Stanton & Castleton, Inc.

An independent firm

2012 4th 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 can not predict what will happen in the future, but we can establish confidence that the portfolios we recommend are balanced to benefit from positive market environments, reduce risk exposure by applying our tools in optimizing asset allocation and investment selection, during negative market periods.

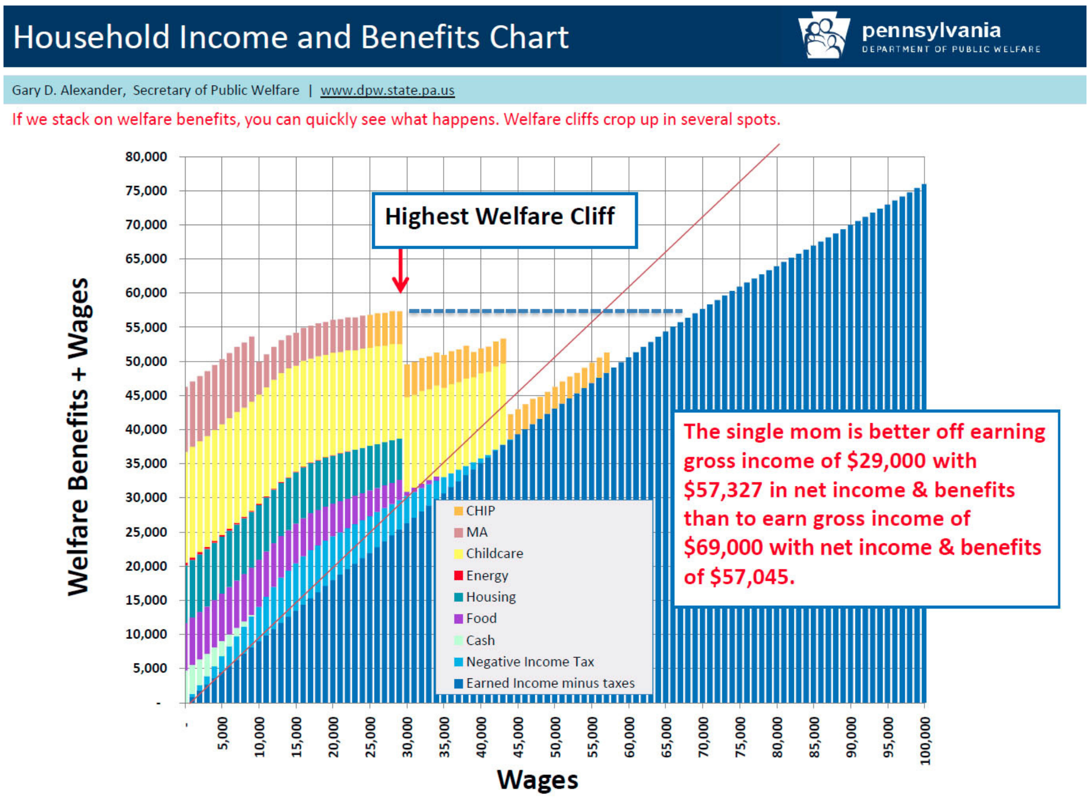
This Quarter we want to depart a bit from the usual format. We decided to put out an internal memo we write called “Our Point of View” in a newsletter a couple of months ago. This was well received and we thought to just expand on that paper for this quarter…so here it is:

