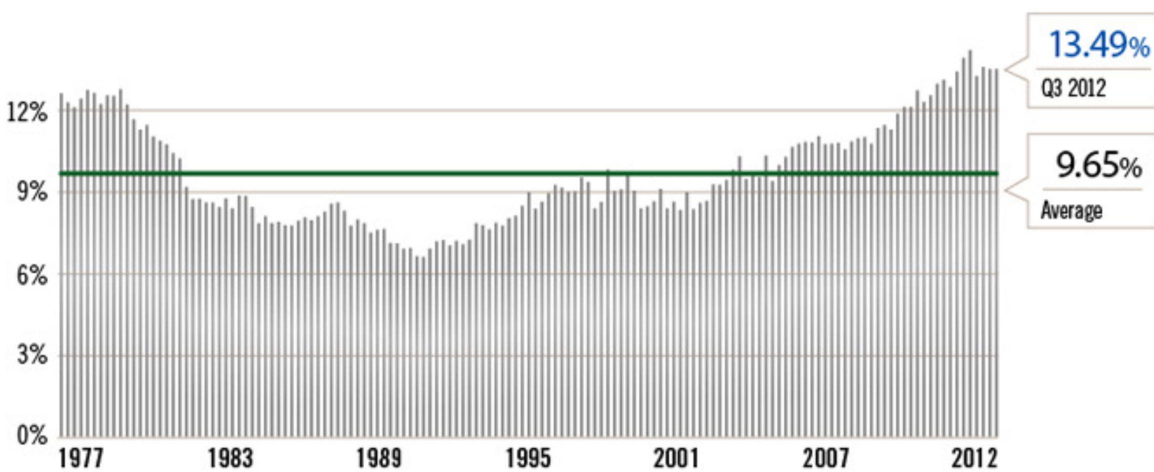
The lack of confidence in the future is also reflected in the survey of small and medium size businesses conducted monthly by the National Federation of Independent Business. The data has improved off the 2009 depressed lows, but remains well below the levels seen when the economy was producing more solid economic growth.



Source: NFIB.com

Lack of confidence is reflected in large corporations as well, which have increased the amount of cash on balance sheets to historical highs and where both capital investment and hiring remained constrained, all signs of a lack of confidence.

