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Perspective

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Taking the Pulse of the Recovery

While I am cautiously optimistic that the overall economic recovery is continuing, there are still areas of turbulence and uncertainty around the globe. Many investors are wondering if we've seen the worst of the economic crisis or if more difficult times are ahead. I hope this paper will provide you with valuable perspective.

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Introduction

Many investors wonder whether we've seen the bottom of the economic crisis and are on the way up. Is it safe to put more money in the market? Are we going to see another crisis? These are all fitting questions to ask.

The good news is that overall, domestic economic trends are showing positive signs – employment, GDP, manufacturing, and consumer confidence have all increased since late last year. Philadelphia Federal Reserve head Charles Plosser predicts that the U.S. economy will continue to grow at a modest 3% in 2012.[1]

However, some analysts are concerned that we may be seeing a repeat of last year's performance, where, in the early months of 2011, the unemployment rate fell to its lowest level in nearly two years, consumer confidence was high, and economic growth was steaming along. However, as we all remember, events took a different turn when turmoil in the Middle East and North Africa sent oil prices soaring, and the European debt crisis revived fears of another meltdown.

In 2012, we can still expect some downside, with issues such as oil price instability, the European debt crisis, and a burgeoning federal government budget deficit contributing to bumps in the overall economic recovery. But, with the right positioning, such short-term dips may provide opportunities for investors.

United States

Employment

Payroll growth beat estimates in December and January, increasing by 200,000 and 243,000, respectively. The unemployment rate dropped to the lowest level in nearly three years – 8.5%, and then slid further to 8.3% in January, according to BLS figures.[2]

Two sectors that are looking particularly rosy are transportation, which added 50,200 jobs in December, the biggest single-month gain since September 1997; and food service, which has added 487,000 jobs since a recent low in February 2010. Although employment numbers are always estimates, they form part of an overall economic picture that we see improving.

Housing

With demand still weak and a pipeline of distressed properties available to buyers, the housing market recovery still has a long way to go; however, builders are optimistic about their chances in 2012. Housing starts, an indicator of new home construction trends, dropped by 4.1% overall in December, reflecting a drop in multi-family condos and apartment buildings. However, single-family construction increased by 4.4% in December and Lennar Corp, the third-largest US builder by revenue, reported a 20% fourth-quarter jump in new orders, and expects a good start to 2012.[3]

Home builder confidence in the market for new single-family homes increased for the fifth consecutive month in February, rising from 25 to 29 on the NAHB/Wells Fargo Housing Market Index (HMI), which is the highest level the index has reached in more than four years.[4]

Retail

Same-store sales at U.S. retailers excluding Wal-Mart Stores, Inc. rose 3.5% in December from a year earlier, according to figures from the International Council of Shopping Centers, indicating a strong holiday performance and increased consumer spending.[5]

