Stanton & Castleton, Inc.

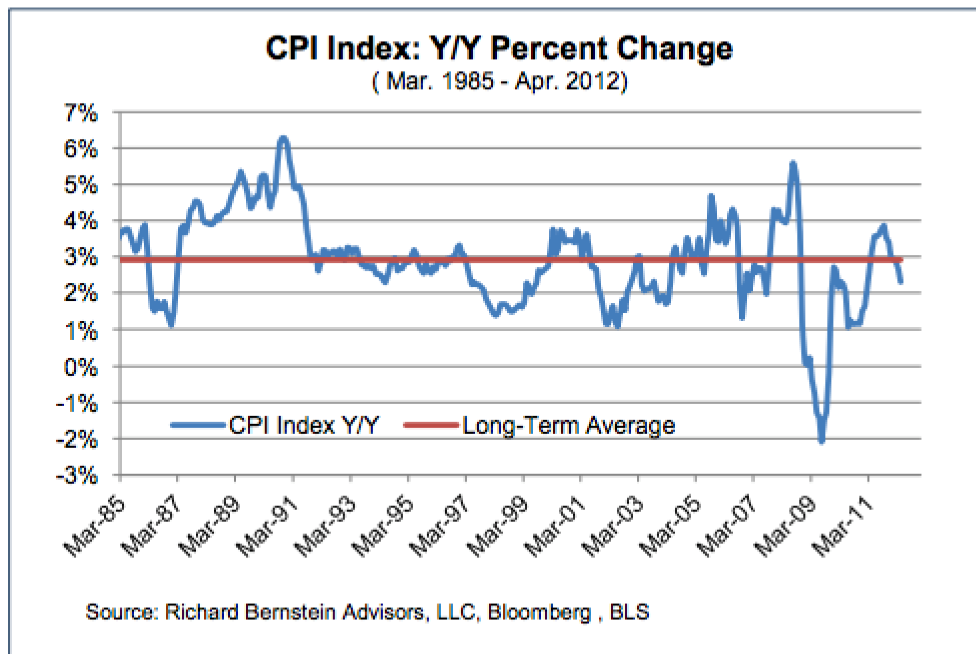
An independent firm

2012 3rd Quarter Capital Markets Outlook

Towards the end of each quarter we meet several times to discuss any changes in our outlook for the current year. We both will have reviewed several Capital Market Outlook publications from a number of respected investment houses including Raymond James. This along with our research of the global markets from both an economic and geo-political perspective helps us establish our expectations for the coming year.

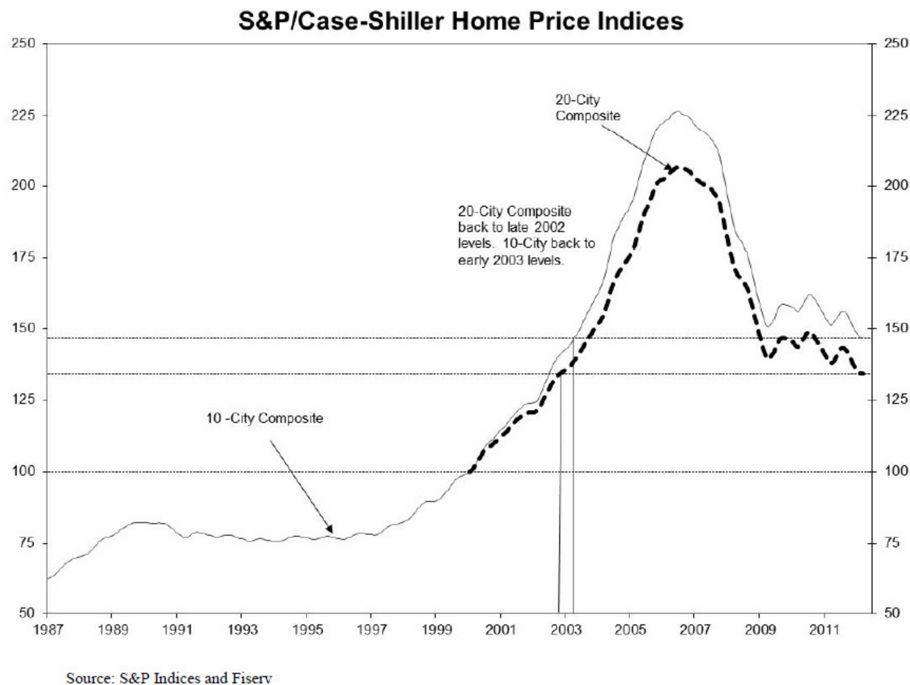
Our objective is to establish a framework for how we believe the markets may behave and identify what we see as the major risks to investments across all market segments. We do not pretend to be able to predict what will happen in the future, rather we want to establish confidence that the portfolios we recommend are balanced to benefit from positive market environments and help to reduce risk exposure through diverse asset allocation and manager selection during negative market periods.

Interest Rates, Inflation, Liquidity & the Federal Reserve:

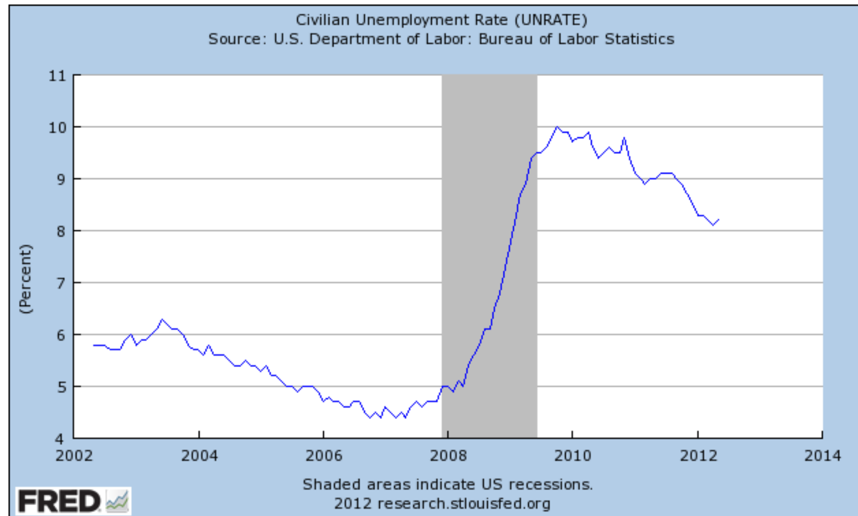


The following is our 2012 3rd Quarter Capital Markets Outlook:

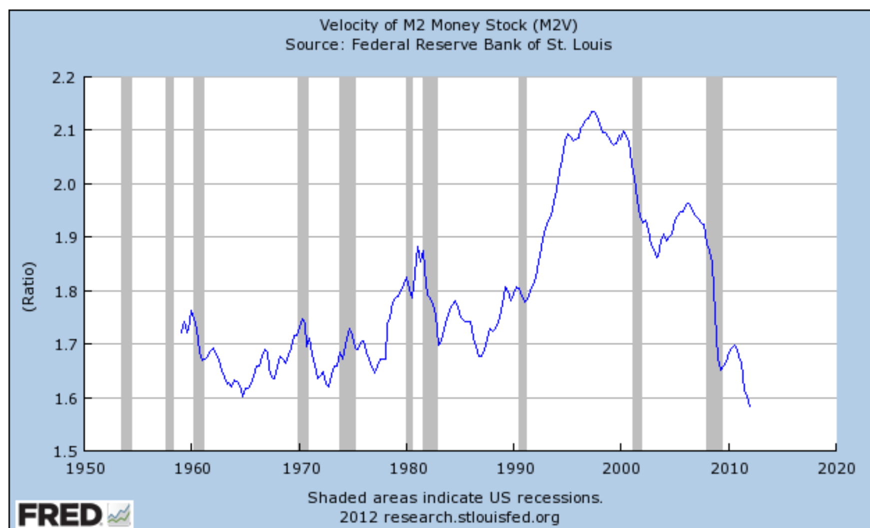
Inflation has started to decline as the overall US economy has cooled on the heels of a recession building in Europe. Falling below the long term average (using 1985 as starting point) inflation appears to be headed lower. If we only use the CPI as a gage to determine inflation the logical conclusion would be something is "wrong" with the Federal Reserves 0% rate policy and a sub-2% ten year US Treasury yield effectively making real returns negative. Looking more closely, if we examine the economies major asset classes some sense starts to be made. Real Estate is still in overall decline nationally and worldwide. Such a significant asset class still in decline almost five years after its peak is deflationary not inflationary.



If we look at the still persistently high unemployment rate (which recently started to trend back up) and the implications that has on disposable income and future consumption, it suggests that perhaps the Federal Reserve is more concerned with deflation in the near future. In fact the defensive actions individuals and entities take in uncertain times; saving more, spending less, lending less and paying off debt…all together can limit economic growth. This "prudent" behavior is good individually however collectively it can lead to destructive deflationary periods. Our personal experience has always been to be on the defense against inflation and we understand what to expect, but deflation is a whole other condition.

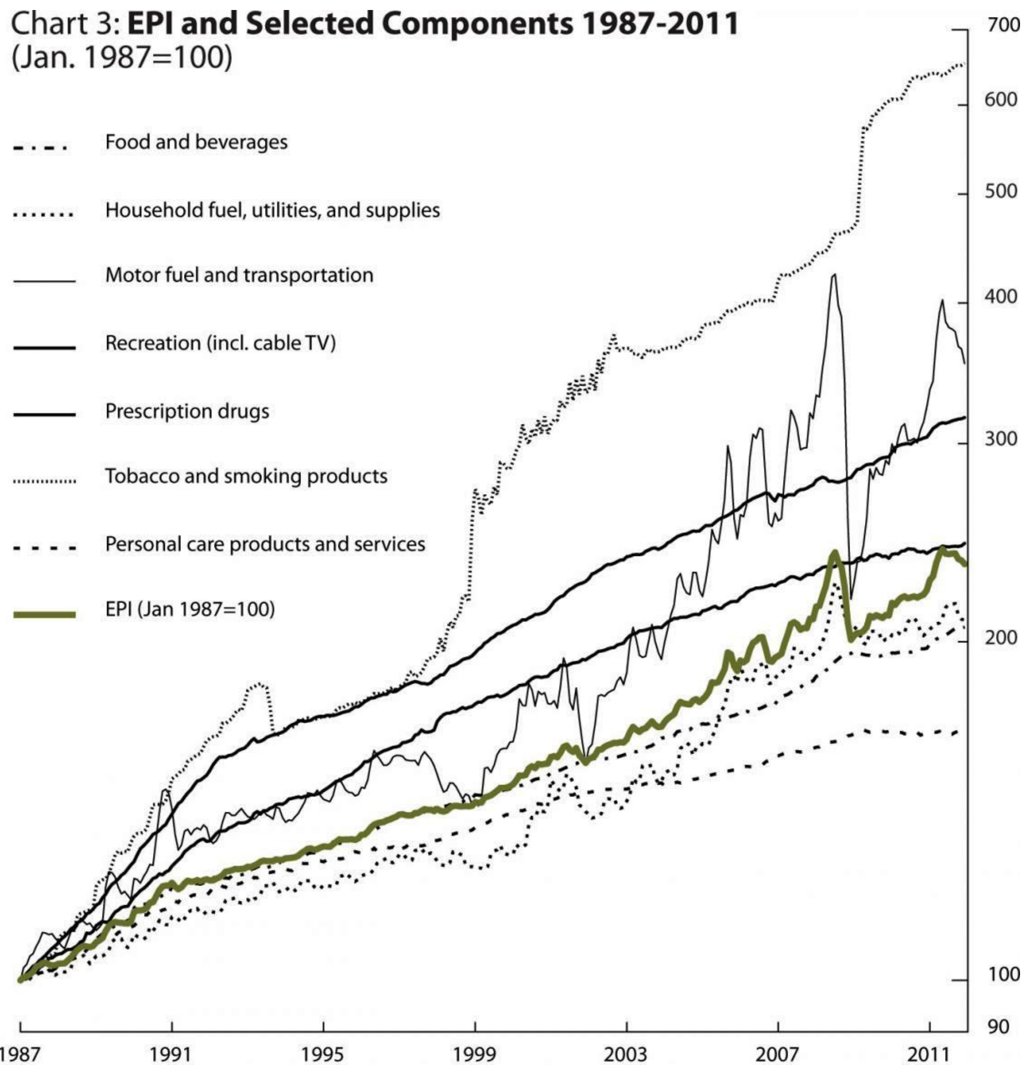


The confusing logic that the massive increase in government spending and overall public debt, which has increased our money supply to levels never seen before, is not (for now) inflationary seems impossible. An "enigma wrapped in a conundrum". Lets think it through; yes there is more money in the system and more federal debt than ever, however the velocity (how fast the dollars are spent and re-spent) of this money has slowed! People are saving the funds or paying down debt and in general spending less. These actions are admired in the individual but if too many follow this course economic growth can be constrained, perhaps to the point of contraction. That appears to be the Federal Reserves conundrum.