S&P 500 Companies
Cash as % of Total Assets

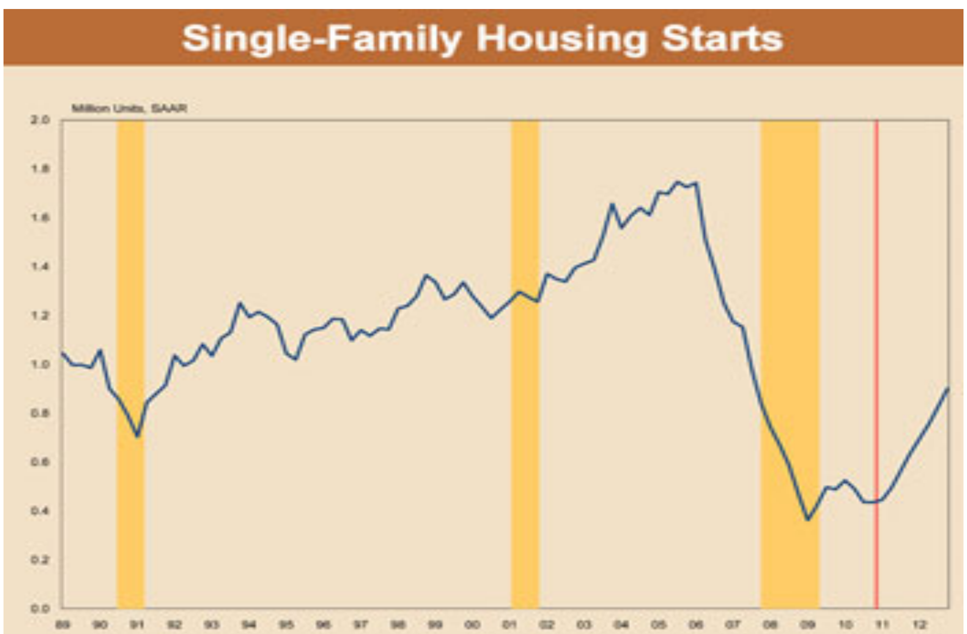


Source: Franklin/Templeton Investments/Ned Davis Research

When will the U.S ever begin to see a sustainable recovery characterized by solid and consistent real GDP growth and strong job growth? Unfortunately, the answer to that question in the near term is mostly in the hands of politicians. Until a long-term deficit reduction plan is negotiated between the Administration and Congress that puts the U.S. back onto a proper fiscal path, the excessive debt overhang will keep economic growth muted, employment growth muted, and earnings growth muted. Politicians have perfected the art of kicking the can down the road. What all of them need is a kick in the can.

To get our fiscal house in order, more belt tightening is required. There is simply no other way to get from here to there. Should politicians pull the rabbit out of the hat and produce a credible long-term deficit reduction plan with teeth (the Holy Grail would be a complete overhaul of the individual and corporate tax code), the stock market would respond with a sizable upside rally as the hunker down, bunker mentality of the private sector would dissipate, capital investment would see a resurgence, and Americans would spend more because their outlook on the future would go from drab to fab (okay, maybe not fab but I loved the line). The odds of that happening? Based on what we have seen in recent years, less than 10%. A more realistic expectation for 2013 is a continuation of a fits and starts economy characteristic of the past several years including a steady, if unspectacular, job growth outlook. Even with the recent fiscal cliff deal, the difficult work of government spending cuts and addressing the debt ceiling lies ahead.

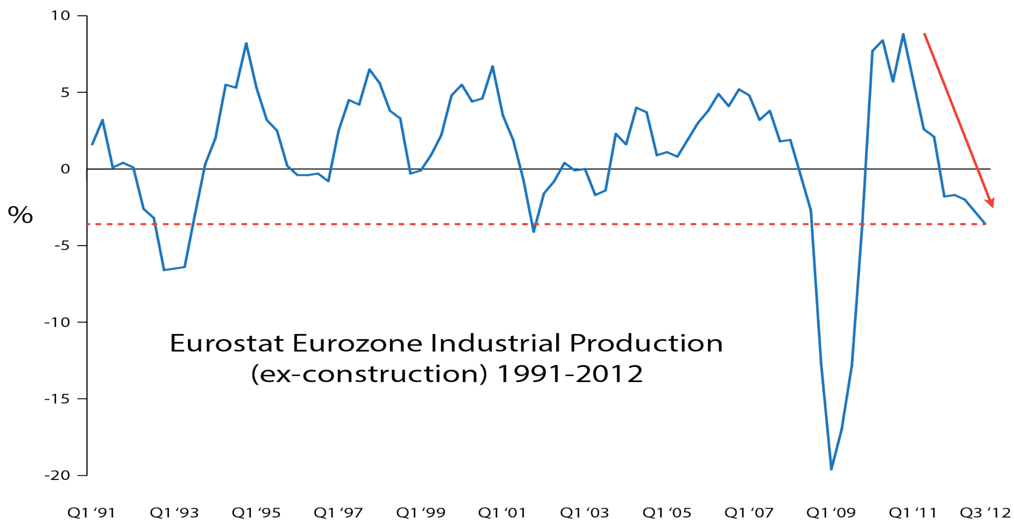
Clearly, the Fed's aggressive policy actions are keeping interest rates artificially low and benefit the more cyclical, interest rate sensitive sectors such as housing and autos. As shown in the next graph, housing starts had a sizable uptick during 2012 as the Fed's monetary policy and buying of mortgage-backed bonds has driven mortgage rates to historical lows. Still, and even with very low mortgage rates, housing starts remain well below the 1.0 to 1.2 million range seen before the housing bubble kicked in during the mid-2000's (Thank you Alan Greenspan. How's the speaking circuit going?).



