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PLUS CA CHANGE…., BUT INVESTMENT STRATEGY DECEMBER 31ST, 2012

SUMMARY

"Plus ca change, plus la meme," but…. "The more it changes, the more (it remains) the same." But in spite of our expectations of a continuation of global economic growth in 2013 similar to that of 2012, we do expect investors to become less fearful as the year goes on, producing a rise in US price-earnings (p/e) ratios and, with some exceptions, those of other global markets as well. Today, the price earnings ratio of the S&P 500 Index, stands at 13.5 times our estimated 2013 earnings of $106/share. If global growth finally accelerates as it benefits from very low interest rates, earnings growth in the US could be closer to 10%, which, with an expanded p/e ratio, could result in very attractive gains of 10%-20%.

During the last several years, investors have been very bearish about: a breakup of the Eurozone and another financial crisis; inflation; a US recession; and a fall off the fiscal cliff in the US, perhaps leading to recession. Thus, the p/e of the US stock market has remained below 15, its long term average ratio. For several reasons we expect investors' fears to subside as:

1. The US, despite the fiscal drag of spending cuts and higher taxes, does ***not*** go into recession, but,
2. Maintains a reasonable level of growth, i.e. 1.5-2.5%, without any significant rise in its inflation rate;
3. European governments and the ECB continue to demonstrate their commitment to holding the Euro-zone together, including Greece, by providing support for governments and the banking system through the ECB and the ESM.
4. The housing sector continues to provide jobs, and as consumers, aided by more jobs and refinancings at exceptionally low interest rates, have more money to spend, and
5. If at least some if not all of the uncertainty surrounding taxation and business conditions disappears.

Thus, we would expect investors to return to stocks.

Furthermore, investors will be plagued with low returns from bonds, as yields are close to recessionary lows, and unlikely to decline further, limiting any further appreciation in bond prices. Indeed the US Treasury Bond market is a bubble waiting to burst! The dividend yields on the S&P 500 at 2.07%, is more than the US Treasury 10 year bond (1.78%). As fear subsides, the urge to gain returns from both appreciation and dividends may send investors back into the stock market.

If the S&P 500 Index trades at 15-16 times, equal to or just over its historical average, the Index might reach as high as 1,700 possibly producing a 20% return for the year?

David R.Kenerson., Jr
Niklas K. Oskarsson

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“Plus ca change, plus la meme,” but…. “The more it changes, the more (it remains) the same.” But in spite of our expectations of a continuation of global economic growth in 2013 similar to that of 2012, we do expect investors to become less fearful as the year goes on, producing a rise in US price-earnings (p/e) ratios and, with some exceptions, those of other global markets as well. Today, the price earnings ratio of the US stock market, represented by the S&P 500 Index, stands at 13.5 times estimated 2013 earnings of $106/share, a modest 6% increase over 2012’s expected earnings. If global growth finally accelerates as it benefits from very low interest rates, earnings growth in the US could be closer to 10%, which, with an expanded p/e ratio, could result in very attractive gains for US portfolios.

Investors have been very bearish about many things during the last several years, including: a breakup of the Eurozone and another financial crisis; inflation, a US recession; and a fall off the fiscal cliff in the US, perhaps leading to recession. Thus, the p/e of the US stock market has remained below 15, its long term average ratio. We expect investors’ fears to subside as:

1. **The US, despite the fiscal drag of spending cuts and higher taxes, does *not* go into recession:**

Our best guess at the amount of fiscal drag on GDP growth from increased taxes (e.g. restoration of the full social security tax on employees) is about 1%-1.5%. Offsetting this to some degree may be a lower price of oil and the stimulus from lower refinanced mortgages. If we go over the fiscal cliff, growth during the first quarter could be very slow raising fears of recession again, until Congress acts. We think they will act eventually, but to what degree and when remains to be seen. We rather expect these negotiations to be continuous throughout much of the year causing chronic bouts of vertigo in the stock market.