While the large role Real Estate as an asset class has on total household spending as either rent or mortgage it also impacts total wealth. The protracted loss of wealth in the now nearly five year decline in values can

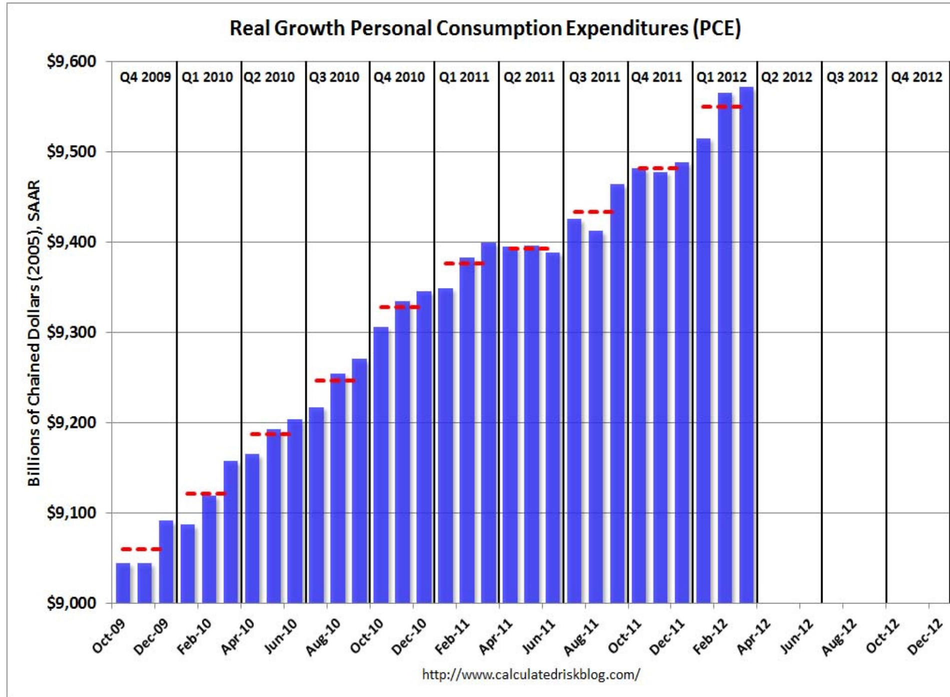
have a prolonged impact on consumer spending; in both ability and willingness. However, this still does not address why we feel an inflationary impact greater than is perhaps being measured. If we look more closely at what we spend our money on it becomes clear the day to day spending on food, transportation, medicine and college for our kids have been going up in cost; dramatically in some cases. ***(The "everyday price index" EPI)***



http://www.aier.org/article/7557-epi-reflects-basic-economic-change

Taken together, the persistently high levels of unemployment, ongoing credit contraction and growing numbers of people nearing retirement age without enough savings set aside, has curtailed spending growth and therefore overall GDP growth. Getting through this tough "transitional" period of an overleveraged economy to sustainable growth is just harder than anticipated.

This also answers some of the confusion over why consumer spending seems to have gone up but we can't grow the economy as in the past without massive government spending programs.



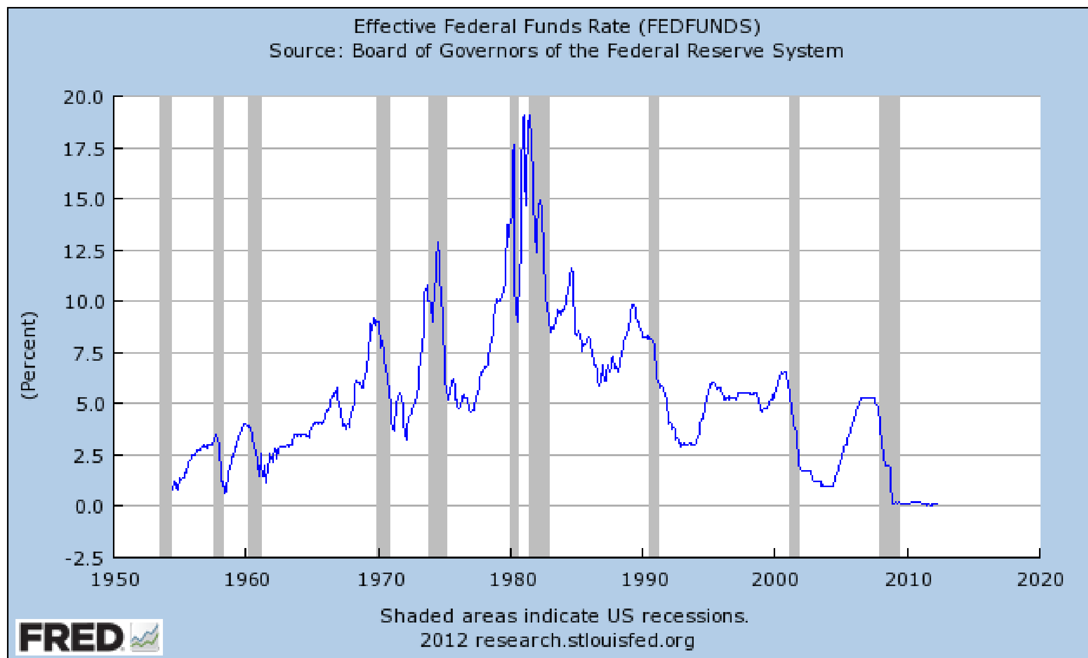
The dichotomy of increased consumption without sustainable growth may lay in the level of total government spending for all programs has continued to grow well beyond total government revenues (tax receipts of all sources). Said another way; government transfers have been increasing beyond our growth but those transfers are counted toward income and consumption.

Billions of Real $	**1970**	**1980**	**1990**	**2000**	**Apr-08**	**2010**	**Mar-12**
Total Personal Income	$4,937	$6,261	$8,569	$11,374	$13,304	$13,007	$13,328
Wages & Salaries	$3,264	$3,767	$4,856	$6,387	$7,011	$6,748	$6,905
Interest Income	$408	$754	$1,330	$1,316	$1,492	$1,065	$984
Dividend Income	$142	$180	$298	$507	$865	$761	$821
Government transfers	$420	$710	$1,007	$1,385	$1,907	$2,333	$2,312
CPI	**38.8**	**82.7**	**129.9**	**172.4**	**214.8**	**218**	**229.4**

www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1

For now, the Federal Reserve seems committed to keeping rates low with their greater concern of slowing economic recovery and worsening unemployment picture. On 12-16-2008 the Federal Reserve (FED) lowered

the target Fed Funds Rate (FFR) to 0% - .25%. "***After more than 36 months into this post recession expansion, the FFR remains at a 0% effective rate. We think this fact quite simply shows how fragile this recovery has been. Our experience tells us "actions speak louder than words". No matter how it is spun thirty-six months of 0% FFR tells us the Federal Reserve continues to be concerned with slipping back into recession."***



"In effect we have a unique "Catch 22" situation:

Containing costs is one way businesses keeps or improves earnings. With labor being most companies highest cost it stands to reason they will try to get more production out of fewer employees. There is also an increased vigilance on capital spending, "a dollar saved is a dollar earned". While consumers rely on income from jobs for most spending, with fewer people working and those that are have lower confidence in the future. As a result we are seeing less inclination to spend on discretionary items. The frugal nature on both sides while helping corporate earnings and improving the consumer's personal balance sheet (for those working) is also working against growth which is greatly dependent on consumer confidence."

Our position continues to be that this process takes longer in a recession of excessive credit. We also see government's traditional roll of "filling the

gap" during difficult periods being tested yet again…the debate over Keynesian Economics persists.