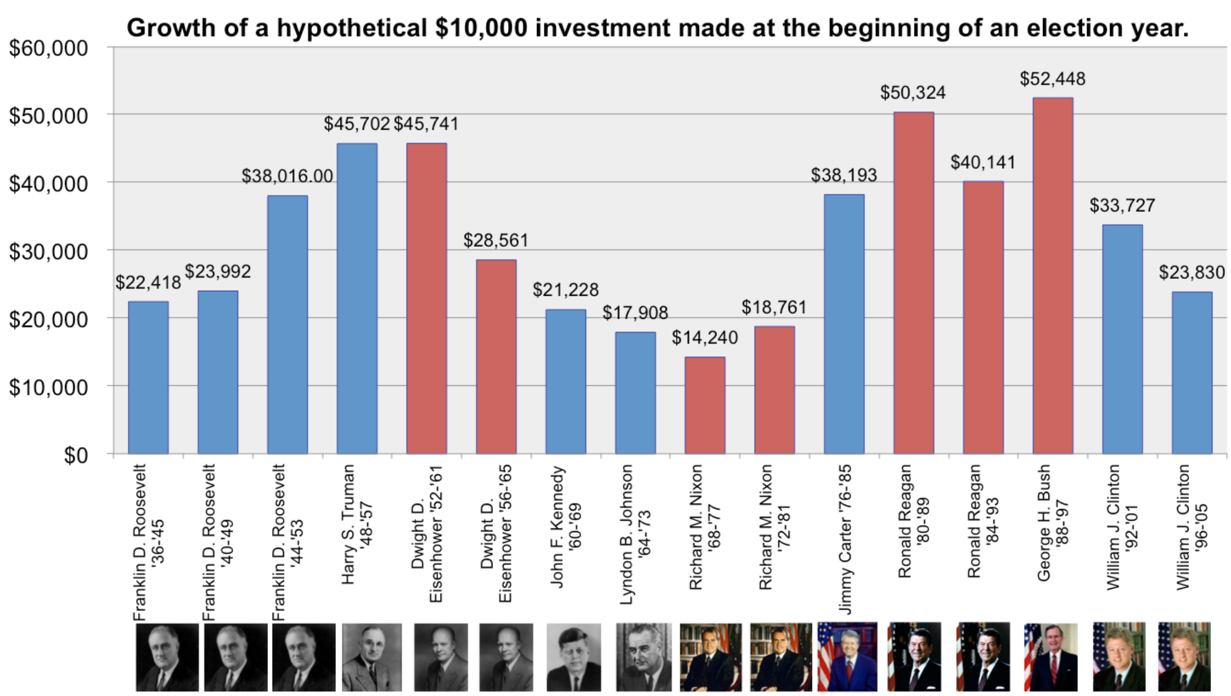
Retail sales increased 0.4% in January, according to a Commerce Department report, however, the increase was less than the 0.7% expected by economists. This modest increase has some analysts worrying about depressed sales, however, core retail sales, which exclude autos, gasoline, and building materials, increased 0.7%, causing the S&P retail index (RLX) to edge very close to its highest point on record.[6]

Manufacturing

The manufacturing industry is starting out the year on a positive note: new orders, production, and employment all grew in January, and companies are reporting excellent business prospects for the year. In January, the Institute of Supply Management's composite manufacturing index (PMI) showed an increase of 1% over December, indicating that economic activity in the manufacturing sector had grown for the 32nd consecutive month.[7] At 95.9% of its 2007 pre-crisis average, total industrial production is looking a lot better lately.[8]

Election Cycle

While investors have always been concerned about the effect of an election year on their investments, the historical numbers show that their fears are unfounded. In the 10-year period following every election year, regardless of which party was elected, the stock market grew. While we cannot predict the future, we can ignore the hysteria in favor of a long-term strategy.



Each 10-year period begins on January 1st of the first year shown and ends on December 31st of the final year shown. For example, the first period listed (1936-1945) covers 1/1/36 through 12/31/45. All returns exclude reinvested dividends. Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. SOURCE: Yahoo Finance.

