Kicking the ~~Can~~ Cliff Down The Road

Last year saw a continuation of the uncertainty that has characterized the markets and the United States Government since the global financial crisis. Markets always operate at the margin and what happened in Washington regarding the fiscal cliff was nothing more than an 11th hour deal that effectively removed the risk of a self-induced recession. Whatever chances there were of a recession, the risks were diverted, and the proverbial "can" was kicked down the road.

For the time being the markets can breathe a sigh of relief that the worst of the economic effects of the fiscal cliff were averted. However, don't hold your breath too long as there will be more debate to ultimately attempt to resolve the fiscal crisis. This desperate deal did little to resolve crucial long-term fiscal issues. The deferral of spending cuts we so greatly require makes the debt ceiling far worse.

Conceptually, solving the debt issue is rather easy. Under the current bill, there is only $1 in spending cuts for every $41 in tax increases. This will be a continued drag on the economy going forward and will increase the deficit. In order to mitigate excess debts, there are essentially two things that can be done:

(1) Reduce spending - cut entitlement programs (ie. social services) and lay off workers

(2) Increase revenue - raise taxes and/or create jobs so more people work and pay income tax

MYTH VS. REALITY

Myth: The economy escaped a "bullet. The "fiscal agreement" made was more of a "grand bargain."

Reality: The reality is that even with the "cliff" having been bypassed, the impact of the legislation will likely subtract 1-1.5 percentage points from GDP (gross domestic product) this coming year.

Myth: Less than 1% of Americans will pay higher taxes from the legislation that was passed.

Reality: 80% of Americans will pay higher taxes.

THE AMERICAN TAX RELIEF ACT

The American Tax Relief Act makes permanent the tax cuts enacted as part of the 2001 tax act.

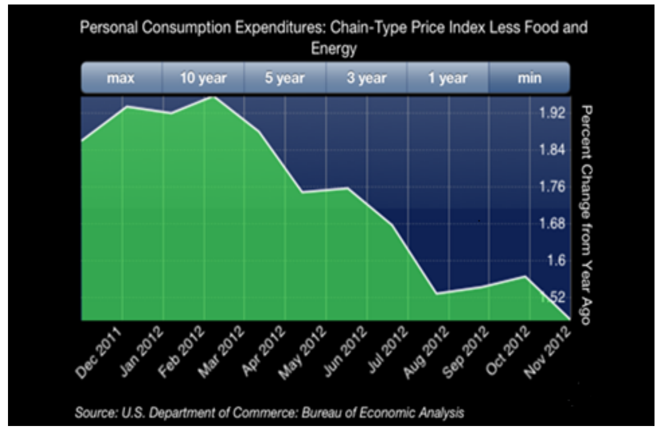
This means, for most Americans, the prior tax rates remain in effect. However, higher-income earners will face higher tax rates.

- A new 39.6% marginal tax bracket has been added for individuals earning over $400,000 and married couples earning over $450,000.
- Higher earners will face a new dividends and capital gains rate of 20%.
- A 3.8% Medicare tax on investment income will be assessed on adjusted gross income over $200,000 for individuals and $250,000 for married couples.
- Itemized deductions and personal exemptions are phased out on income over $250,000 for individuals and $300,000 for married couples.
- The "payroll tax holiday" was allowed to expire and each individual workers payroll tax increased from 4.2% to 6.2% on all W-2 incomes up to $113,700.

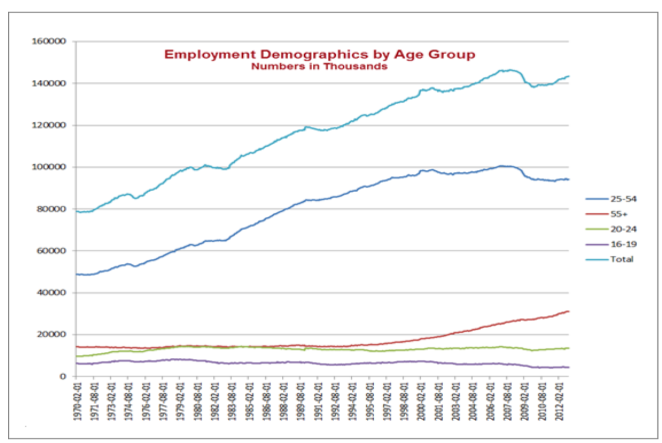
When you combine the above factors along with state/city income taxes, the top income tax bracket can be more than 50%. Taking into account the additional income taxes, the "payroll tax holiday" expiration and exemption phase-outs, the reality is that most Americans will be paying higher income taxes.

