Making Sense of Finance

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Fourth Quarter Review

STOCK MARKET

All major U.S. stock market indices fell in the last quarter of 2012 although they still posted gains for the year. Uncertainty in tax policy (as there was no resolution of expiring tax provisions until January 1st) contributed to the fourth quarter decline, in our opinion. Of the three indices, the NASDAQ Composite had the largest loss for the quarter (-3.1%), yet posted the largest increase for the year (15.9%). Given Apple's stock weighting of approximately 10% in this index, it is not a surprise that the fourth quarter return for the index was negative; as Apple rose 31% for all of 2012 yet declined 20% last quarter. The S & P 500 and the Dow Jones Industrial Average had decent returns last year, with increases of 13.4% and 7.3% respectably. Even after this rise in prices, stocks in the S & P 500 still trade at only 12.6 times next twelve month earnings estimates, considerably lower than the historical average of 14.2. However, it is not necessarily a given that earnings will increase as forecasted.

Financial stocks turned out to be the best performing sector in 2012 with an aggregate increase of 26.3%, though this followed an awful 2011 return of -18.4%. After two years you may have been slightly positive investing in this group of stocks. What turned it around in 2012? After their 2011 performance, stocks in this sector probably looked cheap relative to the overall market and the European Monetary Union did not blow up in 2012 as was the worry in the prior year. Other sectors performing well last year were consumer discretionary groups, in particular auto and home builder stocks and their related companies. Given worries about the implications about the administration's new health insurance plan, it may surprise some to see the health care sector post back to back double digit percentage gains the past two years. The only U.S. stock sector posting declines in 2012 was utilities. To many investors, utilities are looked at as somewhat of a bond substitute. These stocks are typically bought for yield with no growth expectations. Therefore when interest rates appear to have bottomed, the attraction of the utility stock is diminished.

Developed markets outside of the U.S. performed better than our domestic stock market in the fourth quarter according to the MSCI EAFE index (US dollar based). This index increased 6% last quarter which brought it to about even with the S & P 500 for 2012 with a gain of 14%. Euro based country stocks (MSCI EU), led by Greece (!) and Germany, increased over 9% for the quarter and more than 17% for all of last year. Emerging market stocks (MSCI EM) increased 5% last quarter and 15% for 2012 as markets such as Turkey and Thailand outperformed much larger emerging markets such as

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Everybody and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is more about making sensible and prudent choices based on logic and experience, and not on emotion.

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China. There the local Shanghai index (dominated by individual investors) rose only 3%, and that was after a huge gain of 15% in December.

Bond Market

For the most part there was little change in U.S. Treasuries in the last quarter as yields on short term Treasuries remained incredibly low (three month T Bills yield 0.05% at year-end) and only a slight increase in a ten year Treasury to yield 1.78% to close out 2012. The Federal Reserve is largely behind the preservation of low interest rates as they continue the bond purchase program and maintained the very low target of 0-0.25% for the Fed Fund rate. The Fed pledged to keep this rate low as long as inflation stays under 2.5% and the unemployment rate is above 6.5%. This may be a while therefore money market investors should not expect much improvement on their returns in the near future. In the continuance of their purchasing on a monthly basis $45 billion of Treasuries, the Fed changed the composition and is now buying back shorter term maturities which should keep short term rates low at the expense of an increase in long term rates. What does this mean for Treasury investors? After reaching a record low earlier this year on the ten year Treasury of 1.40%, that rate has risen (bond prices decline with increase in interest rates). This may affect not only Treasury investments but mortgage rates as the ten year is a typical benchmark for mortgages.

In other parts of the bond market, the riskier the bond the better as far as gains in 2012. In general, junk (high yield) corporates had a total return of almost 15% and investment grade corporates returned nearly 10%. Due to profoundly low interest rates, U.S. corporations issued a record $1.05 trillion of investment grade debt in 2012!

Emerging market sovereign debt (countries rated BBB or lower) performed significantly better than all other bond sectors last year with an aggregate total return of more than 20% as investors were stretching for yield and increasing their risk to obtain larger returns. These countries also had a record issuance of bonds in 2012 with JP Morgan estimating the total at $411 billion.

Fund Flows

Last quarter, we cited that there had been net outflows for stocks the past few years, even as the market has rallied. The tide seems to have turned and in the first week of 2013, a near record $19 billion in funds flowed into stocks. This was likely spurred on by people holding off investments until the conclusion of the “Fiscal Cliff” which was a fairly benign event, as we had predicted. We think if this trend continues, valuations could rise to more historical levels. Even so, corporate America would still need to continue growing profits to continue this current stock rally. Funds continue to flow into bond funds as well, but we are less optimistic about this asset class. Already, interest rates have begun to move up and this uptrend seems inevitable for years to come.

China

The Chinese market seems to be rebounding. GDP projections for 2013 are currently around 8%, slightly ahead of 2012 preliminary numbers. But remember, high inflation could offset any of these gains. A number of U.S-company-growth has come from Asian markets, so a strong Chinese economy would certainly be helpful. A simultaneous re-acceleration of both U.S. and Chinese economies could be what pulls us out of this economic rut. Signs of recovery in key markets give us optimism for 2013.

Fiscal Cliff

The end result of months of negotiations yielded moderate tax increases for nearly every U.S. citizen, although the rich (income over $425,000 annually) will see a greater impact. Talk of moving into other asset classes or selling one’s entire stock portfolio seem irrational to us, as the investment merits pale in comparison to stocks over a 10-year time period. With interest rates gradually moving up, bonds are not attractive to us, even municipal bonds with their tax-free status. S&P 500 stock dividends currently yield 2.25%, higher than the ten year Treasury with more potential upside. Taxes are lower for the dividends compared to interest from bonds, providing a third advantage, if held over many years. If the domestic economic growth has enough momentum, we think it could overcome the tax increases which will hinder spending from consumers, but the coming six to nine months will be more telling.

Be In It To Win It

We have stressed in the past that we DO NOT try to time the market, simply because the market is irrational over short periods of time (up to 2 years in some cases). The most important factor is to be invested in quality securities over a reasonable amount of time. Most people might be surprised to know that if you included the great depression AND the most recent financial collapse, stocks had a simple average return of OVER 11% A 30-year Treasury today held to maturity would only return 2.9% annually, which may not even cover inflation. Over the past 10 years, stocks would still have returned 6% per year on average. This is why we focus on the quality of the companies we invest in to mitigate losses in weak markets and out-perform in strong markets.

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