

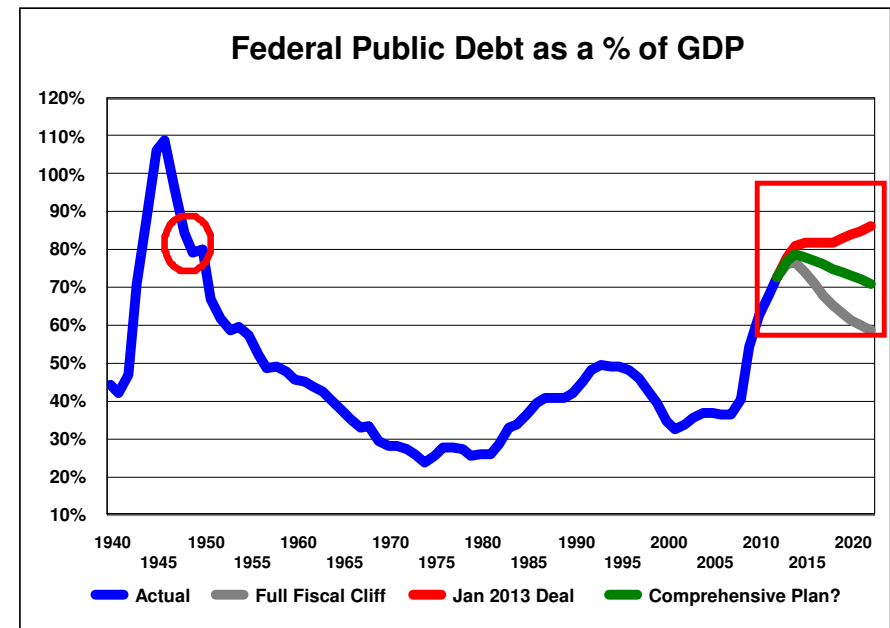
From: Warner A. Henderson, ChFC

**Subject: Now Playing.....Debt Ceiling Crisis: The Sequel**

As generally expected, President Obama and Congressional leaders agreed to a last minute deal to avoid the so-called *Fiscal Cliff*, i.e., rising tax rates for all Americans and severe cutbacks in federal spending. The *Fiscal Cliff Deal* provides a permanent extension of the Bush-era tax rates for joint filers with taxable incomes of \$450,000 or less (about 98% of all taxpayers) and moderately higher rates for those above the threshold. Other important provisions of the deal include an extension of favorable tax treatment for dividends and capital gains for most taxpayers (stocks gained 300 points the day after the agreement was announced). While the deal was generally positive for taxpayers and investors, Congress and the President failed to make any headway toward solving the nation's growing debt problem. Whereas the full *Fiscal Cliff* included major reductions in defense and discretionary federal spending which would have significantly decreased future deficits, our lawmakers elected to kick the can further down the road for another two months to the point when our *Debt Ceiling* limit will be reached. Presumably, the Republican-led House of Representatives will demand reductions in future "entitlement" spending in order to agree to raising the *Debt Ceiling*. Déjà vu all over again. We had a similar crisis back in August of 2011 when the President and Congress failed to reach a "grand bargain" to resolve our nation's debt problem. That failure resulted in a 20% global stock market plunge and the loss of our triple-A credit rating from Standard and Poor's. While such an outcome was entirely avoidable in 2011 - and should be this time around as well - our politicians have demonstrated a knack for creating crises out of perfectly solvable fiscal challenges. Perhaps the President and Congress will steer us clear of another 2011 style *Debt Ceiling Crisis* and the bull market for stocks will continue unabated. On the other hand, the two political sides appear poised for continued dysfunction which may lead to yet another stock sell-off and a further downgrade to our nation's credit rating (let's

hope cooler heads will prevail).

