

Spring 2012

Market Strategies



Risk On? Not So Fast...

Equity markets produced their strongest first quarter performance since 1998. The S&P 500 Index achieved a total return of 12.6%, splitting the difference between the 19.0% return of the NASDAQ Composite and the 8.9% return produced by the Dow.

Globally, developed markets performed largely in line with the US, and emerging markets, on balance, performed modestly better. The EAFE Index gained 10.9% driven by strong performances in Germany, France and Japan. Emerging Markets recovered from a very weak 2011, returning 14.1% in the quarter. This was a much stronger performance than that expected in our “grind higher” thesis.

Fixed income markets were relatively quiet overall. The yield on the 10-year Treasury note ended the quarter at approximately 2.2%, up from the start of the year, but still extremely low. These extraordinarily low yields are challenging for fixed income investors. We remain especially credit-conscious, particularly in the municipal bond market, where we remain concerned with state and local government finances.

We may have already most of the performance we are likely to get this year. Valuations, while still attractive by historical standards, are closer to fair value. We suspect that we may be moving toward a period in which we will see a “market of equities” rather than a monolithic “equity market.” In such periods, broad indices can produce uninspiring returns, masking the performance of individual stocks or groups. History suggests that these periods can reward careful security selection driven by fundamentals and valuation. History also suggests that Presidential election years are generally good years for investors, regardless of which party prevails.

Investors took heart that the latest phase in the restructuring of Greek debt was taken in stride by debt markets. The default (and it most certainly

was a default) was orderly, and did not strain the financial system. Politically, it still has to survive May’s elections, and we still believe it is possible that Greece could seek to withdraw from the euro. Other troubled economies remain a concern, as austerity measures being implemented are soothing to financial markets but potentially devastating to electorates. The political effects can already be seen in the streets, and the economic effects are beginning to show in the economic data, which increasingly indicate that a significant slowdown may be underway. Germany stands as an island in the zone, reflecting its historic fiscal conservatism and an economy built largely on exports, including Asia and other areas less affected by the crisis.

China continues to decelerate as leaders attempt to reign in inflation and effect a soft landing. Data has become increasingly mixed, leading some pundits to forecast a significant slowdown which, if correct, would clearly have a negative effect on overall global growth. Much of the rest of the emerging world, particularly Asia, looks relatively healthy, with good, if slowing, economic growth, rising incomes and low levels of debt relative to GDP.

The US Economy appears to have regained its footing after stalling in mid-2011. GDP growth has returned to 3% which, while tepid, is considerably better than the rates we saw last summer and fall. Job Growth is improving; the economy has now created 2.5 million jobs since the beginning of last year. Manufacturing activity continues to expand. Inflation remains quiet, although many analysts look for it to accelerate as a result of continued expansionary monetary policy. Consumer sentiment

continues to show improvement, even in the face of high unemployment and non-existent wage growth.

The Fed remains on the side of investors, committed to keeping interest rates low and money cheap for the foreseeable future. While there appears to be increasing debate among its leaders, there is little doubt that Chairman Bernanke remains committed to using all available tools to avoid another downturn.

There is, however, plenty to concern us as investors. Europe could sink further under the weight of its sovereign debt, which would affect both financial institutions and governments globally. Residential home prices continue to decline and, while new bailout plans continue to be floated by politicians, none yet seem capable of creating a true “fix” as opposed to merely postponing a day of reckoning. One in six homeowners is underwater in their house, and this number is probably understated. The ray of light may be that home sales have stabilized, even if prices have not. Mortgage rates remain historically low and household formation is once again on the upswing as the job market improves. Earnings estimates, while strong, have been trimmed in recent months, and growth may become increasingly concerned in a smaller number of companies.

Oil prices remain stubbornly high, likely a reflection of price levels needed by producers to manage their own governmental budgets. Meanwhile, natural gas prices have fallen to multi-decade lows, making it cheaper to heat homes and factories, and potentially attractive to convert factories and power plants from other sources of energy.

Taxes and government spending remain high in our list of concerns. We are facing significant tax increases next year which, while helpful to the government’s budget, are inherently contractionary. The debate over tax and spending policies remains contentious and divisive, which could ultimately adversely affect consumer sentiment.

This quarter’s performance is not as convincing to us as perhaps it could be, in light of the relatively light trading volume and gradually increasing levels

of investor complacency as measured by volatility. Only three of the ten economic sectors—Financials, Technology and Consumer Discretionary—outperformed the overall S&P Index. Further, a look at the top performing S&P stocks in the quarter yields a list of second tier names that benefited from high levels of speculative activity. As a result, while we remain committed to equities, we are prepared to respond tactically to changes that so warrant.

With our overall equity allocations, we are seeing leading companies with global reach, strong fundamentals and pristine balance sheets show up in our screens with attractive valuations that we think can work for some time. This reflects the character of our client portfolios.

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