Our Point of View

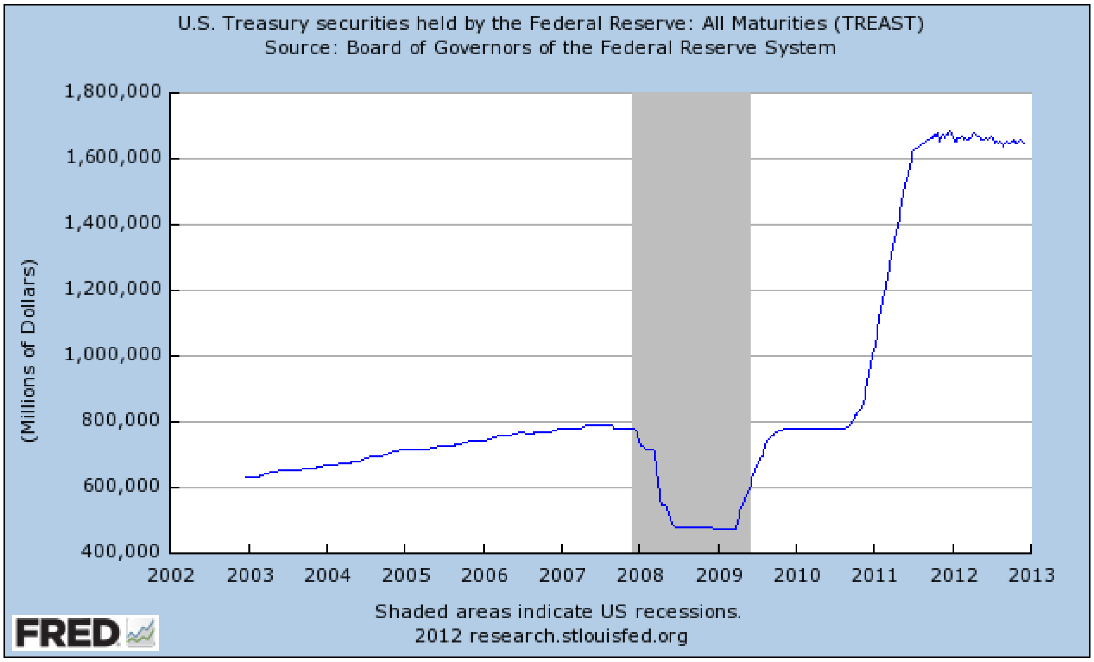
(December 2012)

Current:

Why is this period of economic recovery/expansion from what is now referred to as the “Great Recession” so weak by historical standards? Why do so many “feel” like the economy is not better in their personal lives? If we were to ask ten economists we would get two answers told five different ways; 1) the consumer is not spending enough so the government has stepped in to fill the void temporarily. (Keynesians) 2) the government spending is removing risk of not working or failing and incentive/desire to work for less than can be gotten from assistance programs (New Classical). We include all the corporate bailouts from banks, to auto, to energy etc… in this. The illustration below shows how it's smart not to work too hard in some ways:



We do not want to distract from the economic issue at hand with a discussion of what programs are "worthy" or "necessary". In our view the desire to help people is both worthy and necessary; the path we take should always be open to discussion. Our focus is on the ability to <u>sustain</u> our current path. Sometimes good intentions are at odds with what an economy is capable of. The current trajectory of total Government deficit spending and tax revenue is not sustainable. It will cause our economic system to collapse at some point just like any household that spends more than earned. Eventually our ability to finance (borrow) the difference is removed by the lenders! In the case of the U.S. as confidence in our ability to "get our house in order" by citizens and foreign investors and governments falls … few will want to buy our bonds. You may believe this can't happen but the Federal Reserve buys $45 billion of CMO's each month as part of the third round of "Quantitative Easing" announced in September, with plans to add $40 billion a month of direct purchases of US Treasury Notes starting in 2013. In essence we are selling bonds to ourselves with dollars we create by the Federal Reserve. So long as everyone is confident in the long term viability of the U.S.'s sovereignty and solvency we can do this…but there is a limit.



Currently the debate rages of the "fiscal cliff" not to mention we have to raise the Debt Ceiling in a few months or the U.S. will technically not be able to borrow. Let's look more closely at these two issues.

Why have limits to our national government borrowing at all? It seems we just have a political fight and agree to raise it no matter who is running the show. This is precisely the problem… Congress makes the rules and so can change them at any time. Without some limiting factor that must be accounted for, so far we have not shown the political willingness to control spending, nothing is decided. It appears our collective ability to delay tough decisions will only come to an end when some invisible hand forces us to. Are we there now? The de-leveraging globally could be the inflection point.

The "fiscal cliff" does not exist…it's just a clever way to disguise what has been known for a long time. During the last debate over raising the U.S. debt limit the inability to agree on how to **NOT** reverse just **reduce** our deficit spending (crazy huh), the agreement to was; raise the limit and agreed to agree on something by the end of 2012. As part of that proposal, so everyone would feel motivated to work for a solution, we have sequestration:

"Under the Budget Control Act of 2011 (the Act), sequestration is the automatic reduction of spending triggered if Congress approves spending levels that exceed certain "caps" set out by the Act. Although certain programs-Social Security, Medicaid, federal retirement programs and Medicare-are protected from the full impact of sequestration, spending reductions would occur largely across the board under the Act. The Budget Control Act calls for sequestration of spending from FY 2013 through 2021 and, unless Congress otherwise acts to limit spending, it takes effect January 1, 2013." http://www.wileyrein.com/publications.cfm?sp=articles&newsletter=3&id=7833

Add to this the end of the decade long "Bush tax cuts" that would automatically roll back on January 1st 2013 unless some extension is agreed to and we have a lot of compromise that has to be reached in little time.