The January *Fiscal Cliff* deal, known officially as the *American Taxpayer Relief Act of 2012*, did little to deal with our growing national debt problem. In the chart below, we've graphed our Federal Public Debt since 1940 as measured by its share of our Gross Domestic Product (data courtesy of the Congressional Budget Office). You will note that Federal Public Debt reached a record-high level of 110% of GDP during World War II and gradually fell to the 25% level by the early 1970's. Beginning in the year 2000 (the last time we had an annual budget surplus), tax revenues have grown by just 1.7% annually while federal

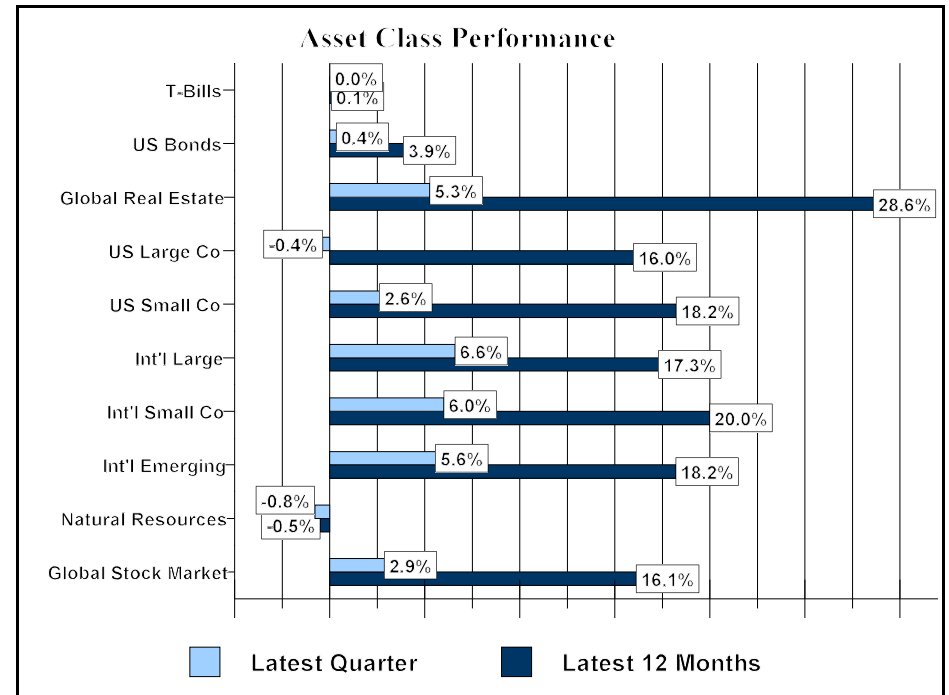


expenditures have grown by a whopping 6.5% per year. And while our Public Debt stood at about 32% of GDP twelve years ago, it is soon projected to reach 80% of GDP for the first time since 1950. Looking forward, the red line in the graph indicates the projected level of debt if *nothing* is done to reduce government spending over the next eight years (the red line includes the new tax rates in the

*Fiscal Cliff Deal*). The grey line represents the impact of the full *Fiscal Cliff* which, ironically, would have dramatically improved the debt picture (as we mentioned in a November *Helm* email, the tax increases and spending cuts contained in the *Fiscal Cliff* were viewed by some as an imperfect *solution* rather than a problem). Most economists conclude that we need a comprehensive fiscal plan, such as the *Bowles Simpson* Commission Plan, which contains about \$1 of new tax revenue and \$2 worth of spending cuts. Such a "balanced" plan might resemble the green line in the graph, i.e., falling somewhere between the red and gray lines. Unfortunately, the recent *Fiscal Cliff* deal raised far less than the necessary tax revenue and didn't reduce federal spending. Congress elected to defer the contentious spending debate for another two months to coincide with the *Debt Ceiling* deadline. So stay tuned, over the next few months we'll be subject to much political drama surrounding the *Debt Ceiling* which needs to be dealt with simply to honor our *existing* obligations. This will likely go down to the wire, once again, as Republicans in the House of Representatives are preparing to demand reductions in *future* spending as a trade-off to allow an increase in the *Debt Ceiling*. House Republican Conference Chairwoman Cathy McMorris Rogers recently stated, "I think it is possible that we would shut down the government to make sure President Obama understands that we're serious. We always talk about whether or not we're going to kick the can down the road. I think the mood is that we've come to the end of the road." Given this likely showdown, as investors we should expect to see the same sort of market volatility we endured during the last *Debt Ceiling Crisis* in August of 2011. Before elaborating further on volatility, let's review the latest performance numbers which were remarkably positive for 2012 (despite all of the political turmoil and economic uncertainties).