2 **The US maintains a reasonable level of growth, i.e. 1.5%-2.5% without any significant rise in its inflation rate;**

Depending on Congressional action it is conceivable that 2% might be optimistic, but we rather expect the major spending cuts to occur in later years, if at all, keeping a long term lid on economic growth as we lower our future payables and promises. If such cuts are not made, then we expect a second lowering of the rating on US Treasury bonds, and rising rates as investors become concerned about the long term outlook for such bonds.

3 **European governments and the ECB (European Central Bank) continue to demonstrate their commitment to holding the Euro-zone together, including Greece by providing support for governments and the banking system through the ESM.**

As we wrote last July 1st, (Over the Hump!), the Europeans have now shown that they recognize the necessity of common banking supervision, and ultimately the need for a union-wide protection of depositors (to prevent the need to switch banks in times of emergency). They also recognize the need for funding systemically critical banks with capital directly rather than through their governments (because it can increase the amount of government debt so substantially that it worsens one of the problems the EU is trying to solve, i.e. excess government debt.) Such funding will be very important for both Ireland and

more importantly, Spain. Finally, Mario Draghi, the European Central Bank’s President made it clear that the ECB would do whatever is necessary, including buying government debt directly, if necessary, to keep the Euro-zone together. This last promise represented a second “big bazooka” and effectively took away a substantial amount of risk. As a result, both Italian and Spanish interest rates dropped very substantially.

Nonetheless, a note of caution is warranted: ECB supervision of Euro-zone banks has now been postponed until March of 2014. Notwithstanding the ECB’s commitment, which clearly backstops the governments, more trouble in the Spanish banking system – which we expect – could produce additional volatility in European and US financial markets.

Yet to come on the European front, are common economic and labor policies. These will take some time.

4 **The housing sector continues to provide more jobs and income, and mortgage refinancings provide more spendable cash flow for consumers.**

As we have noted several times in these strategy pieces, each new home built creates three new jobs providing additional income and spending for the economy. The new housing market has improved as the number of foreclosed homes on the market has declined and banks have increased their mortgage lending. Finally, consumers, aided by refinancings at exceptionally low interest rates, have and will have more money to spend, which they will do if at least some if not all of the uncertainty surrounding taxation and business conditions disappears.

The Need for Income as well Drives Investors into the Stock Market:

2013 is a year where some of the uncertainties become certain, for better or worse! Dodd Frank regulations are to be completed (?), the fiscal cliff is decided (?), etc. Usually fears are worse than the reality, and thus, the removal of uncertainty to us, is a positive factor even if it has some bad news.

It is not just subsiding fears, but also not wanting to miss out on substantial returns in the stock market that may encourage investor back into stocks. Returns in 2010, 2011, and 2012 have been, despite the volatility, about 15%, 2%, and 16% respectively or an average annual return(not compounded) of more than 10%. We think it only takes a bit of relief from uncertainty to unleash the stock market.

Over the last three years bonds have provided total returns (income and appreciation) similar to stocks. But with yields close to recessionary lows, we expect bonds to provide little appreciation from here, leaving only the very low yields for investors. Indeed the US Treasury Bond market is a bubble waiting to burst, and the S&P 500 Index yields (at 2.07%) more than the US Treasury 10 year bond (1.78%) which doesn't even offset inflation if it remains at 2%. As fear subsides, the urge to gain returns from both appreciation (in the stock market) and dividends will rise.

If the S&P 500 Index traded at 15-16 times, or equal to or just over its historical average, the Index could be expected to reach as high as about 1,700. Thus, investors could be looking at another year of 10%-20% returns in the stock market. We consider this well within the realm of possibility over the next 13 months.

What to Do:

We continue to retain our investments related to the financial sector, housing, and infra-structure development after having lightened up on our technology exposure during the year. The most significant new development is seeing how the economic statistics have shifted in China since this past October, indicating that China's slowdown has ended and its economy has shifted from slowdown to slow (?) takeoff?! We are increasing our exposure to China, and therefore also to Brazil for whom China is its leading market.

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