In our view a lot of theater is being made of these events. We had fiscal cliff clocks on CNBC:

<u>This takes away from the serious discussion</u>. The current trajectory of public spending in all forms by the U.S. government at every level is not supported by the tax revenue taken. This is made worse by our weak economy which demands more in government spending support. Even if we were to grow at 2% the gap will still get wider each year. The facts as we see them are that as a nation we have to face how to reduce the level of support to the 50% who pay little or no tax by creating opportunity for each to earn a better life. That alone is not enough; we have to reinstall the need to earn your own way even if it is harder in the beginning. Many of us can recall a time when we took a cut in pay to land the job we wanted. It was a risk that we took and got an opportunity for a better future…not a guarantee.

While we're working this out we need to re-examine what are the critical public programs and why they are so expensive! To have confidence and trust in these programs we must have accountability. We don't think it is an exaggeration to say this dynamic is strained in both the public and private sectors today. We need to create fairness in our government and the discipline in taxation. Corporations will have to contribute, not just by improving margins by reducing labor costs (downsizing) but by investing in people and innovation to grow. Our labor force will have to gain new skills to produce not just consume. Finally the government will need to go on a diet and learn to spend less "better".

These are the hard issues that have to be weighed. In 2013 some increase in tax and cut in spending is already built into any agreement. This will pressure an already weak economy, but corporations are flush with cash and better able to weather any slowing. If we can find the right balance and confidence in the future is translated into investment in new production (new hires, new factories, new products …) we may find that elusive 3-4% GDP growth needed to change our future.

Near (2013):

What to expect? We see little risk that "falling off the fiscal cliff" will occur. The media created metaphor has no real meaning and our government has no choice but to find some face saving compromise. What the agreement is in detail and whether it is enough to alter the direction of our leveraged economy will be the real question. On this score we have some thoughts, but first I will share with you three phrases I wrote down and keep on my desk to help us "see the forest for the trees";

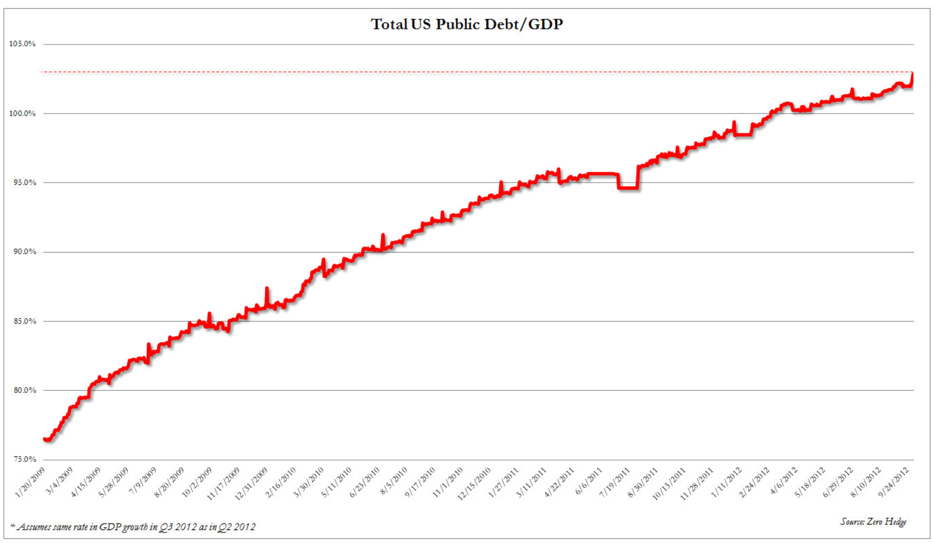
Cogitative dissonance: ***"the feeling of discomfort when simultaneously holding two or more conflicting cognitions: ideas, beliefs, values or emotional reactions"*** **as applied to social psychology:** ***"people have a bias to seek consonance between their expectations and reality. According to Festinger, people engage in a process he termed "dissonance reduction", which can be achieved in one of three ways: lowering the importance of one of the discordant factors, adding consonant elements, or changing one of the dissonant factors. This bias sheds light on otherwise puzzling, irrational, and even destructive behavior"*** (http://en.wikipedia.org/wiki/Cognitive_dissonance).