Source: NAHB.com

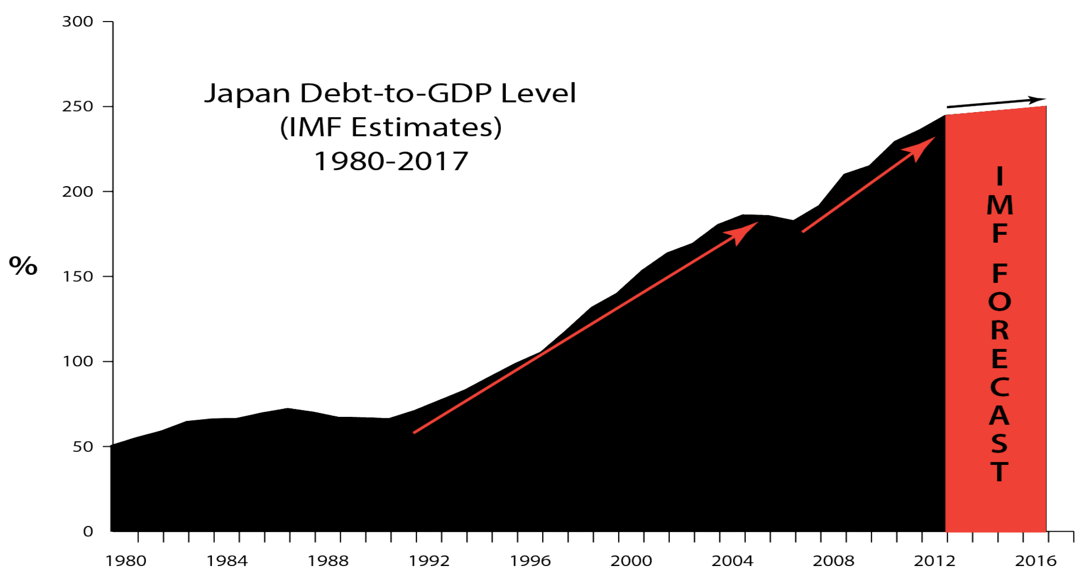
Auto sales are another bright spot in an otherwise drab U.S economic picture. With subdued demand over recent years, the average age of the installed base of U.S. vehicles has moved above 11 years, meaning that deferring purchases for many consumers has reached an end point and they are increasingly forced to buy a new car. Annual auto sales improved from 12.8 million units in 2011 to 14.5 million units in 2012, a 13% year over year increase.

While the U.S. is not a hotbed of economic growth, it's one of the better houses in a bad neighborhood, as the macro picture outside the U.S. remains even more challenging. Most of Europe remains mired in a recession. Perhaps the best thing that can be said about Europe is the worst appears to be over as industrial data has recently stabilized after falling for most of 2012. However, unemployment is at 11.8% and youth unemployment near 25%.