### Asset Class Performance Observations

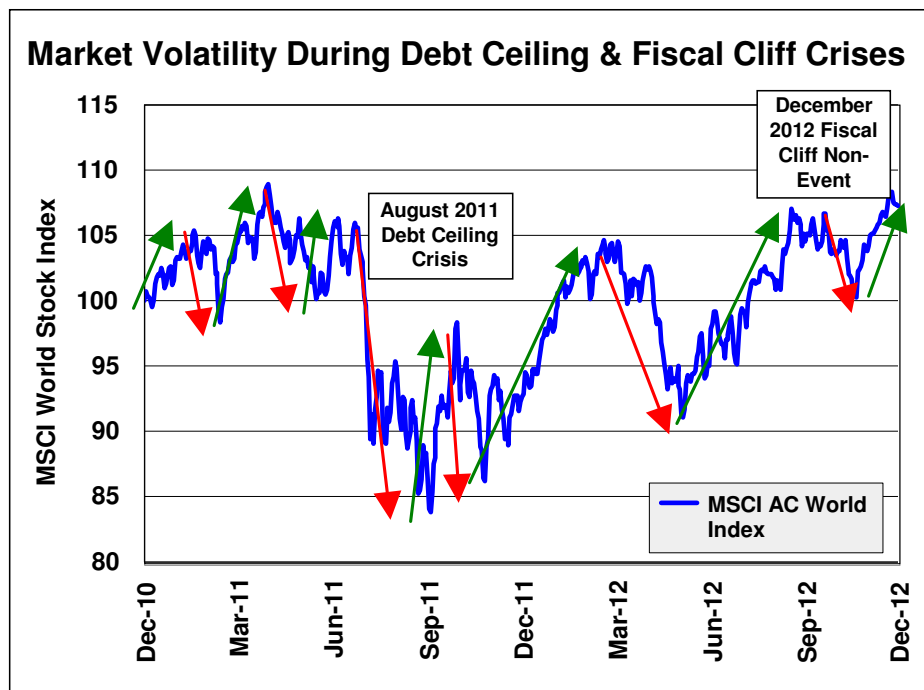
The returns for the fourth quarter were generally robust as investors seemed to shrug off the *Fiscal Cliff* drama, or perhaps had become so desensitized as to ignore it. After all, with the media behaving like Chicken Little (i.e., the sky is falling) over the past few years, perhaps investors were tuning out the media's drumbeat of fear and tuning in news about a global economy which was showing signs of improvement. With the European Debt Crisis easing, foreign stocks delivered the highest returns. Leading the way were Int'l Large, Int'l Small and the Emerging Markets with three month gains of 6.6%, 6.0% and 5.6% respectively. Global Real Estate was next (+5.3%) followed by US Small Companies (+2.6%). US Bonds (+0.4%) and T-Bills (0.0%) were essentially flat while the two losing asset classes were US Large Co's (-0.4%) and Natural



Resources (-0.8%). The Global Stock Market gained 2.9% for the quarter. For the trailing twelve months, the returns were surprisingly strong and exceeded even the more optimistic prognosticator's predictions for 2012. The only losing asset class was Natural Resources (-0.5%) which suffered from speculation that demand for energy would slacken in a slowly growing economy. While we generally agree with the slow growth forecast, we also see energy stocks as being attractively valued at current prices. Longer-term, we view the Natural Resources asset class as a good portfolio diversifier and an inflation hedge. (One bright note within the energy sector was Clean Energy Stocks which posted a gain of close to 20% for the year.) In the other asset classes, T-Bills delivered a near-zero return (0.1%) while US Bonds grew by 3.9%. The best performing asset class was Global Real Estate which gained close to 29%. All of the remaining stock asset classes delivered healthy returns ranging from 16% (US Large) to 20% (Int'l Small). For the year, foreign stocks generally outperformed US stocks; however, at mid-year the opposite was true. For the first six months of 2012, foreign stocks were down 8% while US stocks were down just 3%; quite a turnaround during the last six months!

