Market Commentary

December 31, 2012

Thelma & Louise

The title above may bring back memories of the final scene from the movie with the same name, when the main characters opt to drive off the precipice as they are cornered by law enforcement officers rather than face the alternative. Given the media and market obsession with the “fiscal cliff” debates I understand your thinking, but that is not where I am going with this. “Thelma & Louise” are actually the monikers that we gave to my youngest daughter Kathryn and her friend Morgan when they were in high school. They were tagged with the names after a wandering adventure in a neighboring town. Kathryn was a somewhat new driver, and they were on their way to a community service event with their field hockey team to a location that was no more than 15 minutes away. Unfortunately, “Kat” had an undeveloped sense of direction, probably because she listened to her iPod and paid no attention whenever we were in the car. Apparently her friend Morgan was no better. They wandered for more than an hour, never reaching their destination, before turning back to finally arrive back home safely. The story became legendary and hence the link to the wandering characters from the movie above.

I’ll forgive you for asking what this has to do with investing in the market, but please let me explain. The “fiscal cliff” may be the focal point, but the wandering journey that brought us to this point, and the wandering journey that will no-doubt happen afterwards, will have a significant impact on the markets and all of us.

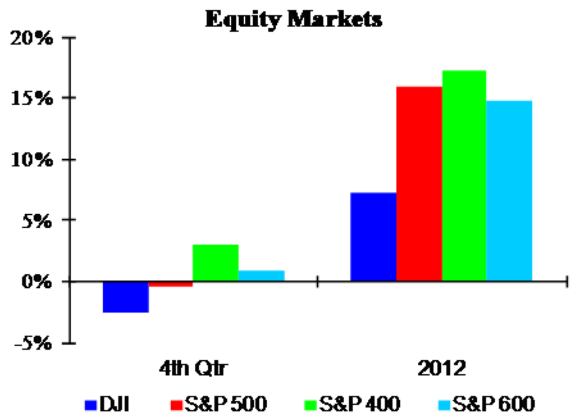
Like the teenagers above, our elected representatives on both sides of the aisle have spent little time developing the skills needed to navigate the issues that confront us, but seem confident that they can get to their desired endpoint anyway (each with a different endpoint, by the way). We have fiscal issues of spending and entitlements that are clearly unsustainable, a tax system that is inefficient and distorted by special interests, and economic policies that do little to promote much needed growth. In addition, we are amassing debt to pay for things we want today, effectively shifting the burden of payment to future generations.

The amazing thing to me is that, despite all of this, the private sector seems to be doing ok. Sectors of the economy show some signs of improvement. Housing seems to have moved off the bottom, the stress in the financial sector has lessened, consumer spending has held up, and the stock market continues its upward trend. The Eurozone hasn’t disintegrated and growth in China seems to be improving. Some economists attribute these results solely to central bank policies around the world that have poured liquidity into the system by printing money to purchase government debt and depress interest rates, a practice known as quantitative easing.

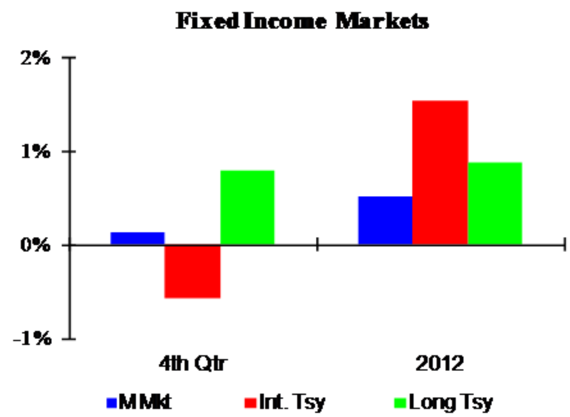
My concern is that each of the participants in this process has distorted some aspect of the economy to offset the actions of the others, and that there is no concerted plan to unwind it. As a consequence, any near-term recovery will be uneven at best, and it is unlikely that the economy will be able to generate consistent sustainable growth. The markets may do better, and we may have avoided the abyss, but this will do little to generate substantial long-term growth.

The solution for my daughter was simple with the aid of modern technology: make sure she has a GPS device to guide her. That option is not readily available for our politicians, especially considering that they can’t even agree on where they are going, let alone how to get there. But as dysfunctional as the political process can be, our economy adapts. And the one thing that we have learned over the last several years is that the markets are resilient, as well. Stocks have weathered a number of setbacks but corporate earnings have grown. Corporations have taken advantage of historically low interest rates to strengthen their balance sheets and lower their cost of capital. These balance sheet improvements have also contributed to improved operating results. The stock market has reacted to these improved results, stronger balance sheets, and liquidity injections from the Fed by pushing to new highs. Stocks are expressing the belief that corporate management can continue to produce results and that the Fed will be able to successfully unwind their intervention activity without a problem.

While we have our concerns, financial history has taught us that the adaptability of our market economy is our strongest asset. We cannot predict every outcome, but we know that ultimately sound investment fundamentals will prevail. Markets may react emotionally to events, or focus on the current “hot” investment theme, but we will continue to focus on the primary business fundamentals that we believe are essential for sound investing. Our GPS is a process that we use to identify companies that are priced attractively, with strong revenue and earnings growth, solid balance sheets with quality assets and reasonable debt levels, and strong free cash flow. We strongly believe that an investment process based on the consistent application of these sound principals has the best chance to successfully guide us to our investing destination.



The positive impact from the Federal Reserve’s most recent round of liquidity injections proved to be fleeting, as the markets’ focus moved to the unruly budget process in Washington. While large stock indexes posted slightly negative returns, their smaller cap brethren did better. More cyclical sectors of the market turned in positive returns as well, perhaps reflecting a slight improvement in underlying economic activity both in the U.S. and overseas.



Prices of shorter-dated Treasury maturities reversed their gains from the previous quarter, while longer maturities reversed their losses. For the year, total returns from Treasury securities where subdued, with most of the return coming from their coupons. Investors are increasingly concerned that the era of strong returns from Treasuries is behind us, and are beginning to question how and when the Federal Reserve will reduce its enormous portfolio of fixed income securities.

Sincerely,
Daniel A. Morris