Confirmation bias: ***"a tendency of people to favor information that confirms their beliefs or hypotheses. People display this bias when they gather or remember information selectively, or when they interpret it in a biased way. The effect is stronger for emotionally charged issues and for deeply entrenched beliefs"*** (http://en.wikipedia.org/wiki/Confirmation_bias)

Don Quixote: ***"Don Quixote is a character in a novel by Miguel de Cervantes, first published in 1605, added on to by Alonso Fernandez, and finished by Cervantes in 1615. In the "real world" of La Mancha, Spain, Quixote is known as Alonso Quijano, a thin country gentleman, familiar to all as kind and friendly. He lives with his daughter and two servants. As a gentleman, he spends time studying medieval romance stories, full of knights, chivalry, castles, and jousts. This all goes to his head to the point where he goes*** *crazy* ***and actually starts outfitting himself as a knight. He believes that he has been called by voices to change the world and right all wrongs"*** (http://www.quixote-quest.org/resources/Feedback/WhoIsDonQuixote_102700.html)

(Update: as of this writing it appears a partial agreement was made to avoid the fiscal cliff 12/31/12)

What do these concepts have to do with managing investment risk? Like all of you and especially for those of us trying to advise others, we have to be aware of these influences on how we interpret the economic and political environment around us. Making sense of the absurd, understanding contradictions, listening to more than just the things we want to be true or agree with and finally staying grounded in the probable and possible not the impossible or highly improbable. While we have to have some process for managing extreme risk, the cost of eliminating all risk is too great for most investors (if even possible). These notions bring us back to the core tenants of our investing; risk management through diversification and portfolio optimization in asset allocation employing our proprietary tools.



After we celebrate the agreement (in whatever form) to avoid the mythical fiscal cliff it will be time to access if the deal has a reasonable expectation of changing our federal deficit trajectory. We (the U.S.A.) currently owe about $16.4 Trillion dollars, we earn (the U.S.A. gross domestic product) about $15.5 trillion dollars. Total Federal, State, local government spending is about $6.4 trillion dollars and our total Federal and State revenue (taxes) is almost $4 trillion dollars.(http://www.usdebtclock.org/) If we look at the CBO's (congressional budget office) "Alternative Fiscal Scenario" ;

The alternative fiscal scenario is one where the following occurs:

- Extension of the expiring tax cuts, except the payroll tax, and indexing the AMT to inflation
- Elimination of the sequestration spending cuts in the DOD
- Elimination of spending cuts in non-DOD discretionary spending
- Medicare's payment rates for physicians remain unchanged from the current amounts

The CBO projects a 2013 deficit of $1,037,000,000,000.00 dollars (that is a trillion). If we were to go off the cliff the CBO projects a deficit of $641 billion dollars. Any agreement that is politically acceptable involves greater debt through increased deficit spending once again delaying any serious spending reductions into the "future". All these approaches are gambling on "kick starting" the economic growth in investment and labor to get the economy growing at 3%, 4% or even 5%+ growth, which will expand tax revenue and close the deficit gap.

While this is possible we think it's improbable. If your household was the U.S.A. and you earned $150,000.00 a year spent $160,000.00 each year owed $160,000.00 and told your wife that it was ok we will borrow the difference because you will be making $200,000.00 a year in a few years…would you be sleeping on the couch? It could work out that way or even better, however you <u>could</u> also make the same, less or lose your job! In the short run we all may take this risk, however if things were not going the way we planned, it would not be long before our family decided to <u>live on less for a while</u>. We would vacation less or not at all, buy less takeout or none at all, look at off brand purchases, make what we buy last longer…in short we would make some tough but necessary decisions to make it to "better times". We would also likely still be happy and find new ways to enjoy our lives that involved spending less. After all in this modern world we have abundant resources and conveniences that make everyday life much easier.

Without a real "family agreement" to live smarter now so we can live better later the "fiscal cliff" will be replayed each year till the "agreement" is forced on us by some external factor or the overwhelming imbalance we created. Our thinking is this realization is near. The time of ***cogitative dissonance*** where we think we can have our cake and eat it too no longer feels right….and ***confirmation bias*** we all listen to the things we want to hear from the experts and politicians so we can keep eating cake (I call this avoidance therapy)….and ***Don Quixote*** where we just pretend things are what we want and we can always have cake.