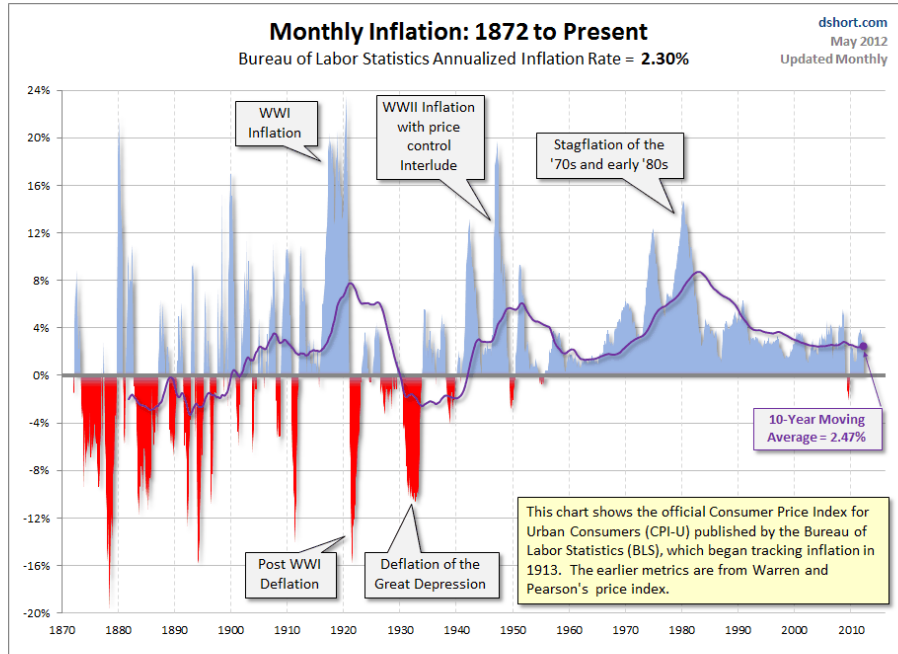
The continued turmoil in Europe with the on again Greece default in the news along with a growing concern that if this happened than Spain and Italy may follow have plunged Europe into a chaotic state. Euros are leaving these countries and finding refuge in Germany, US, UK or Switzerland as investors fear waking up and holding Drachma or Pesetas …. In fact Germany recently sold government two year bonds at 0% interest! What was unthinkable last fall, a Greek default and leaving the European common currency, is now openly discussed as are the emergency plans being developed.

Can the Euro survive an orderly exit by Greece? In our view Europe will survive however it is growing increasingly unlikely the Euro as the regions common currency will survive in its current form, if Greece were to default. Our reasoning is simple: while collectively it would be in all of the 17 European Common Currency countries to agree to difficult austerity programs in their own countries (especially the strong countries like Germany)... for the weaker nations (Greece, Spain, Italy…) it would be in their self interest to be the first to leave. So once started the rush to the exit would be irreversible.

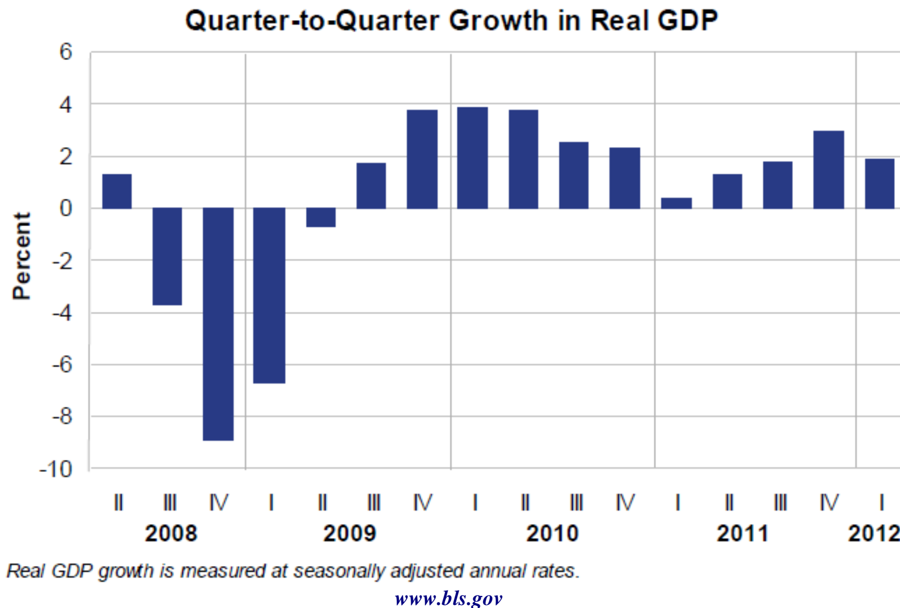
With all these prevailing winds in the economy we continue to see the Federal Reserve holding interest rates down at current levels. Our summary from the Q1 2011 CMO still reflects our major position:

"We continue to come back to a reoccurring theme when evaluating the post "great recession" economy; when "bubbles" that were created and extended by a rapid increase in debt on increasingly higher risk assets "burst", the time it takes to rebuild public and private balance sheets makes a recovery more fitful and extended. While the near term result will likely be continued volatility in the markets and some occasional shaking in overall confidence that we will reestablish strong growth; the end result could be a very healthy economy growing by spending that is from operating cash flow at every level. Once debt is reduced to a level that individuals and institutions are not threatened we could have a new secular bull market emerge."

Provided we can avoid tipping into overdependence on government spending as the solution to avoid any contraction no matter how inevitable. In the past century we have perhaps traded more stable economic growth to avoid the painful but purging contractions of the past…but now have to deal with protracted periods of economic malaise.

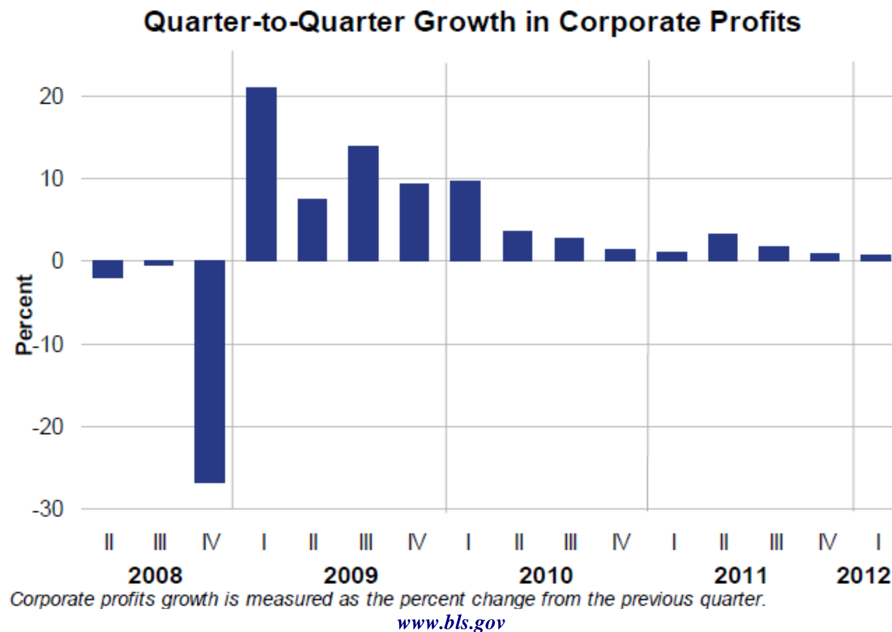


The Economy:



www.bls.gov

The 1st Quarter GDP was revised down .3% to a 1.9% growth rate. This is the eleventh positive quarterly GPD growth since the end of the "great recession" in June of 2009. For the last year overall GDP growth has been a tepid 2%, well below the 4% estimates made only a few months ago. The "operation twist" by the FED and Europe's LTRO bank refinancing program seem to have lost their positive effects both in the US and certainly in Europe now gripped in recessionary pressures. In the US earnings may suffer. As the world slows we are also seeing a marked decline in the rate of growth in US corporate profits;