Corporate Finances

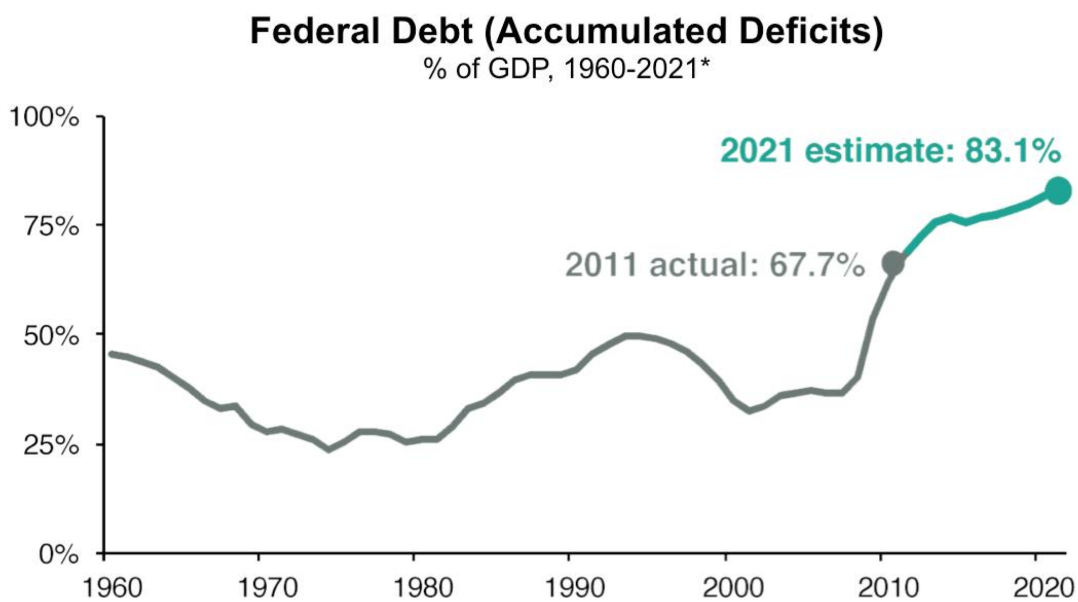
Since 2010, analysts have been buzzing about the large stockpiles of cash corporations have on their balance sheets. In its first-quarter report, Apple (AAPL) disclosed that it was sitting on $97.6-billion in cash and marketable securities, fanning speculation that the company would soon announce a dividend. According to some estimates, U.S. corporations have an estimated $1.5-$1.8 trillion in cash and securities. Over time, we expect that these cash reserves will translate to increases in hiring and spending, thus adding further impetus to the recovery.[9]

Taxation and Debt

Congress is expected to pass a deal extending both a payroll tax cut and jobless benefits through 2012. While it is unlikely to provide a major jolt to the U.S. economy, the deal should help support the recovery. A 2011 report by Moody's Analytics estimated that every $1 decrease in revenue from reducing the payroll tax for workers expands the economy by $1.27.[10]

On a less positive note, President Obama reiterated his plan to retire the Bush-era tax cuts on household income over $250,000 a year. The president is also encouraging lawmakers to eliminate the alternative minimum tax, while requiring millionaires to pay at least 30% of their annual income to the Internal Revenue Service.[11]

For obvious reasons, the national debt and budget deficit are of concern to us, and we are seeing few signs that the problem is getting smaller – on the contrary in fact, it seems to be getting larger. As you can see from the chart below, the deficit is only projected to increase with time.



Source: U.S. Treasury, BEA, CBO, OMB, J.P. Morgan Asset Management. 2011 numbers are actuals. *Estimates for 2012 – 2021 are based on adjustments to the August alternative scenario from the CBO's "Budget and Economic Outlook: An Update" which was released on August 24, 2011. This adjusted alternative scenario assumes an extension of all Bush tax cuts, annual adjustments to AMT and Medicare payment schedules and a 1-year extension for calendar year 2012 only of the payroll tax cut and extended unemployment benefits. Additionally, this adjusted alternative scenario assumes a reduction in troop presence in Iraq and Afghanistan starting in 2012, which is in line with current policy. Note: Years shown are fiscal years (Oct. 1 through Sep. 30). Data reflect most recently available as of 12/31/11.

Energy Prices

Although coal and natural gas prices are down after an unexpectedly mild winter, escalating tensions in the Middle East have led to turbulence in oil markets. Oil rose above $101 a barrel in Asian markets on February 15th, and some analysts fear prices above $120 a barrel in the coming months.[12]

If oil prices remain high in 2012, it could have a dampening effect on consumer spending and overall economic growth as consumers are forced to spend more at the pump. Higher transportation costs could also lead to overall increases in product costs. This is one factor we are watching closely.