THE ECONOMY

It has been about 3 ½ years since the economy "officially" came out of the last recession and the economic growth has been anemic at best. One major factor holding the economy back is the lack of job growth and income growth. Average hourly earnings have been trending downward even as the unemployment rate has been falling. A substantial portion of how the economy grows is dependent upon consumers spending i.e. expenditures. Food and energy are not included as these are basic necessities.



With little job growth and employers maintaining salaries, consumers are spending less. Looking at who is getting jobs is an important component of who spends in the economy. The statistics are interesting and worthy to understand how it affects the growth of the economy and how it relates to spending. The chart below reveals that 100% of the job growth since the recession is in the 55+ age group.



The plunge in employment is happening in the prime spending and working age group of 25-54. The participation rate is dramatically dropping as well due to potential workers seeking employment that are no longer being counted.

Consumer spending tracks income growth, which is why there is so much attention paid to the retail sales growth numbers reported. Wall Street bulls are looking for ways to justify how spending is alive and well or accelerating. Retail sales in 2012 have been erratic, even when adjusted for population growth and inflation. We continue to be preservation minded in portfolio management as the recovery has been frustratingly slow. The sobering reality is consumer sales remain at the level we saw about six months into the last recession.

The graph below shows that NY State total wages remain relatively flat. Few jobs and little growth in pay equates to small spending. Impacting this further are the higher taxes that consumers are now faced with. Payroll taxes have also gone up by 2% (returning to previous levels) as Congress agreed to let the 2011 taxes lapse.

PORTFOLIO MANAGEMENT

The above commentary tends to paint a picture of slow growth and limited upside. In money management, long-term success lies not in achieving short-term results, but avoiding the pitfalls that lead to large losses of investment dollars. While it's not too popular in the media to point out many of the economic headwinds, it would be equally naïve to only point out the positives in the months ahead. Although it may be true that many markets rise more than go down, unexpected market drops are the main reason investors do not achieve their long term goals. The substantial part of the loss is not just the capital, but also the loss of time to recoup the negative impact. Time is the one component that is irrecoverable.

We recently conducted extensive interviews and research projects with many of our managers, analysts, partners, and strategic alliances. The list is extensive and includes PIMCO, Oppenheimer, JP Morgan, Goldman Sachs, BNP Paribas. Equally important are our own clientele who in many cases work for global companies within the Fortune 500. We continually look at the economic data driven models as well as applying the everyday "guy on the street" perspective to what's really going on.

I recall a meeting I attended with Peter Lynch, a venerable Fidelity manager in the late 1980's. He said, "You learn a lot about a company's business when you hang out in the parking lot to see who's coming and going, and how many….. You can't learn that from reading a prospectus or talking to management…." Although the sage advice still exists today, technology has changed how businesses operate. This is why independent data driven survey firms, which show internet traffic, is likened to the same "Lynchian" parking lot theory today.

The below analysis is a condensed review of the reasons to be bullish or bearish based on much of the above research criteria we conducted. We believe this will help you understand the "why question" of bull vs. bear which is often debated in the media.

BULLISH VIEW

$85 billion per month

The Fed is a virtual printing press of money and, as such, has magnitude to inject liquidity. One example of this is that it allows banks to lend more and to generate returns by borrowing for 0% and investing in guaranteed investments such as Treasuries or collateralized loans. This liquidity is forced into the financial system and has raised asset prices. Historically when the Fed injects liquidity it creates a bullish environment for investing, i.e., "Don't Fight the Fed."

Interest Rates Are Low

Federal Reserve Chairman Bernanke has given a "green light to the markets." He has made a commitment that he will not raise interest rates until unemployment goes lower. We have become a time driven world to a "data" driven world. The Fed Chairman has been quite verbal and is trying to send this message to the markets. This commitment will likely keep rates low through 2015 (bullish view).