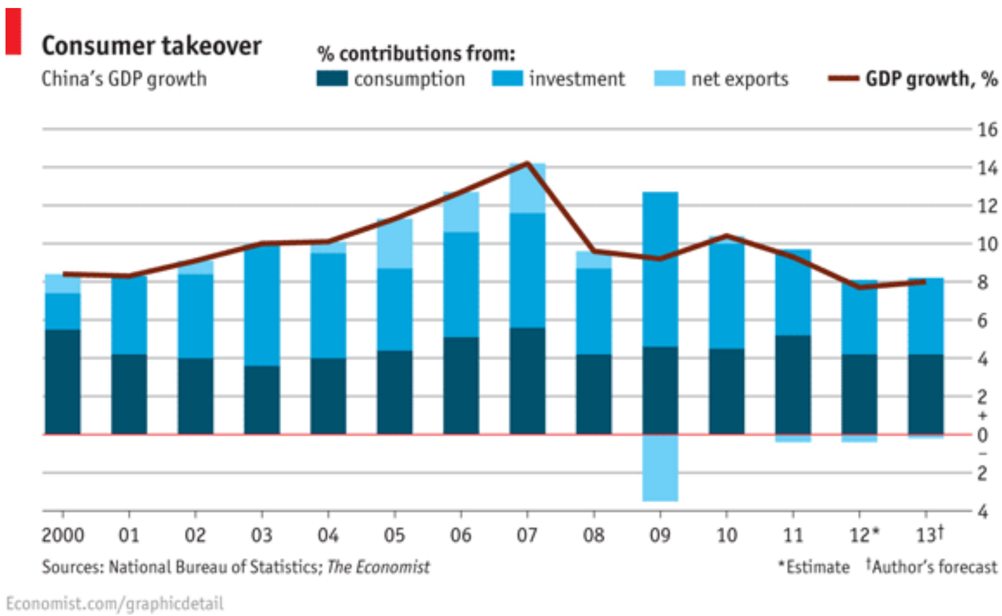
Source: Bloomberg

Japan, under a new Prime Minister Shinzo Abe, is embarking upon a new and aggressive round of policy actions (including politicians now dictating to the central bank what policy actions it should implement) to try to bring Japan out of its 20-year deflationary stupor. Japan is the proverbial bug in search of a windshield, massively in debt (debt/GDP of 240%) with an ugly demographic profile. Ever heard of quadrillion before? Japan has now hit it, with ¥ 1 quadrillion of debt outstanding.



Source: Bloomberg

China, a worry spot for most of 2012, has shown stabilizing economic data over the past three months and the uncertainty over major changes in its political leadership and economic policies has eased.



The markdown of global economic growth appears to have run its course but the catalysts for improving global economic growth in the Age of Austerity appear elusive at this point in time.

What If?

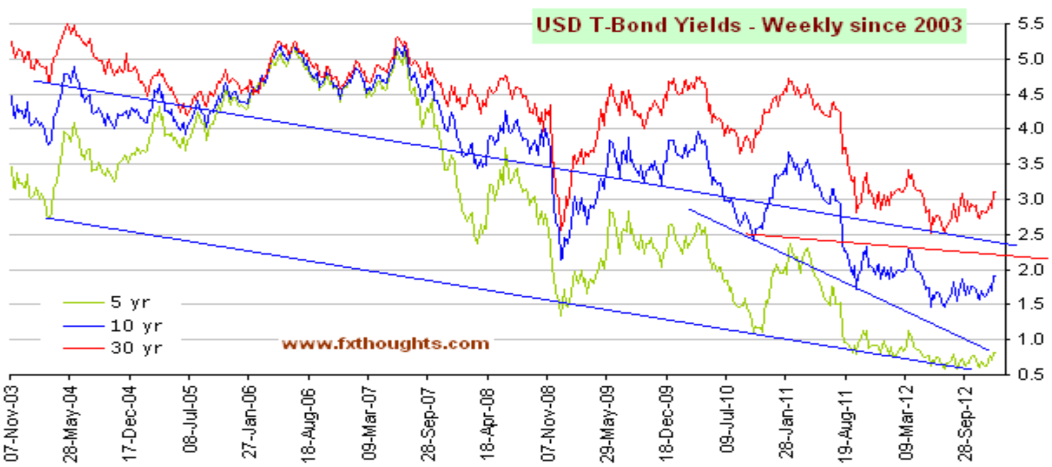
At the time of publishing last year's Investment Outlook, Street expectations for 2012 S&P 500 operating earnings stood at $107/sh. The current 2012 estimate is now down to $102/sh or 6% year-over-year growth. Economic growth expectations worsened as the year progressed due to a large drop in business confidence in mid-year and the uncertainty inflicted on the economy by the pending fiscal cliff. From a fundamental perspective, earnings growth was worse than expected yet the stock market delivered strong mid-teens positive returns. For that, you can thank Ben Bernanke and Mario Draghi. Despite lower earnings growth of 6%, the market advanced 16%, with multiple expansion the main factor behind the stock market's strong performance.