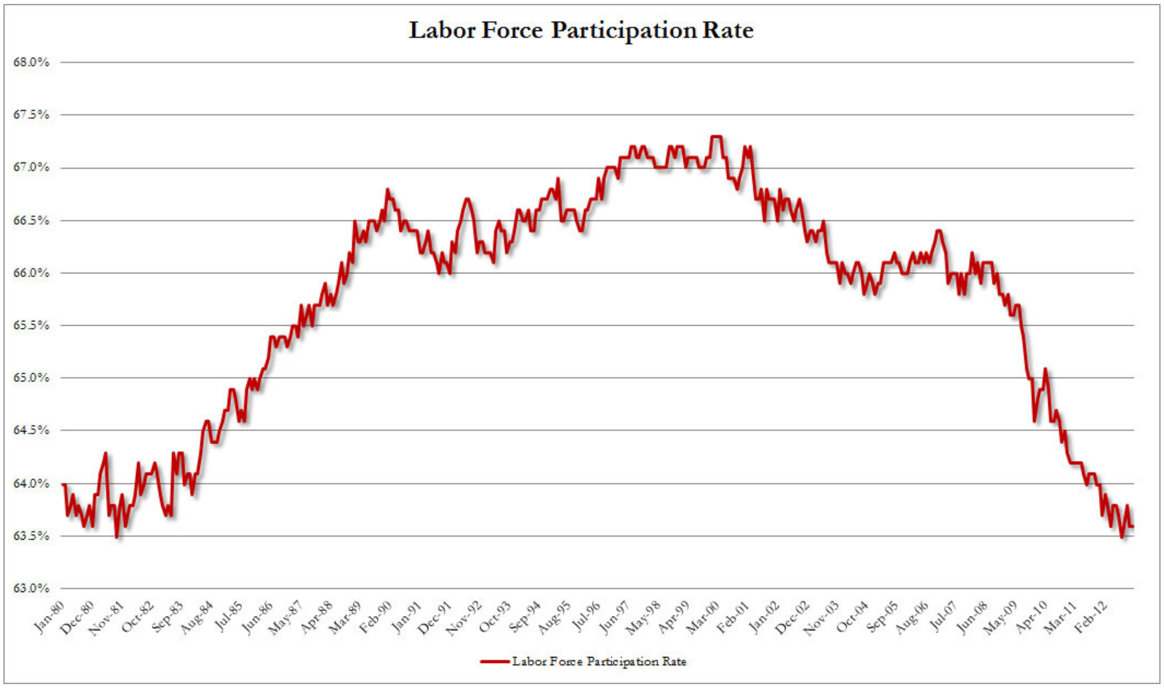
What we expect is everyone, markets included, will breath a sigh of relief on whatever deal is made in Congress…and after this euphoria is past and we have looked closely at the numbers it's likely the bloom will be off the rose. If enough is accomplished to begin to reverse our spending while increasing revenue *without supplanting spending and investment* we may begin to see a long term recovery emerge. Our expectation is for more of the same in terms of volatility and we are still predisposed to prepare for some unexpected event "sell off" that will be both disconcerting and also an opportunity to invest into some great performing equities.