Investor Perspective

While indicators such as employment numbers and housing indexes are simply estimates, they contribute to our overall understanding of the domestic economic picture. The question we have to ask is: What overall trends are we seeing? Strong employment numbers, growing retail performance, and an upward housing trend are all indicators of an economic recovery. Strong employment numbers mean higher spending as consumers feel able to open their wallets and spend. The bottom line is that the economy is getting better.

The current national debt situation is an area of concern. Clearly, the government is unwilling to take decisive action to curb spending and is actively adding to the deficit. If a solution is not found soon, the U.S. could be facing a situation similar to Europe's. We hope the politicians won't let their personal agendas get in the way of finding lasting solutions to a problem that will ultimately affect every American.

Europe

In a signal that the debt crisis in Europe isn't over, on February 13th, Moody's downgraded credit ratings on six European countries, and issued warnings on France, Britain, and Austria.[13] Financial stocks are taking a beating in international equities markets over concerns about adequate response to the debt crisis and write-downs on Greek debt.

Greece is undeniably in a recession, with its economy contracting 6.8% last year, and debt default looming on the horizon. To add to its troubles, a traumatic ejection from the EU is possible amidst allegations that Greece is failing in its austerity measures and reluctance among EU finance ministers to release the next round of bailout funds. Protests in Athens have turned violent with anger about 20.9% unemployment and austerity cuts spilling over into the streets.[14]

The Italian economy has officially entered its fourth recession since 2001, with GDP declining 0.7% in the last quarter of 2011, weighed down by government budget cuts. The IMF forecasts a 2.2% contraction in 2012 and the S&P has downgraded Italy's debt rating from A to BBB+ amid concerns about Italy's high external public debt. On a positive note, Italy's industrial production unexpectedly rose by 1.4% in December, despite the recession.[15]

Portugal's economy shrank for a fifth quarter in December as the government cut spending and raised taxes to trim its budget gap. According to the National Statistics Institute in Lisbon, the GDP decline is related to reductions in household spending and lowered internal demand for consumer products. The construction industry is among the hardest hit, with ten building companies filing for bankruptcy each day. [16]

On the bright side, on February 14th, People's Bank of China Governor Zhou Xiaochuan announced an interest in assisting with the European bailout and increasing China's investment in Europe. The Euro rallied on the back of this vote of confidence in the European economy, closing at $1.3186 on February 14th.

Africa and the Middle East

Syria

Violence in Syria continues as President Bashar al-Assad continues to crack down on protests and Syria teeters closer to a full-blown civil war, which could draw in neighboring nations and outside allies. Recent allegations that Iran is assisting Syria in evading international sanctions have led many to fear that this could turn into a proxy war with Sunni-majority countries Turkey, Saudi Arabia, and Persian Gulf states backing the opposition, and Shiite states Iran and Iraq on the side of President al-Assad. Such a crisis could destabilize the entire region, and force the intervention of the U.S. and its western allies.[17]

Iran vs. Israel

Saber rattling between Iran and Israel has contributed to increased uncertainty in oil prices. Tensions between the two nations have risen following a bomb attack on an Israeli diplomatic target in India and the capture of two suspected Iranian bombers in Bangkok.

Though Iran denies possessing nuclear weapons, many analysts believe that they have an active development program. Sanctions have had little effect on Iran, and now some fear that more drastic measures may be taken to prevent Iran from acquiring nuclear weapons. Some analysts predict that Israel may strike at Iran's nuclear facilities; if this happens, Iran could retaliate by disrupting vital oil routes and reducing oil production.

Iran has also threatened to close the Strait of Hormuz, used for a third of the world's seaborne oil trade, if the West attempts to ban Iranian oil exports. Although alternate routes through Syria, Lebanon, and Turkey exist, a blockade could seriously affect global oil prices. Recent reports indicate that Iran has built up its naval forces in the Gulf; however, the Fifth Fleet of the U.S. navy routinely patrols the strait and would be capable of preventing a naval blockade.[18]

Investor Perspective

While the debt situation is still uncertain in Europe, with the entry of China into the picture, investors can hope for a resolution. However, until concrete proposals are on the table, it will be impossible to assess long-term impact on the euro. China has the ability to invest as much as $560 billion overseas, an amount that dwarfs even Europe's need. China's foreign direct investment into the EU was just $4.3 billion in 2011, a 94% increase over 2010, according to Ministry of Commerce data.[19]

Turmoil in the Middle East is most greatly felt in oil prices, which are an indicator of current demand, current and future supplies, and investor sentiment. Oil prices are greatly influenced by fears of supply interruption, meaning that every negative headline from the Middle East sends prices through the roof.

However, we believe that fears about Iran are greatly exaggerated. According to 2006 estimates, Iran contributes only 5% of global crude oil production. While Iran may threaten to cut off oil exports, it is highly unlikely that they will follow through on their threat.

Oil exports made up 60% of government revenues and more than 18% of Iran's total GDP last year, meaning the country would suffer significantly if its oil exports were interrupted.[20] Furthermore, members of the Organization of Petroleum Exporting Countries (OPEC) such as Saudi Arabia would very likely increase production to both cash in on higher oil prices and stabilize the market, as they did during the Libyan revolution in 2011.

Conclusion

While we are cautiously optimistic that the overall economic recovery is continuing, there are still areas of turbulence and uncertainty around the globe. In particular, we are concerned about the situation in the Middle East as well as the continuing debt crisis in Europe. Though we cannot control all factors or foretell the future, we can take steps to invest intelligently and safeguard our long-term investments while keeping an eye on global economic conditions.

Particularly in times of economic uncertainty, we believe it is important to seek professional advice when investing. We also believe it is important to develop a personalized investment plan that takes into account your current and future needs, investment time horizon, and appetite for risk. This ensures that no matter what the markets are doing in the short-term, you know that your investments are working towards your long-term goals. It is critical that you develop the discipline to stick with your plan. When investments are declining, investors' nerves can get the best of them, causing them to pull out at exactly the wrong time.

While it is impossible to predict exactly how global events will affect markets, generally, each downside offers an upside somewhere else. We specialize in looking for these upsides, and diversifying* our clients' investments into different asset classes. Our goal in doing this is to help them smooth out the highs and lows, avoid the worst-case scenarios, and take advantage of opportunities that exist.

One of the most important benefits of working with a professional financial advisor is the comfort of knowing that you have experts monitoring all aspects of the global economy. We want to assure you that we are diligent about researching current trends and using all the analytical tools at our disposal when helping you make investment decisions. Above all, we want you to relax and enjoy the life you have worked to earn, knowing that there is an experienced, vigilant hand at the tiller.

If you have questions or concerns about your portfolio, we are always at your service. It is a pleasure serving you and we are honored by your trust.

Warm Regards,

V. Michael Greben

Would someone you know benefit from receiving this communication? If so, call my office at 410-356-0111 to provide us with their contact information and I will be happy to send them a copy.

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The S&P Retail Index (RLX) is a capitalization-weighted index of domestic equities traded on the New York Stock Exchange, American Stock Exchange and NASDAQ. The stocks in the Index are high-capitalization stocks representing a sector of the S&P 500. Past performance is no guarantee of future results. SOURCE: Yahoo Finance.
The Housing Market Index (HMI) is a weighted average of separate diffusion indices based on a monthly survey of NAHB members designed to take the pulse of the single-family housing market. Each resulting index is then seasonally adjusted and weighted to produce the HMI. Past performance is no guarantee of future results.
The PMI is a composite index based on five components of the ISM's monthly manufacturing industry survey: new orders, inventory levels, production, supplier deliveries and the employment environment. Each component is adjusted for normal seasonal variations and weighted to produce a single monthly index number. Past performance is no guarantee of future results.

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