The low interest rate environment will continue to weigh on the ever-increasing number of investors entering retirement who are upset that they cannot get guaranteed (fixed income) returns to meet their standard of living expenses. These "yield chasers" are being pushed out of cash and into stocks (equities) searching for income from dividends while thinking they will get some growth too. "Yield chasing" usually ends badly when volatility sets in, however, in the current environment with low interest rates expected to persist, the probability of a decline is low.

"The Trend is Your Friend":

Traders have used this phrase for quite some time and it can be considered wise advice to some. With the rise of technology, high frequency trading and other derivative based investment vehicles, mathematically "risk" engineered models can be traded quickly to make profits. As long as this trend remains positive it will suggest to the investor to maintain the exposure to the market. While there is some upside resistance, the trend has been generally positive.

BEAR VIEW

Taxes/Fiscal Cliff Debate

Although we have presently averted a government shut down as the fiscal cliff resolution is behind us, the next big event for the market will be the debt ceiling debate. Back in 2011, the debate over the debt level drove Standard & Poors to lower the credit rating of the U.S. from AAA to AA. This drove the stock market down over 10% within a month's time.

The risk is that the debate will reach enormous proportions, propelled by media coverage, and will shake the markets. That said, market participants are aware that the US will not actually default on its debt. Any real negative impact to the financial markets may not be as severe as in 2011. Additionally, there is still $85 billion/month of QE (quantitative easing) flooding the markets.

Increased taxes will likely put a drag on the economy, estimated to be 1-1.5% on GDP. Spending cuts must occur in Washington, though there has yet to be substantive debate about this. As the debt ceiling debate continues it will likely impact the markets further.

EARNINGS

Ultimately, what drives stock prices higher are companies earning more profits. The ability for corporations to continue keeping profit margins intact by reducing labor, keeping wages frozen and cutting other costs is coming to an end. Historically, companies expand because there are real underlying earnings growth. Therefore, cost-cutting measures are not a sustainable form of earnings expansion.

Any deterioration of earnings will lead to a P/E (price to earnings) decline. This could ultimately lead to a total p/e multiple decline in the market as a whole. Currently, the S&P is projecting a 14% rise in earnings for the coming year 2013. This bullish outlook has two major risks:

(1) Many corporations in the S&P 500 have already shown early signs of weakness within the slower growth economy. The impact of significantly higher taxes and spending cuts yet to occur will impact earnings further in 2013. Many businesses have yet to feel the increases in costs related to healthcare, replacement of inventory, and production improvements previously tabled.

(2) The recession in Europe will continue throughout 2013 putting a further drag on corporate earnings. The drag on exports makes up roughly 40% of domestic corporate profits and more than 13% of GDP.

PORTFOLIO MANAGEMENT

We have no fiscal deal, merely an agreement that was compromised on in short order. To date, there are no real spending cuts to the US budget as they have yet to be negotiated. The uncertainty will likely prevail through the 2nd quarter as we debate spending and the US will likely face another "quality of debt" review. Although our bond market went higher in the face of a US debt downgrade to AA from AAA, this may not be the same set of circumstances once again. The rest of the world may demand higher interest for holding US debt, thus a chance exists that rates could rise by market forces.

With the pace of spending ultimately being reduced, along with higher taxes, stagnant wages and little job growth, we have a muddled economic outlook. Payroll taxes may represent a 1% drag on GDP growth. The US Government spending cuts also have a negative impact on GDP. All told, these issues represent significant headwinds in an already tepid economy.

<u>Positives To Consider</u>:

- Housing and financial sector appears to be recovering.
- New and existing home activity has bounced off extreme low levels.
- US banks have stronger balance sheets today than they did just 3 years ago.
- Lending has picked up to some degree.

- The Federal Reserve remains on hold
- Globally: GDP growth, emerging markets leading
- Europe and emerging countries may have seen the worst part of their downturn
- Emerging market countries never really declined as much as the US and other nations
- Positive growth and fiscal responsibility

As interest rates continue to decline, the benefits also decline for the propensity to make returns in bonds. Additionally, as interest rates decline, bond values increase. Therefore, the lower rates continue to go, the less they have to fall.

