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MARKET AND ECONOMIC OUTLOOK

STOCK MARKET

A stock market rally in the fourth quarter of 2011 helped bring major U. S. stock market indices close to where they started the year. The Dow Jones Industrial Average was one of the best performing averages of the quarter and year with increases of 12% and 5.5%, respectively. The S & P 500 Index although rising by a double digit percentage (11%) in the last quarter closed out the year basically flat, posting the smallest movement (up or down) in the index since 1947. At first glance, this suggests a non-eventful year in the market. However, what actually took place was quite the contrary. The S & P 500 declined almost 19% from its three year high, set on April 29th to its low for the year on Oct. 3rd. Eighty five stocks in the index dropped 20% or more last year. The Nasdaq Composite gained almost 8% in the fourth quarter but still finished the year with a small loss of 1.8% for all of 2011. Stocks in general have been highly correlated, meaning they moved together. In 2011 there were 69 days that 90% of the S & P 500 stocks moved in the same direction making it more difficult to use diversification to obtain market beating returns. Equity markets were driven by "newsflow" coming mainly out of Europe rather than specific company news or earnings. In fact, many companies are reporting record sales, and have strengthened their balance sheets by keeping costs under control and building up cash. (This increase in cash has led to a $50.2 billion increase in aggregate dividends announced in 2011).

In contrast to the third quarter, most stock sectors had gains in the fourth quarter of 2011, although not necessarily for the whole year. Smaller cap stocks tended to perform better than large cap stocks in the fourth quarter, which traditionally happens when stocks are rebounding from market selloffs such as last summer's. The more economically sensitive sectors did the best last quarter (energy, industrials, and materials group). Even with this fourth quarter recovery, industrial and materials company stocks ended the year with a loss. And although posting some of the smaller returns for the fourth quarter, it was the telecoms, utilities and consumer staple stocks of the S & P 500 that led the way for all of 2011 with total returns (includes dividends) of 6.3%, 19.8% and 13.9%, respectively, as investors were drawn to companies that pay decent dividends.

Our domestic equity market performance does not look so bad when compared to the performance of most foreign stock markets. The majority of European stock market indices experienced double digit declines for the year. For the fourth quarter, the MSCI EAFE Index (22 developed countries outside of the U.S.) rose only 3% and ended 2011 with a loss of 12%. The MSCI Emerging Market Index (21 emerging market countries) increased 4% for the last quarter and still managed to lose 20% for the year as these riskier assets were not in vogue in 2011. Partially to blame were economic problems in Europe and slow growth in the U.S., since many emerging market nations are export-driven. The Chinese and Indian markets continued to decline last quarter and were some of the worst hit for the year with declines in the local markets of 22% and 25%.

BOND MARKET

The bond market did not play out necessarily as many professionals deemed in 2011. Al-

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Karagosian Financial Services, Inc.
315 5th Avenue 704B
New York, NY 10016

Phone: 212-213-1898

CONTRIBUTING WRITERS:

Seaver Wang
Christine Terry

Editor-Seaver Wang

Karagosian Financial Services, Inc.

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MARKET AND ECONOMIC OUTLOOK *(CONTINUED)*

though U.S. Treasuries yields were flat last quarter, in 2011 long term Treasuries by far outperformed all other types of bonds, even with their credit downgrade. Last year Treasuries with terms over ten years in the aggregate produced a total return of 30%, which most investors did not foresee coming into 2011. For short term maturities, the Federal Funds target rate did not budge during the quarter and still remains at a negligible rate of 0-0.25%. Treasury bills are yielding less than 0.1%, therefore it is very difficult to generate any income owning money markets and CDs.

In the corporate bond market, high yield (lower quality) bonds rebounded after a rough third quarter returning 6.5% last quarter. Investment grade corporate bonds, although not having as lucrative returns last quarter, proved to be the better corporate bond performer for the year with total returns of 8.2% for 2011. Along with Treasuries, municipal bonds were a surprise in the fixed income category last year. In the fourth quarter, total return for munis was a respectable 2.1% and for the year tax free municipals returned almost 11%, much to the amazement of many as warnings of defaults of local governments scared off investors at the end of 2010.

2012 OUTLOOK

For most of 2011 we were optimistic about the U.S. economy and about corporate sales and profits. We were mostly correct on both fronts; however, the market disagreed with us. Most companies will report their 4th quarter and full-year results in the next month or two but estimates are for S&P 500 companies to have 11% year-over-year sales growth and 16% year-over-year earnings per share growth. Meantime, valuations for companies declined 20% below the 60 year average of 15x, or about 12x trailing earnings. Studies have shown that earnings per share have the highest correlation to stock market movements over time so we feel even more positive about the equity markets in 2012. Undoubtedly, continued fears about Europe will persist, but the effects are likely to diminish over time. We find forecasting macroeconomic statistics as futile so we will only say that we believe GDP growth will be greater than in 2011 and that unemployment will continue to decline (currently 8.5% vs. 9.1% in July, 2011). We would also add that most market recoveries rarely occur in a straight line.

The longer-term outlook (5-10 years) for the bond market still looks dim as record low interest rates persist. This is unlikely to continue for much longer, although we can not say whether this will continue for one, two, or even three more years, but we think 2012 is a turning point that will favor equities over fixed income securities although a positive factor should be lower defaults, as municipal budgets grow stronger through the combination of cuts and revenue increases. Also, strong profits ought to improve the credit quality of U.S. companies. In all, we think that market volatility will remain at bay compared to 2011's wild ride, and in the first 12 days of the new year, the markets have been remarkably well behaved. The past three years have been particularly trying for most of us, but I leave you with this passage from the most recent Berkshire Hathaway (BRKA) annual report, written by Warren Buffet, the greatest investor in the world, that puts our situation in perspective.

"Commentators today often talk of "great uncertainty." But think back, for example, to December 6, 1941, October 18, 1987, and September 10, 2001. No matter how serene today may be, tomorrow is *always* uncertain. Don't let that reality spook you. Throughout my lifetime, politicians and pundits have constantly moaned about terrifying problems facing America. Yet our citizens now live an astonishing six times better than when I was born. The prophets of doom have overlooked the all-important factor that *is* certain: Human potential is far from exhausted, and the American system for unleashing that potential- a system that has worked wonders for over two centuries despite frequent interruptions for recessions and even a Civil War- remains alive and effective. "