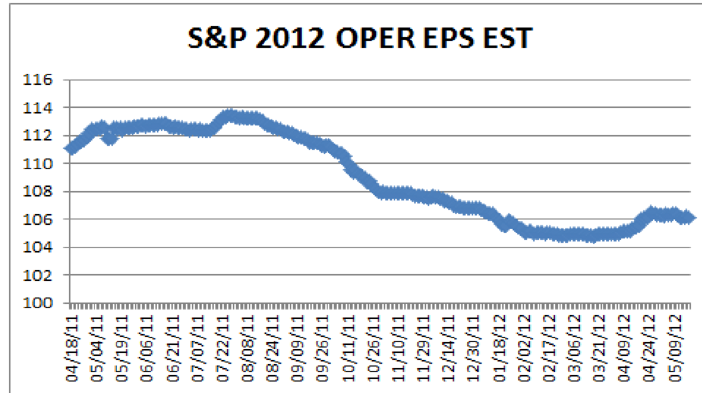
Corporate profits growth is measured as the percent change from the previous quarter.
www.bls.gov

Equity Valuations:

Equity valuations are always a moving target, adjusting to the recent past and current near term expectations. The S&P 500 Index (an unmanaged index of 500 widely held stocks that's generally considered representative of the U.S. stock market.) current earnings and future earnings expectations influence market valuation. What is a reasonable valuation for the S&P 500 Index?

The answer is; that depends. It depends on growth, earnings and the current expectations for the overall increase and the rate of increase in corporate earnings. The "market" is a reflection of the recent past trends and our confidence that these trends will improve, stay the same or deteriorate. Normally we try and put some historical numbers here along with current consensus earnings expatiations so we can estimate a range of possible valuations for the equities market, however not this time. We thought the

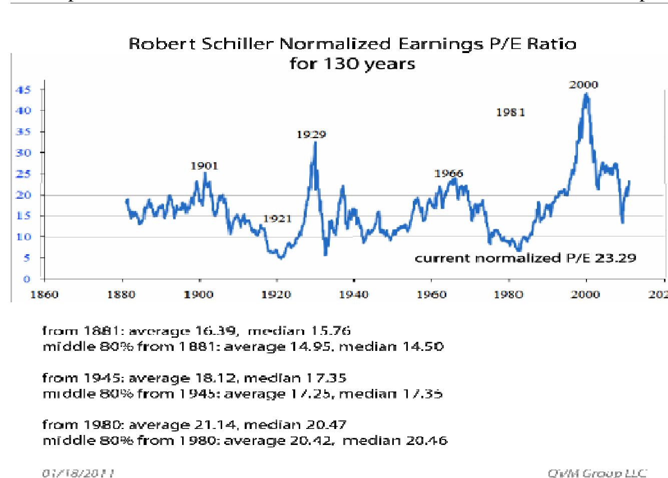
above graph shows clearly the rate of decline in the growth of corporate earnings. If this trend continued (with Europe entering a recession) the US may slip into earnings contraction. In fact we have seen reductions of earnings growth estimates by analysis this past quarter. Since market valuations are a multiple if price/earnings P/E forecasts, a lowering of expectation could lead to a contraction of a "fair value" multiple. This appears to be a reason for some of the recent sell off.



http://www.caseshiller.fiserv.com/fiserv-case-shiller-indexes-news.aspx

Once again, estimates looking forward are not an exact science; they are more an art form. We have to find reasonable measures to help us establish what the range these estimates may fall into. If we look at a period during a sustained bull market we will see higher market multiples applied to overall valuation, conversely during recessions or weak economies we often see low multiples applied to fair value forecasts. As the veteran ballplayer told the rookie going up to his first big league at bat… "He (the pitcher) doesn't want to walk you so look down and away…but watch out for in your ear" what's that mean? This part of investing can be very subjective!

http://www.caseshiller.fiserv.com/fiserv-case-shiller-indexes-news.aspx



Understanding the markets helps in evaluating current and future risks providing us some insight on how to balance this all in each client portfolio. We try to maintain historical perspective and a reasonable expectation when investing in equities. Since 1987 the Dow Jones Industrial Averages has recorded 75 years of positive returns and 40 years of negative returns. So when you hear "long term" investing this is the point we think is being made. The average up for those 75 years was +19.27% and the average down in the 40 was -15.325% *(source data: Dow Jones Indices, 12/31/2011)*. If you net all years we get a simple average of +7.23%. What is also interesting is that largest negative are often followed quickly by huge gains: 1929,30,31,32 were down -17%,-34%,-53%,-23% … followed by 1933,34,35,36 up +64%,+5%,+39%,+25%. Sometimes we have to remind ourselves that wide swing (high standard deviation) has been part of investing, maybe more than we care to admit. Remember what Benjamin Graham said:

"In the end, how your investments behave is much less important than how you behave."

So even with a lot of "confusion" in the world today, if you hold the conviction that Capitalism and Democracy will prevail we think the long term trends will also prevail.

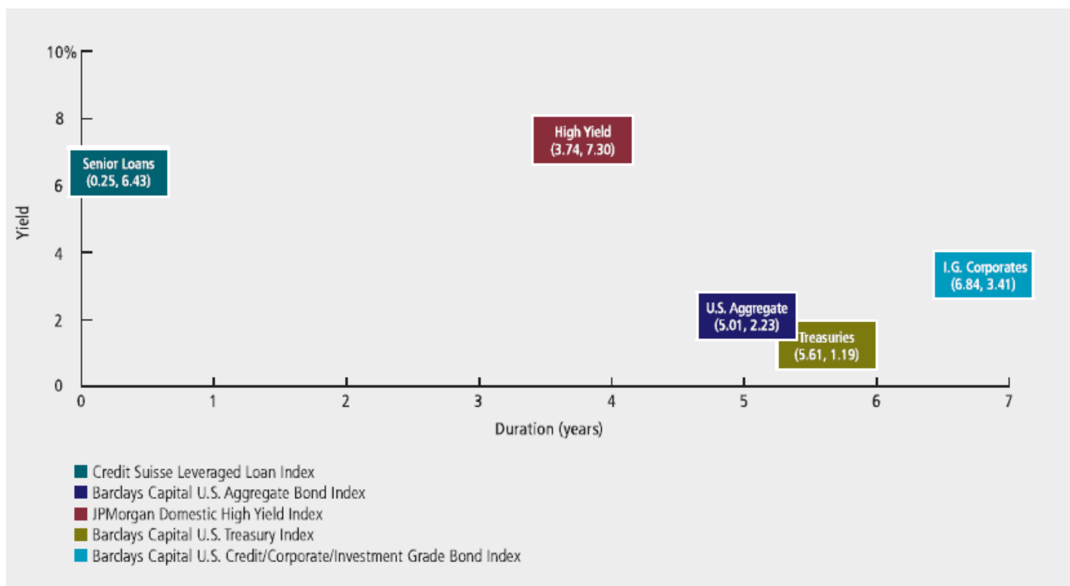
Bond Markets:

We have now been through Quantitative Easing I, II and Operation Twist since 2008 in an effort to first stabilize and then reestablish sustainable organic economic growth. We also assisted Europe in their Banking bail out, LTRO (Long Term Refinancing Operation) by opening up an "unlimited" credit line in the form of dollar swaps with the European Central Bank. For all these programs we still have not reached a point where the economy can sustain growth on its own. The ongoing de-leveraging worldwide has governments rushing to fill the void of income and spending in the private sectors. The byproduct has been persistently high unemployment causing further drag on growth prospects.

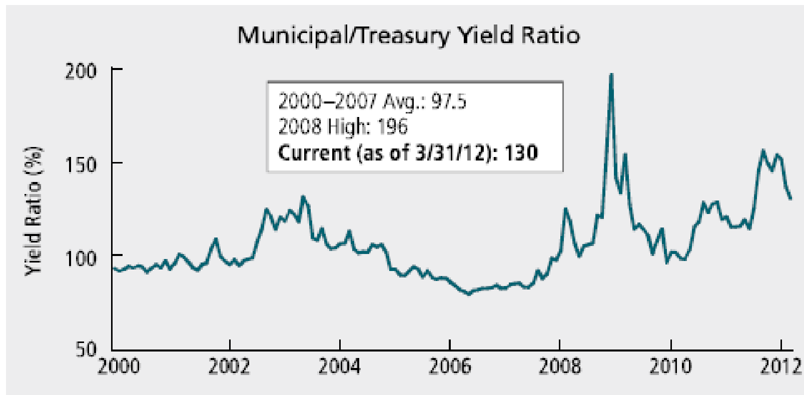
As the overall GDP slips back to sub 2% growth rates for the 1st Quarter, a full 1%-2% below earlier forecasts we wonder if the economy can grow without extraordinary government assistance. Currently we have 10 year treasury yields near 1.5% and the discussion is can we go below 1%. Imagine telling that to someone in 1982 or 1998 or 2007, yet today it seems

perfectly plausible. Clearly the efforts to re-ignite self sustaining growth have been less effective than hoped; otherwise we would not have negative real interest rates. The effort to avoid a painful and disruptive “rebalancing” of over leverage by letting banks, companies and even some governments (Greece) to fail…(forcing lenders to take the loss and deal with the austerity in rebuilding the economy) may end up causing more pain that we originally sought to avoid.

With things so unusual we see a real possibility of sub 1% ten year yield and so bonds may continue to out perform equities. The risk of loss from the inevitable rise in rates because our economic policies are successful and growth returns along with inflation OR unsuccessful and we see inflation from a sea of dollar printing…. Either way we favor short term bonds, low duration funds and cash; yes at 0% or even slightly negative real yields it can be painful, however not as painful as double digit losses. We see cash as an asset…the trick is to know when to hold it in larger quantities and when to add to growth/yield alternatives. Some interesting yield plays still exist and we are always on the lookout. In this equity market decline we like dividend paying defensive equities and intermediate to short corporate, high yield and some foreign bonds. We also see a wider differential in the spread between municipal vs. treasury yields due to the continued fear of municipal defaults. For now we see little chance of any change in the FED’s current interest rate policy.

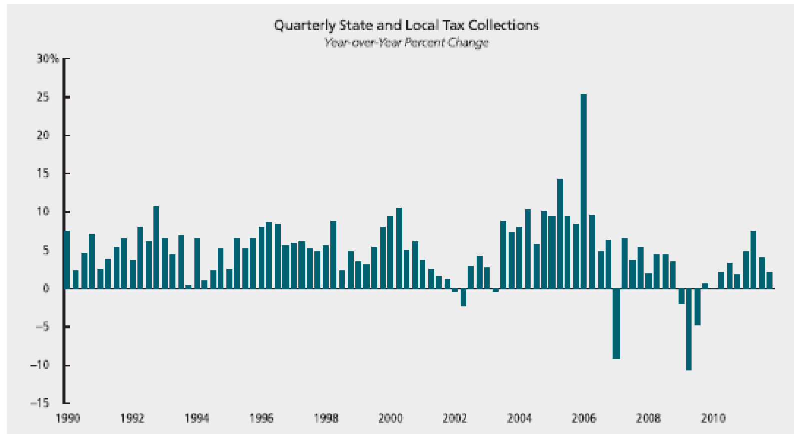


Source of chart data: Barclays Capital Research, JP Morgan Research, Credit Suisse Research, 3/31/2012



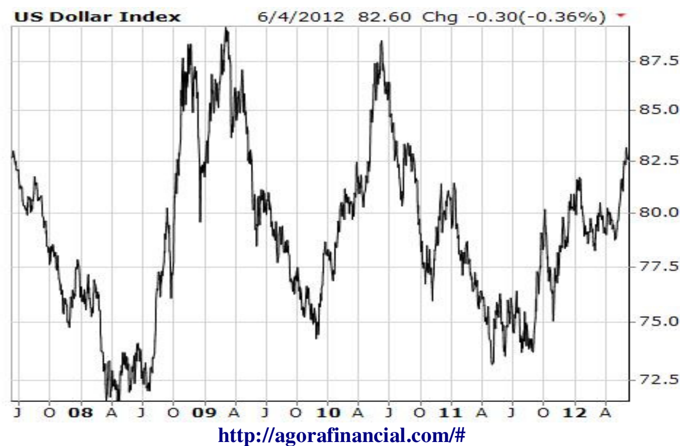
Source of chart data: Barclays Capital Live and Bloomberg, 3/31/2012.

Each State has its own revenue and tax issues to balance, however overall the total tax collected has trended up making those massive default fears in municipal bonds perhaps not as high a probability as the market fears.



