

Winter 2012

Market Strategies



Review and Outlook

We entered the year (as we did 2010) with the thesis that markets would “grind higher,” as a gradually broadening global economic recovery would stimulate earnings growth and improve investor sentiment.

This thesis largely prevailed through mid-year, when we turned more cautious in light of the increasing severity of the European debt issue, issues surrounding the US debt ceiling debate, and concern over earnings estimates. US economic growth slowed from crawl to stall, leading some analysts to call for a fall. Estimates of global growth were cut dramatically mid-summer by multiple organizations. The upshot was relatively predictable: the first-half grinding gain of 5% was erased by a 14% decline in the third quarter. A strong recovery in October saw equities largely recoup their losses, after which the market meandered along to a flat year.

The S&P 500 produced a total return of 2.1% for the year, as dividends offset a flat price performance. The NASDAQ Composite, dominated by technology companies, declined 1.8% on a price basis. Large cap stocks outperformed, as the S&P MidCap and Russell 2000 Small Cap Indices returned (1.7%) and (4.2%), respectively.

The US was the world’s safe haven in 2011, as global markets suffered from Europe’s debt crisis, slowing growth in China, and rising inflation rates in Latin America and non-Japan Asia. The tsunami in Japan and floods in Australia and Thailand upset global supply chains, while poor growing conditions in many parts of the world drove up agricultural commodities prices. These factors contributed to an 18% decline in emerging markets equities and a 12% decline in the developed markets.

European investors accelerated their movements of financial assets to the US as the reduced exposure to European banks, adding to the considerable strength of the US Treasury market. Focused on safety at any

cost, investors have pushed yields on the 10-year Treasury to the lowest levels in history. Gold, another “fear” asset, also put in a strong year, gaining 12%, although it finished the year well below its summer highs.

European leaders need to find a credible solution to their debt issues for markets to move substantially higher. The bond rating downgrade of France, Italy and seven other countries just re-emphasizes the urgent and compelling nature of the problem. While political and financial leaders seem committed to finding a resolution, the fiscal austerity required is not being met well by the affected electorate. If there is a difference from a year ago in Europe, it is that the economies of many of the countries have weakened, to the extent that the Eurozone may be approaching recession, if it isn’t already in one. This clearly complicates any resolution of debt issues and, if it were to become severe, could lead to another global recession. We’re watching this, but don’t currently believe it is the likely outcome. Europe’s problems will constrain global growth, but should not eliminate it.

The Greek drama has probably largely played out, although it is still possible that country could attempt to leave the euro. Italy is the bigger problem, with Spain not far behind. The Fed may have undertaken “QE3” through its funding commitment to the European Central Bank, in support of its efforts to stem the crisis by providing massive liquidity. An increasing number of analysts and pundits are forecasting the end of the euro; we aren’t yet in that camp, but we certainly don’t rule out the possibility. Should it come to pass, we would likely see difficult and volatile market conditions for some time.

We don't expect another recession here, absent a very deep European downturn, but we do expect growth will continue to be sub-par. Financially-induced recessions historically have had slower recoveries than the more common consumption-induced downturns. Home prices, stubbornly high unemployment and stagnant wages will continue to pressure consumer spending.

Equity valuations are very attractive at current levels. Stock prices look to be discounting essentially no earnings growth forever, a situation we consider unlikely. While we expect earnings growth to be challenged this year, the dividend yield on the S&P 500 at 2.1% is greater than the yield on the 10-year Treasury Note. Fully half of the stocks in the S&P currently yield more than the Treasury, and half of the Index members are trading at less than 15 times trailing earnings. Given the low interest rate environment, which is expected to last for some time, we think it's only a matter of time before investors more fully embrace stocks. In the meantime, generous dividends help pay us to wait. As a result, we are gradually redeploying the cash we raised in the summer back into equities.

Our equity strategy is more cautious than a year ago, but we remain somewhat pro-cyclical. Our cyclical holdings emphasize sectors and companies we expect to particularly benefit from renewed growth in emerging Asia and Latin America. Other than Germany, we are avoiding Europe, including the developing economies of central and eastern Europe. We especially like US multinationals with strong presence in emerging Asia, and consumer names that offer a compelling value proposition.

Technology did perform as well as we had hoped last year, but we still believe that corporations find technology investment compelling from a return on investment perspective. We are balancing these cyclical holdings with more defensive positions in yield-oriented energy, consumer staples and healthcare.

We remain cautious on the financials for the time being, given Europe's problems and the questions that remain as the US implements its own regulatory reforms.

Fixed income portfolios will continue to reflect our emphasis on intermediate-term maturities and credit quality. We remain concerned about U.S. Treasuries, given meager yields, but are beginning to see more attractive opportunities in the investment grade corporate markets. We are also evaluating certain sovereign sectors, and will continue to use high-yield bonds as appropriate. Our municipal bond strategy remains focused on credit quality and essential services.

Presidential election years historically have been good for investors. Since 1952, equity markets have finished up in 12 of 15 election years, posting an average gain of 6.8% (excluding dividends), despite a -37% performance in 2008. Excluding 2008, the average election year gain of 10.1% comfortably exceeds the annual average of 8.9% over the period. It doesn't matter which party wins the White House, although market performance has been stronger in the years when an incumbent prevails.

Finally, we can't ignore geopolitics in our investment strategy. We identified Iran and North Korea last year in this regard, and both remain potential trouble spots. The Arab Spring events of 2011 were taken in stride by the markets, and perhaps have now evolved into mainly domestic affairs for the affected countries. We continue to watch for signs of potential unrest in other countries in the region and are prepared to adjust our strategies to meet changing conditions.



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