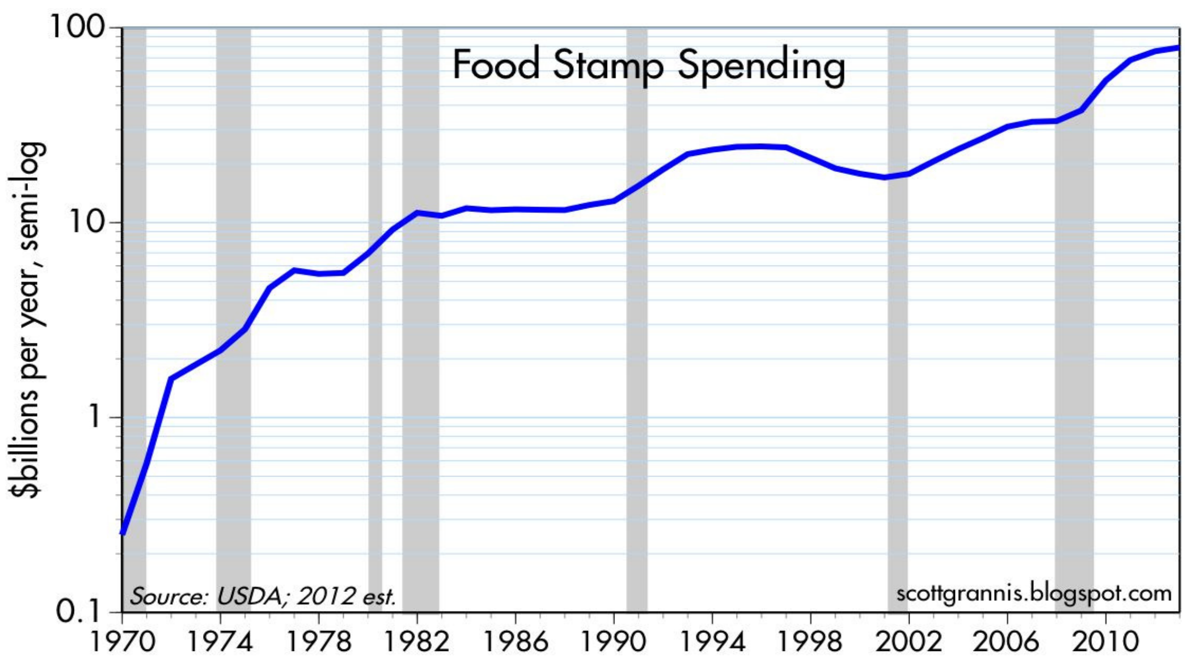
We also feel that while a dramatic rise in interest rates is unlikely in the next few years, we may see the low in rates in 2013. Here too we see either an unexpected rate rise and/or a "credit event" will provide an opportunity to find better rates in the intermediate term investment grade bond sector. We are still not chasing yield by extending maturities even if the Federal Reserve's zero interest rate policy is trying to force everyone to do so. It seems to us that this policy has distorted the "normal" relationship of risk in credit, term and equities to the point many people may end up adopting more risk than then are comfortable with. This kind of investing nearly always ends poorly for the average investor as they are always the last to adjust when the long term regression to the mean occurs across asset classes.

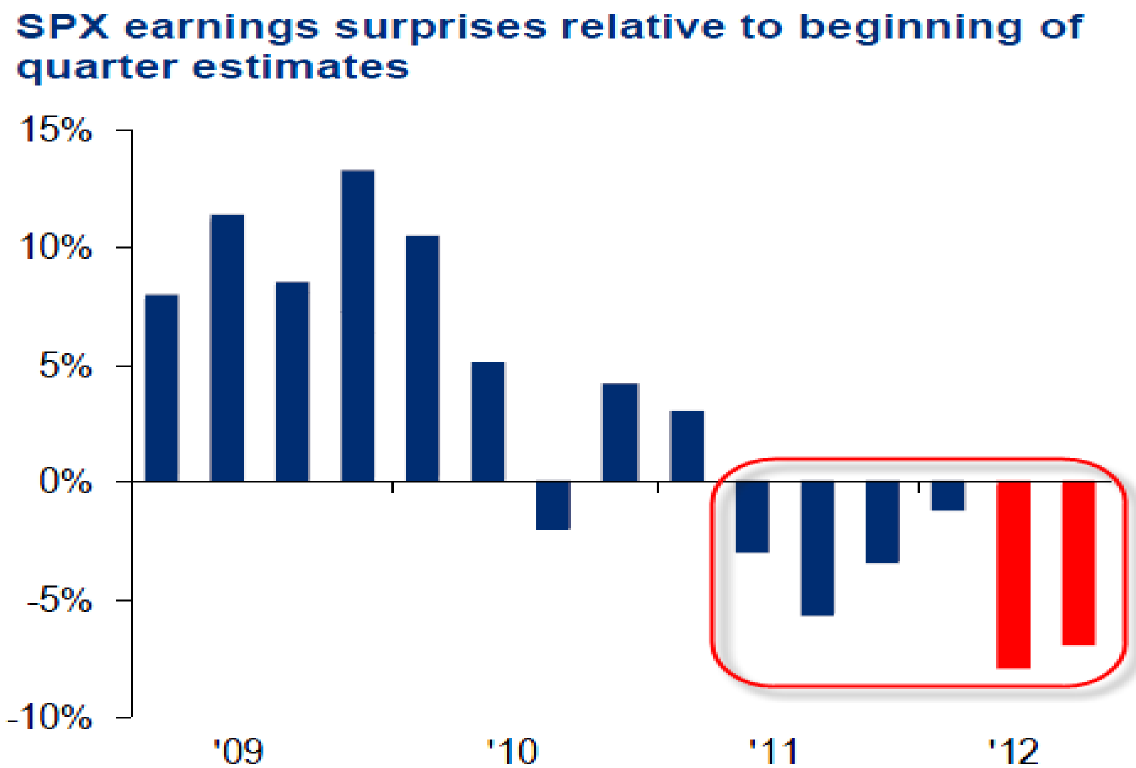
Just to be clear, our early understanding of a fiscal cliff deal is that it has mostly just moved the sequestration discussion down the road a few months. More importantly for the "average wage earner" (even if you're collecting unemployment) the payroll social security tax is going up 2% across the board (from 4.2% to 6.2% of wages) and the Medicare tax will go up .9% (to 2.35% from 1.45%).