## Stock Market Volatility During the Debt Ceiling & Fiscal Cliff Crises

Over the past few years, we've worked with our clients to add defensive elements into their portfolio structures to help dampen portfolio volatility. Such elements include: (1) raising the allocation to Fixed Assets (primarily short-term bonds), (2) emphasizing high-quality dividend appreciation stocks within US Large Cap asset class and (3) adding Tactical Asset Allocation funds to the Equities mix for aggressive portfolios. Each of these strategies has helped to reduce portfolio volatility during the extremely tumultuous past two years. As seen in the chart below, the red and green arrows indicate stock price gyrations of at least 5% over the past two years; thirteen in total making this one of the more volatile periods in stock market history. The most significant downward move was the 20% sell-off during the first *Debt Ceiling* debacle in August and September of 2011; the

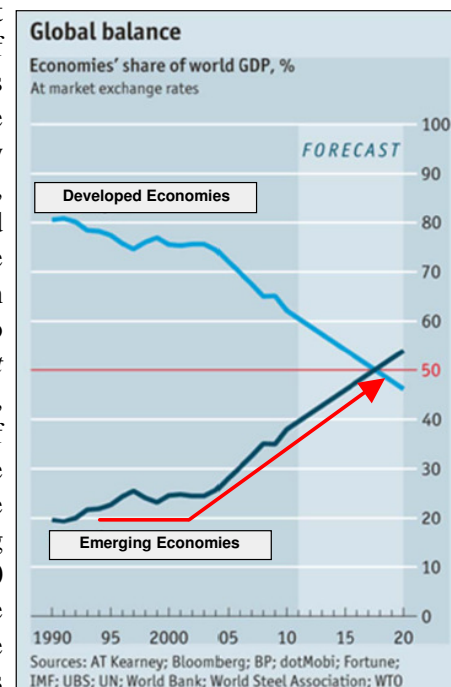


most significant upward move was a 17% gain in early 2012. Over the entire two-year period, the Global Stock Market posted a cumulative gain of about 8%. In looking ahead, we see heightened volatility for the markets over the next few months leading up to the *Debt Ceiling* debate; beyond that, the European Debt Crisis is another potential volatility trigger. Given these risks, we're not ready to pull-back on our defensive portfolio measures yet (although we intend to make

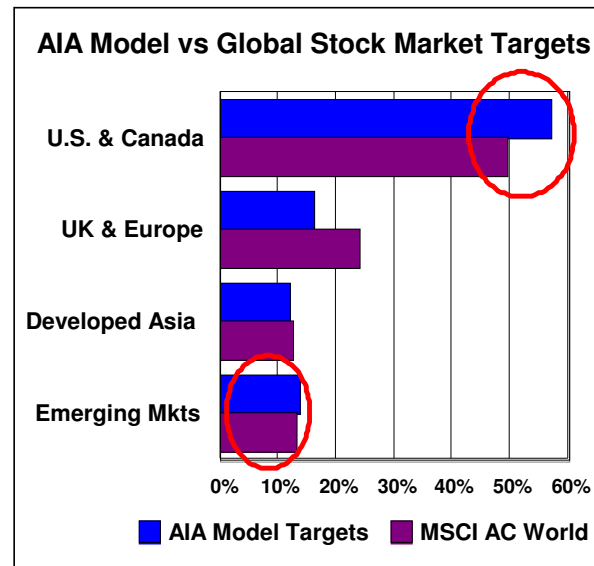
adjustments), but given our generally optimistic view of stocks over the longer-term, especially in the Emerging Markets, we would look to future stock market volatility as a opportunity for portfolio rebalancing, i.e., buying stocks at lower prices. Over the past two years, there have been two significant rebalancing opportunities where the stock market has corrected by at least 10%; August-September of 2011 and April-June of 2012. Portfolio rebalancing has enabled clients to use such downturns to their advantage.