Source of Chart data; U.S. Census Bureau, 12/31/2011

Currency Markets:



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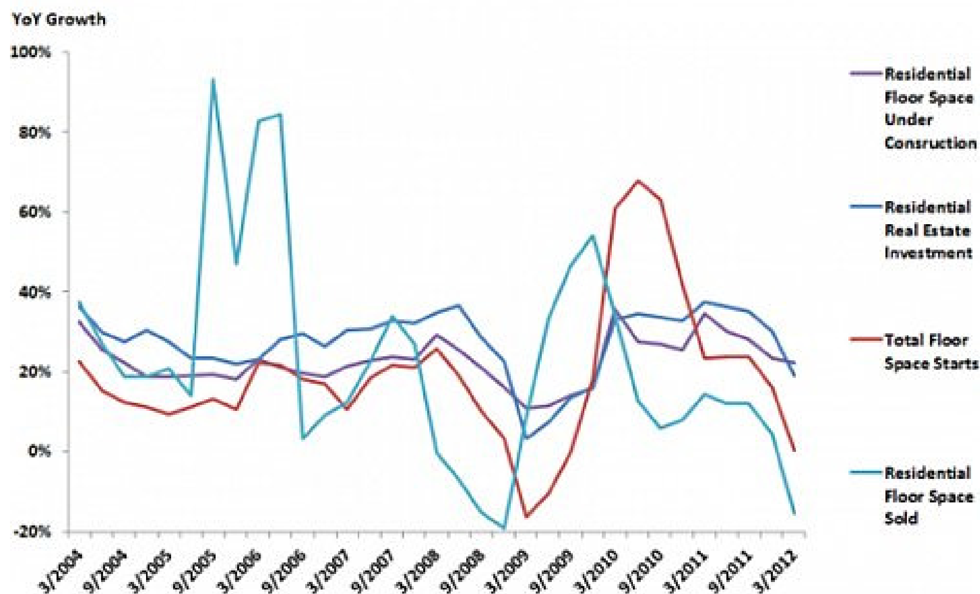
We said a year ago: ***"The recent turmoil in Europe with Greece in technical default on their debt, the further weakness in Spain, Italy and Portugal along with the lack of commitment from the stronger nations of the European Union to "bail" out these weaker partners has helped the U.S. dollar recently. However our own political impasse on the debt ceiling and budget deficit has stalled any real appreciation to the dollar. What is clear to us is that the U.S. dollar has been in a long decline for the past decade. The long trend of debt and leverage expansion has hurt our valuation to other currencies. If we can resolve our spending deficit and get on a path to meaningful deficit reduction we could see the dollar rebound as Canada has done this past decade, following a similar crisis in the 1990s."*** Still True!

Now let's mix in a slowing in the Chinese economy the building recession in Europe and risks to the European Monetary union and we see money flowing into those countries whose governments and currency is perceived to be stable long term: United States, UK, Switzerland, Germany…causing their rates to go to all time lows and currencies to appreciate. In fact some of these governments are contemplating issuing negative interest rates to try and stem the flow of funds into their system.

Chinese Property market

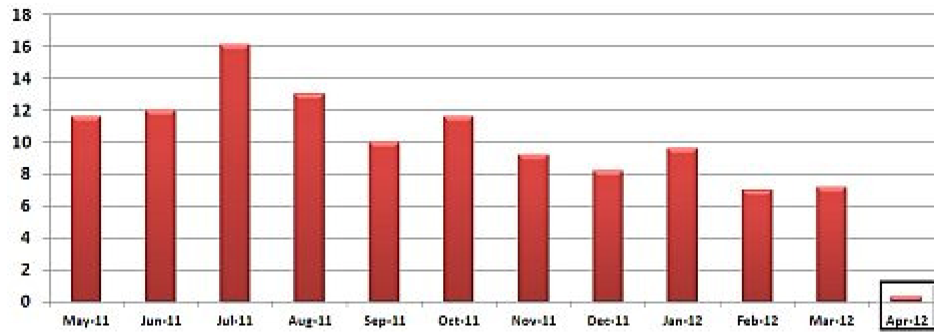


Source: Peterson Institute for International Economics

Looking towards China, while most believe it will continue a path towards global economic dominance we see the reasoning but think it's easier said

than done. Our simple thought is given the west's difficulty "managing" an economy how can we be so confident in a not transparent government controlled Oligopoly? Has this ever succeeded long term in history? We shall see.

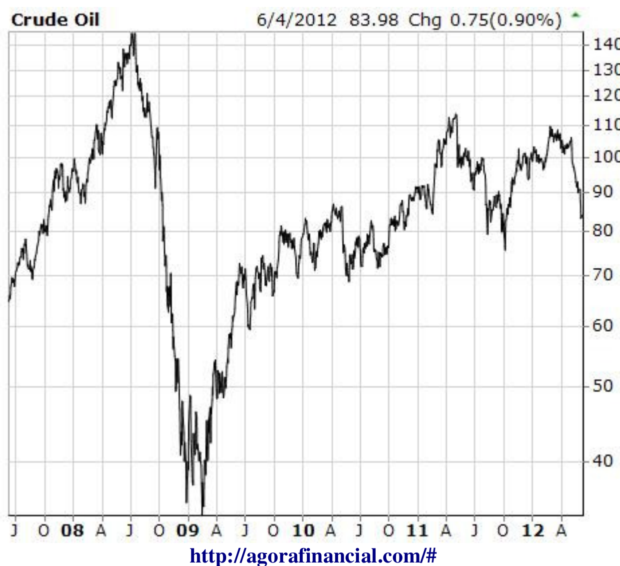
Chinese Power Production



Source: National Bureau of Statistics

Looking at some simple but important metrics in China reveals they too have to deal with a complex global slow down in the same areas as the west. Power (utilities) production, or rather a decline in the rate of increase may tell us something about real demand and growth…like the "canary in the coal mine".

Energy & Real Estate:



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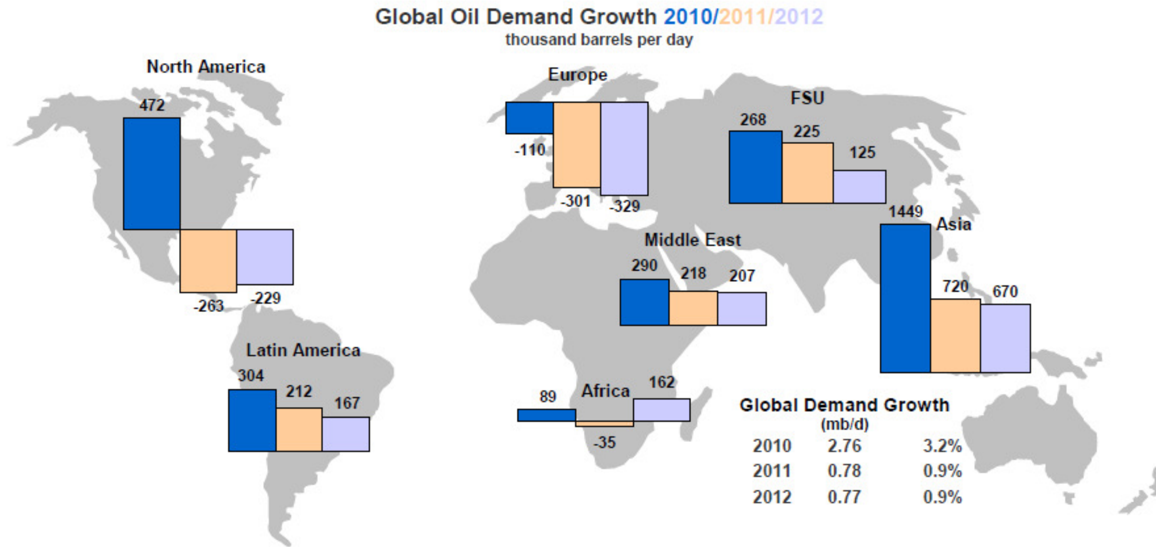
After recovering from the steep declines in 2008-9 during the "great recession" as demand world wide continued to grow, we are seeing a pull

back from the high price levels. This is again coincided with the fear of global recession stemming from the European Monetary Union troubles spilling over to the U.S.



