# Second Quarter 2012
## Necessary Caution & The Supreme Court Health Care Decision

**US Stock Market:** In our first quarter review, we urged caution to our clients. From our perspective, the strong performance of the first quarter was overly enthusiastic. Our caution proved to be not only necessary, but timely.

For the second quarter, the major indices gave up between 2.5% and 5.1%. Despite the weak second quarter, the Dow Jones Industrial Average is still up 5.4% at the half way point of 2012. Annualizing that performance would deliver better than a 10% return for the year—right in line with the averages of the past 85 years. ***However, we often forget what a bumpy ride the journey to "average" can be.***

**Health Care and The Supreme Court Decision:** We have fielded a variety of calls from people wanting to discuss the Supreme Court's decision on the Affordable Healthcare Act. We are ambivalent on the topic as it is too soon for anyone to claim victory.

Despite the Obama Administration plainly stating that the new individual mandate was not a tax—the Supreme Court has said it is a tax. Since the Federal Government has the authority to tax, the law will stand.

Normally, young people would pay lower premiums as they are typically healthier and older people would pay more. Unfortunately, this is not the case as younger people are forced to subsidize the premiums of older people.

Obviously, if young people realize they are paying higher than normal premiums, they would opt out. To circumvent this issue the government implemented the rule that you must either buy their insurance (the individual mandate) or pay a fee (tax) which subsidizes other users of the system.

It is interesting to us that due to the new law, no one can be denied insurance based upon pre-existing conditions. As such, there is no incentive to buy insurance in advance of any need to use it. Once the need for medical care arises, you simply buy in as though you were a customer all along.

This thought would not work if the tax for not buying insurance was similar to the cost of the insurance.

However, the penalties appear to be far lower, starting at $95 or 1% of annual income in 2014, whichever is greater, and rise to $695 and 2.5% by 2016. Comparatively the cost for annual insurance would be about $5,000, at least.

If you assume a $50,000 a year income (a fair number for most people under age 35) that 2.5% penalty tax still comes to just $1,250.

There is also the issue of paying the tax. If you don't want to pay the tax, it is not a crime! Currently, the collector for the tax will be the IRS—but they don't have the power to collect this tax via liens or levies. At this point, the only thing the IRS has stated is that they may keep your income tax refund (if one is due) to offset the tax you owe. If this holds up, we are sure that people will heavily scrutinize their income tax withholding.

To deal with this issue, the IRS expects to hire more than 10,000 enforcers of this new provision. We suppose this is one way to decrease unemployment.

Employers will also start to scrutinize the impact of this law. The employer mandate will require firms to buy health insurance for their employees or pay a penalty. However, this mandate only applies to firms with 50 employees or more. Sadly, we think that in a slow economy many employers will think twice about hiring that 50th employee.

Given these issues, you can be guaranteed that the Affordable Healthcare Act will be modified going forward.

**Energy/Inflation**: On the domestic front, oil fell from $100+ per barrel to the mid-$80 range. This has taken some pressure off of households. Conversely, natural gas has reversed its pricing drop and has increased from $2.20 per MCF to the $2.70 range.

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**Europe:** The issues across the pond are far from over. However, on the last day of the quarter we received a glimmer of hope that a coordinated plan is under way to bail out the European banks in some capacity. The 17 European Union countries agreed to shore up their monetary union and attempt to bring down the borrowing costs of Spain and Italy. If the EU banks write down their bad debts it will give them an opportunity towards recapitalizing their balance sheets.

Unfortunately, we think that this solution will treat the symptoms—but do little to stave off the burden of excessive debt and non-existent growth.

**Fixed Income:** Interest rates reversed trend with the ***10 Year US Treasury falling back down to a paltry 1.64%.*** There is nothing on the horizon that makes us think that the Federal Reserve will alter its interest rate policy of virtually zero. Unfortunately, the Fed is out of bullets in terms of stimulating the economy. As such, ***look for interest rates to stay low for a considerable period of time.***

This environment may create a great time to borrow money, but it is a horrible time to be looking for interest income.

**Apple:** Last quarter we discussed the unbelievable performance delivered by Apple. As we cautioned, the love affair with Apple is being tested. After peaking at $636 per share in early April, the stock fell to $530 by May. No matter how good Apple may be, overpaying for assets will have disastrous results.

**Unemployment:** In the past month, the ***official unemployment figure increased from 8.1% to 8.2%***. That is troubling to us as many that have exhausted their 99 weeks of unemployment fall off the rolls of the "officially unemployed"—even though they still don't have a job. The tick up in official unemployment concerns us.

For further verification, we went to the Bureau of Labor Statistics to examine the Labor Participation rate. This tells us how many people are actually working—as opposed to the crazy way that unemployment is calculated. Unfortunately, ***the Labor Participation rate has confirmed our fears—the rate is currently only 63.8%--the lowest level in 30 years***.

**China/India**: Both of these drivers of the emerging markets are slowing. The last week of the quarter saw Nike's quarterly earnings fall far short of analysts' estimates—with a slowdown in China cited as the main culprit.

We have been aware of some of China's issues for quite some time now. In a recent interview with hedge fund manager Jim Chanos, Chanos stated that China has built out 60 billion square feet of space—half of this is residential and half is commercial. Chanos determined that this is a tremendous overbuilding as that allocates a 5 foot by 5 foot office to every man, woman and child in China. Obviously, ***it is a situation of overbuilding*** and one that cannot continue. As such, Chanos says China's GDP will slow and the demand for raw materials will also slow.

On Sunday July 1st, China also announced that the official purchasing manager's index fell to its lowest level in seven months. They cite ***slowing exports, factory output and fixed asset investment as main drags upon China which may lead to their worst slowdown in 13 years***.

**Our Investment Philosophy**: There are significant structural challenges to the world's financial markets today. Admittedly, it has made us more cautious. However, despite the plethora of problems we know that people will continue to buy beer, cigarettes and food on a daily basis. As such, we continue to emphasize simple companies that are in demand each and every day. These generally continue to be large, liquid "blue chip" type of stocks that pay large and increasing dividends on a regular basis.

Finally, with the 4th of July upon is it is a great time to ***thank all who have served our nation, defending our freedoms***. Our nation is far from perfect—but there is no place we'd rather be.

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™