## Now That The Hockey Season Has Begun.....

After losing most of their season to a labor dispute, the National Hockey League and the players finally reached a deal to end the three-month lockout. But what's this have to do with the quarterly investment report? Is it an example for our leaders in Washington of how two opposing sides can reach common ground and hammer out a deal? Perhaps, but not what I had in mind. Rather, as I was thinking of macro trends in the global economy, I was reminded of a lesson from Wayne Gretzky, arguably the greatest hockey player of all-time. In his autobiography, he recounted the many lessons learned from his father who would drill him on the fundamentals of smart hockey. An important lesson Gretzky learned was to skate to "...where the puck is going, not where it's been." Beyond the hockey rink, I believe this lesson can apply to one of the most significant macro trends in the global economy, i.e., the growth of the Emerging and Frontier Markets. Referring to the graph to the right, note how in 1990 the Developed Markets dominated the global economy with an 80% share of the world's GDP. Gradually, their share has fallen to the current 40% level as the Emerging Economies have exhibited rapid growth with China being the major driver (a growth curve resembling that of a hockey stick). *It is estimated that over the next five years the Emerging Economies will comprise more than 50% of the world's GDP*; a major macro trend which will profoundly influence future investment opportunities and asset allocation decisions.



Currently, stocks in the Emerging Markets comprise approximately 13% of the entire capitalization of the Global Stock Market as measured by the MSCI All Country World Index. Last year, our target allocation to the Emerging Markets was 12%, or about 1% "underweight" compared to the benchmark. For 2013, our investment committee has decided to raise the Emerging Markets target for our model portfolio by about 2% with a comparable reduction in the allocation to US stocks. As a result of our new asset class targets (indicated in the chart below), we will now be *slightly* over-weight in the Emerging Markets, neutral weight in Developed Asia, underweight in the UK & Europe and we will remain significantly over-weight in the US (as with the hockey puck analogy, asset allocation considerations are moving targets and we anticipate further



adjustments in the future). A key element in our decision rests on the relative valuation of US versus Emerging Markets stocks. At the beginning of 2013, Emerging Markets stocks were trading at a "discount" to US stocks of roughly 15% as measured by Price to Earnings Ratios (US stocks had a P/E of 12.6 compared to a P/E of 10.8 for Emerging Market stocks based upon estimated 12-month earnings). While we believe US stocks are

attractively priced relative to their historic valuations (one reason for our over-weight), we find the valuations in the Emerging Markets to be particularly attractive and worthy of an over-weight (we will discuss the various target weights and specific recommendations with each of our clients during upcoming portfolio reviews).

### Final Thoughts

Many investment strategists are forecasting another strong year for stocks based upon generally attractive stock valuations, an improving global economy and the potential flow of funds into stocks from bonds. The eternal optimist, Jeremy

Siegel of the Wharton School of Economics, believes the market could climb another 15-20% in 2013 (he made a similar prediction in 2012). "I'm on record saying I think there is an overwhelming probability that we're going to get a Dow 15,000 by the end of the year....." Much of his optimism is based upon favorable stock valuations and his belief that Washington will take constructive steps toward reigning in the growth of entitlement spending (hope springs eternal). Other strategists we follow are more cautious, however. The global investment strategy firm of BCA Research is likewise forecasting continued improvement in the global economy, but only sees stocks rising by 6% for the year. Their stock forecast might be brighter were it not for the many unresolved economic and financial obstacles on the horizon. In their latest publication, *Outlook 2013: Fewer Storms, More Sunny Breaks*, they write, ".....how things play out will depend a lot on politics - especially in the U.S. and Europe. That makes things even more unpredictable than usual. We assume that politicians ultimately will behave rationally, but we could be proven wrong on that." Alas, this is the dilemma we face as investors today. On the one hand, the economy appears to be improving and we could have another great year for stocks, but on the other hand, the politicians are holding the trump cards and their actions could send the markets into turmoil. Given this predicament, we believe the best course of action is to maintain a steady hand on the helm and keep existing portfolio defenses in place for the short-term. Once the *Debt Ceiling* tension eases, we believe it will become appropriate to ease off on the defenses and become somewhat more aggressive with a particular focus on undervalued asset classes, including the Emerging and Frontier Markets (i.e., where the puck is heading).



I thought I'd close with enduring words of wisdom from John F. Kennedy which seem particularly appropriate today, "Let us not seek the Republican answer or the Democratic answer, but the right answer. Let us not seek to fix the blame for the past. Let us accept our own responsibility for the future." Amen.