For 2013, Wall Street strategists (top-down) are currently expecting $108/sh of operating earnings for S&P 500 Index or 6% year-over-year growth while stock analysts (bottom-up) covering S&P 500 companies currently have a $113/sh forecast or 11% growth. Let's do some basic what-if scenario analysis taking the average of those two estimates or $110/sh or 8% growth. If we maintain a 14X multiple and multiply it by the $110/sh estimate, the S&P 500 target level would be 1540 (14X $110/sh). We ended 2012 at 1426 on the S&P 500 so this implies potential upside return of 8% for the S&P 500 Index for 2013 assuming no multiple expansion. If earnings growth for 2013 is more like 5% or S&P 500 operating earnings is more like $107/sh and keeping the same 14X multiple, then the potential upside target for the S&P 500 Index is reduced to 5%. Conversely, if you are in the camp that says that the world economy has bottomed and aggressive central bank policies will float all boats and lead to better earnings growth of 11%, then fair value for the S&P 500 would be more like 1585 or potential upside of 11% from the 12/31/12 close. In the event of an outright recession, all bets are off on the upside.

Summary

A world awash in debt ($200 trillion of total debt outstanding-eegads!) has a governor on growth, so it is unlikely there will be a miraculous upside surprise for economic growth during 2013. One thing that seems almost certain for 2013 is the central banks are going to keep the foot on the gas pedal and are unlikely to reverse the current easy monetary policies until a sustained economic recovery is firmly in place and job growth meaningfully improves. The continued expansion of central bank induced liquidity will, like 2012, maintain a positive backdrop for stocks, but perhaps not as much as the shock and awe that the QE related announcements had during 2012. In fact, each new round of QE seems to generate less and less enthusiasm from the markets and Fed officials seem increasingly aware (nervous?) of this fact.

Despite a less than stellar big picture outlook, BaBaBa Benny and the Feds (Benny!, Benny!, Benny!,) extreme low interest rate and bond buying policies have force income starved investors to assume more risk (see next chart), making stocks one of the only games in town worth playing. When Benny stands on a podium and says unequivocally that Fed policy is designed to boost the stock market, even someone with a thick skull like me gets the hint. The Fed's Zero Interest Rate Policy means money markets will deliver negative returns after inflation. Bond yields for a broadly invested bond fund reside in the low 2% area and after inflation return virtually zero and are negative for shorter maturity bond funds. If you want more out of bonds, you have to be willing to assume more credit risk and go into high yield bonds.



With the S&P 500 Index currently yielding 2.2% and offering a higher yield than most bond funds, more traditional income/yield oriented investors are forced to consider stocks or hybrid investment strategies to earn decent income/yield (MJMIA's High Dividend Yield strategy currently sports a 4.7% dividend yield). If the world experiences disinflationary trends due to the great global deleveraging era in front of us, and central banks keep the pedal to the metal, then income biased stock strategies should continue to be a good place to invest during 2013. The fact is that many blue chip companies with stellar balance sheets offer yields higher than bond funds and the S&P 500 Index. Unbelievably, 50% of the companies in the S&P 500 Index have dividend yields higher than the yield offered by the 10 year U.S. Treasury bond.

In a world where money markets yield 0%, bonds yield in the low 2%, and stock returns are unlikely to generate results like 2012 (barring a reacceleration of earnings growth), an investor with a balanced portfolio should expect to earn mid single digits returns on a total portfolio basis during 2013. It's not pretty, but at least it's something. Lower return expectations may be with us for some time to come.

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IMPORTANT DISCLAIMER: