First Quarter 2012--The Calm Before The Storm?

In review of the first quarter, the stock market's performance quickly gives the impression that things are great in the world. If only we shared that enthusiasm.

The Dow Jones Industrial Average had its best first quarter since 1998 and stocks from Tokyo to Mumbai and Frankfurt posted their strongest quarterly gains in many years.

Although we enjoy positive performance, we are not sure it is warranted. The concerns that existed at the end of the year still remain with minor exception.

In all, 52% of U.S. companies beat earnings estimates, but that was below the 60% average since the U.S. economy began its recovery in the second quarter of 2009. Many stock indexes are now trading at levels that exceed analysts' forecasts for year-end.

Companies are still rather hesitant to hire or make large capital expansions. In the short run, this boosts profit margins—but in the long run it is unsustainable. Although we continue to favor stock market assets—we are being extremely selective in what we will own.

Fixed Income: Contrary to the stock market's strong performance, the bond market was quite weak. ***The total bond market lost .3%*** for the quarter while other sections fared much worse. ***Long term (20+ year) US Treasuries lost more than 7%*** during the quarter.

With the 10 year US Treasury yielding a measly 2.2% investors are not paid much at all for such a long term investment. Furthermore, ***demand for low credit quality (junk debt) hit a record in the first quarter***.

Investors are so starved for income that they are increasingly looking to the stock market for dividend income and to higher risk assets such as junk debt. In response, the amount of junk debt issued in the first quarter broke an all time record extending back to 1980. Should the economy falter, this decision could leave many investors regretting their decision.

Apple: It is not often that we would devote a section of commentary to just one company. However, the love affair with Apple is something we have not seen since the tech bubble of 2000. Apple is responsible for more than 10% of the S&P 500's rise this year, and 39% of the Nasdaq 100's gains.

Apple's market cap (the value of all of its shares outstanding) is now larger than Amazon, Microsoft, Oracle, and Intel—COMBINED! Just in the first quarter Apple's stock gained $180 billion in market capitalization.

Make no mistake—Apple is functioning on all eight cylinders—for now. However, ***Apple cannot defy gravity and is not a monopoly***. Many with blinders on may be in for a rude awakening. The success of one company does not equal success of the broad market. In fact, quite the opposite is true; it has masked broader based weakness in the general market.

Greece/Europe: ***Debt holders in Greek bonds will only get 12% to 14% of their original investment back***. This is the type of restructuring that we can look forward to with Spain, Portugal and possibly Italy, Ireland and France.

Greece is viewed as the ***"canary in the coal mine"*** and therefore should not be viewed with a sigh of relief, but rather an alarm that there will be more of this in the future. Unfortunately, the other countries are much larger and there will not be enough money to bail them out.

We first sounded the alarm bells on Greece in May of 2011 and less than a year later they were in default. The same circumstances now present themselves with Portugal. Portugal's economy is forecast to contract 3.3% this year - its deepest slump since the 1970s - as the government implements austerity measures under a 78 billion euro ($103 billion) bailout from the European Union and International Monetary Fund. It will not be surprising if ***Portuguese debt holders face a default event by the end of this year.***

Health Care: It is impossible to predict how the Supreme Court will rule, but skepticism from ***key justices heightened the possibility the 2010 health overhaul could be overturned in June,*** when the court is set to announce its opinion. Under any outcome, the decision will wedge itself into the 2012 presidential election.

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<u>Banking Stress Tests:</u> The first round of banking stress test results have been released with ***most of the major banks passing***. This was viewed positively as an indication that stability, as well as profitability, has been returned to U.S. banks.

<u>Energy/Inflation</u>: On the domestic front, we continue to see higher inflation than the government is admitting. With oil prices solidly above $100 per barrel this should be no surprise. Oddly, natural gas prices hit a ten year low this week and the market is flooded with record supplies of natural gas.

Of note, an interested statistic offered by Goldman Sachs is that ***for every 10% increase in the price of gasoline, GDP declines by .4%***. If accurate, the cost of gas will trim almost a full point off of national productivity this year.

U.S. gasoline prices jumped 6% in February and are expected to climb higher due to shut downs in critical refining operations in the Northeast. Soaring gasoline costs were behind a jump in the prices shoppers paid last month and are showing signs of hitting Americans' confidence in the economy.

Consumer prices increased 0.4% from January, the biggest rise since April 2011. As such, it should be of no surprise that a survey of consumer sentiment unexpectedly dropped, as gas-price worries outweighed optimism about improvements in the job market.

Inflation continues to run far higher than is being "officially" reported and productivity will be lower. Using figures from ShadowStats would indicate that ***inflation is running between 6.25% to more than 10%.***

<u>Unemployment:</u> First-time jobless claims fell by 5,000 to 359,000 in the latest week. Although this is an improvement the unemployment figures are difficult to decipher. Much of the improvement in the official unemployment figure is due to people whose 99 weeks of benefits have expired. As such, more people may not be filing first time unemployment claims; however, that does not mean that things are significantly improving. ***For those whose benefits have run out—they are no longer "officially unemployed"—but they still don't have a job.***

Furthermore, for the unemployment rate to stay right where it's at, the U.S. must add 125,000 new jobs each month once new entrants into the work force are factored in.

For the unemployment level to drop to just 7% by October, the economy will have to add 350,000 jobs each month.

<u>Durable Goods:</u> New orders for manufactured goods rose 2.2%--but this was less than expected in February and a gauge of future business investment also fell short of forecasts according to the Commerce Department.

<u>Housing:</u> U.S. home prices fell in January to the same levels they were at nearly a decade ago. However, there were signs of stabilization, according to S&P Case-Shiller indexes.

As you can see, there are still many headwinds to the investment landscape both domestically and beyond our borders. Given this, we have been selectively taking money off the table and either moving it to short term liquid assets or reinvesting into things that are clearly cheaper.

Make no mistake; we think our cautious stance is necessary. However, given the value that we are currently able to find, we continue to be relatively optimistic about our portfolios.

<u>Finally, we will be hosting our annual client appreciation party at Fossati's (302 S. Main) on Thursday April 19th from 5PM to 8PM.</u>

We hope you will join us for a cool drink and something to munch on. It is always a great opportunity to visit a bit and let you know how much we appreciate the opportunity to work for you. Please put it on your calendar.

If you have any questions on this, or anything else, don't hesitate to stop by or give us a call.

Sincerely,

Dave | Warren

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™

Warren Udd
CERTIFIED FINANCIAL PLANNER™