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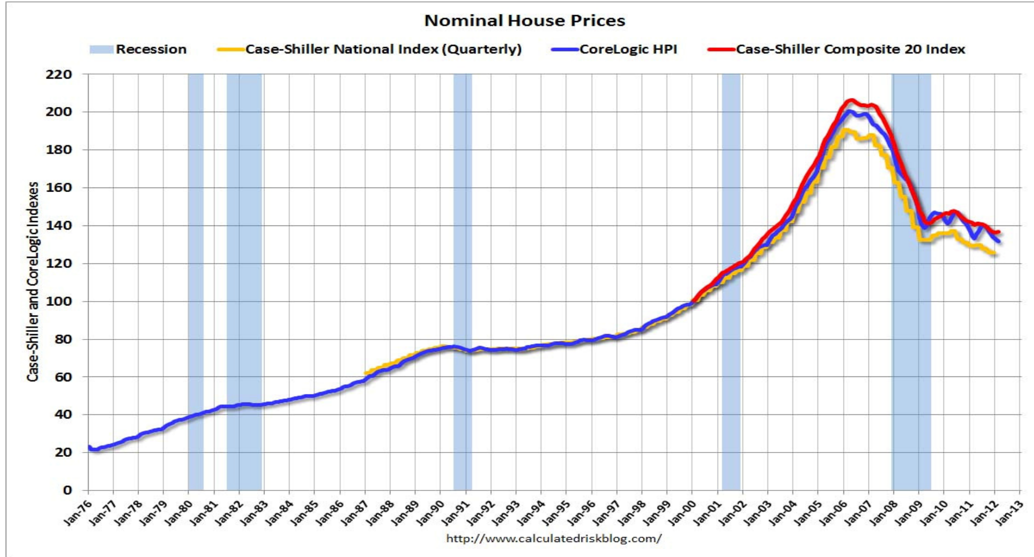
While total demand has risen overall the rate of increase has slowed dramatically recently. In the U.S. and Europe the numbers have turned negative but not enough to offset total world demand…so we have persistently high prices at the pumps. The recession in Europe appears to be affecting the rest of the world more recently and that has resulted in the current sell off in crude oil. If this continues we could see a dramatic price decline near term however we feel that would be short lived, seeing crude averaging 80$ to 100$ for the current year.

Comment from a year ago:

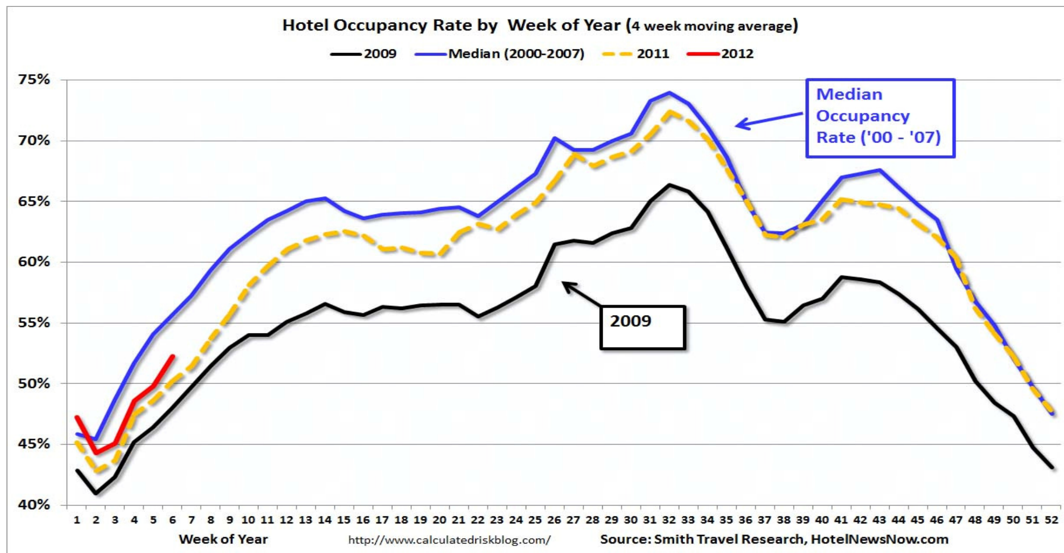
"The residential real estate market continues to struggle. We have seen some stabilization at current values and that is the first step towards a price recovery. However, conditions are still fragile and subject to renewed decline. With a persistently high unemployment rate and stricter underwriting for home loan qualification this market could remain flat to down for an extended period."

As the following chart shows, housing is still trying to find a bottom. This is looking at several broad spectrum measures for housing, while some areas may have improved or stabilized, much of the country is still in decline.



We still have not seen a material change in the housing market, although the rate of decline has slowed and some indication things are stabilizing are appearing, no real increase in demand has occurred yet.

We find it's useful to also look at other measures of economic activity in different forms of property investing. The travel and Hotel industry occupancy rates, after some initial improvement things appear to be declining. Is this another "canary in the coal mine"?



Concluding Remarks:

Once again from a year ago….still relevant:

"The past several decades the U.S. has been consistently increasing government spending. During periods of normal economic growth it seems reasonable increases are desirable, however over the years we have redefined the notion of "reasonable". Today we find ourselves in a debate over not just what is reasonable, desirable or fair; rather we need to weigh what is sustainable. It is no secret at the personal household level that too much debt, too little savings and too much spending will result in disaster. We are less able to see this at the government level until we reach some period of extended economic stress. The current debate both politically and economically is driven by a recognition that some adjustment to "reasonable" needs to be made. When all the haggling is done we will have lowered the level of spending and the level of public obligations we support back to a sustainable level. This process may take a decade to change our public course however it will be done. As in the past, this should fuel the return to consistent economic growth which in turn will free resources available to explore the definition of "reasonable" spending again.

Consider the recent debate in Wisconsin and recall election….or the "Yes on B" pension reform that passed in San Diego recently. This "debate" seems to be taking actionable form.

We are optimistic in the final outcome because in the end it will be the only viable option. With that in mind, we continue to see this decade as a return to long term historical market performance. While the first few years may continue to be volatile by historical standards the ensuing years should be positive if things progress as we expect."

In the U.S. these public debates and decision making have a collective, organized and enforceable process to reach solutions thanks to the Constitution and a hard fought Civil War... We see no such process in Europe which makes their solutions much harder to arrive at and less likely to be successful: in our opinion.

"In the end, how your investments behave is much less important than how you behave."

Benjamin Graham
The Intelligent Investor

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