Bond issuers are calling in their higher interest rate (coupon) bonds, leaving a larger balance of lower coupon bonds in the market. This raises the potential for more volatility. This is why the coupon on a bond is becoming important, as it will be more proportional to the growth and income of the portfolio.

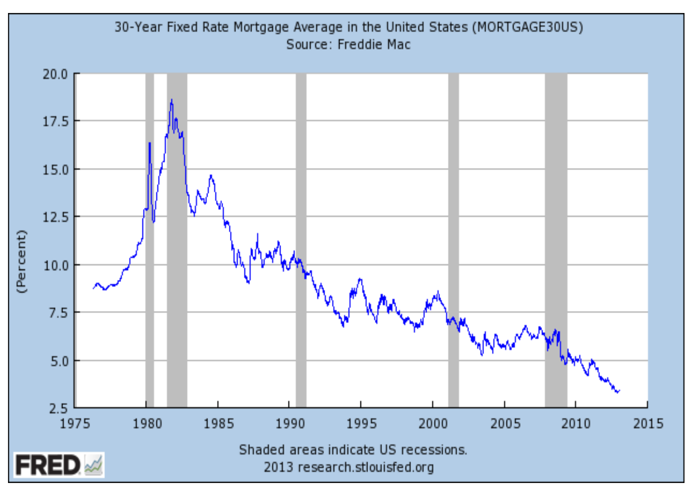
In 2012 bonds enjoyed positive growth. In 2013, thanks to Washington, we believe bonds will have a more volatile year. Mathematically speaking, bonds have little upside for appreciation, as interest rates are so low. Again, coupon income is a key component to planning.

We continue to enjoy broadly, well-diversified portfolio structures in multiple asset classes. Many have less to do with stocks or have a negative correlation to what happens in the general stock market.

<u>Bond and other fixed assets to income</u>:

- High yield components: Managers have reduced maturities to a less than 5 year maturity. Quality and liquidity have improved.
- Governments/Agencies: Higher coupon, lower duration taking profits as interest rates decline, moving proceeds to higher coupons.
- Adjustable Rate bonds/funds: Bonds like floating rate mortgages added. As rates rise so to do the bond interest rates benefitting in a rising rate environment.
- Emerging market debt: Bonds outside the US have a healthier GDP/debt ratio, and improving macroeconomic fundamentals.
- Municipals: Where appropriate, value in high coupon, short call provision bonds. General retail "do it yourself" investors are missing these values.

The below graph is representative of how steep the slope of declining interest rates has been as seen through 30 year mortgages. Interest rate declines have been exceedingly positive for bond prices. The inverse of course is also true in that a rising interest rate environment will negatively impact bond values.



Equities/Stocks:

- Large Cap Managers: Generally broadly diversified with solid financial balance sheet, significant cash on hand, good fundamentals, dividend paying.
- Small Cap/Mid Cap International: Companies with significant resources and an increasing presence in growth and global markets. SMID companies have performed well this year vs. larger cap component. Management selection poses a significant research advantage to portfolios seeking growth.

MLP (Master Ltd. Partnerships) Oil/Gas Delivery:

- Continue to provide a steady income, over 6%.
- Dividends continue to increase.
- Low correlation to stock market.
- Gas related products, i.e. propane, methane etc. continue to grow in delivery.
- Management is typically vested .
- The portfolio is broadly diversified to many companies, reducing the risk to income.

Alts (Alternatives):

- Provide an overall general portfolio benefits as risk in global macroeconomics are rising. Helps to steady and benefit on significant trends whether negative or positive.

We feel the above commentary will give you some sense of where we are and what the future may look like. I want to thank all on our team including our investment committee, partners, and strategic alliances that we have had the pleasure to work with for many years.

On behalf of our entire team, I look forward to seeing all of you in our new office in 2013. We have officially moved in and are quite comfortable in our new “digs.” It’s kind of nice to have new things. Ahh…the smell of new carpet! It reminds me of how old my old stuff really is!

As always, we welcome your questions and commentary.

We wish you good health, happiness and prosperity throughout 2013.

Warmly,

JJ Burns