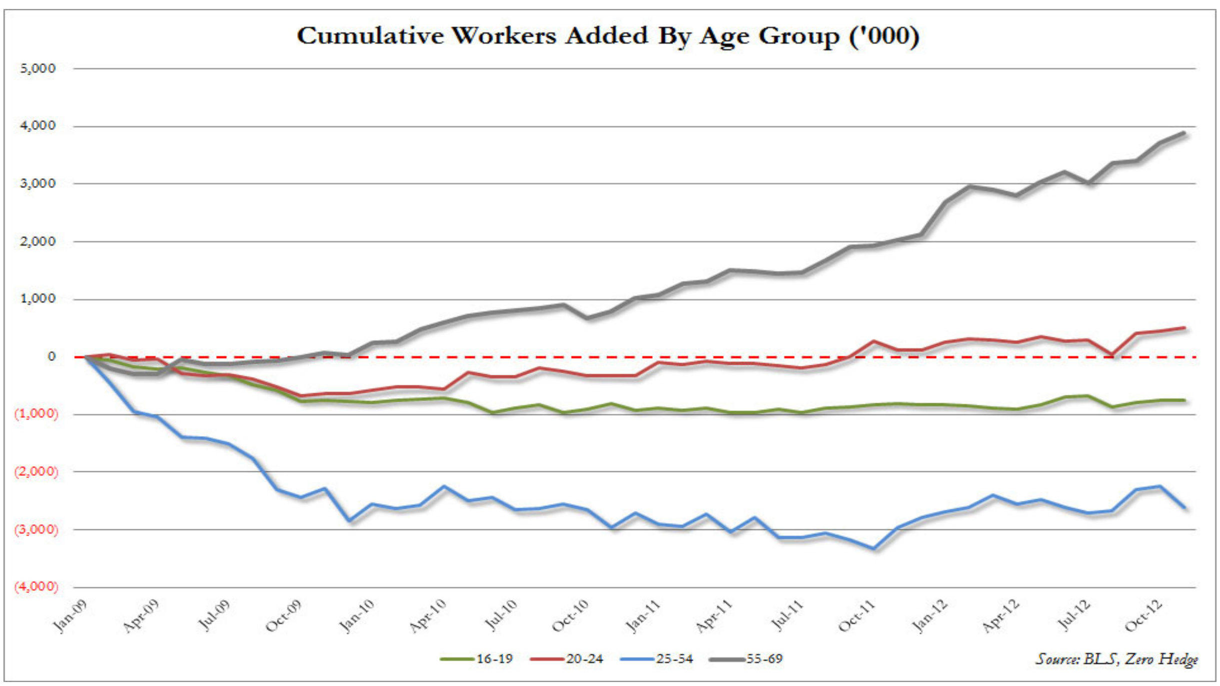
From our viewpoint it seems this effort is counterproductive to the Federal Reserves and Administrations attempts to increase consumer spending….the average earner is now making less. Once again the "devil will be in the details" but also in how the consumer and industry perceive the deal. If the belief results in action; new hiring, new product development, and new investment in capital equipment, innovation and renewed small business formation this could be a success. We will count to ten and look more closely to see if the confidence is followed through with actions.

Final thoughts… This period has presented some confusing trends and strange economic data. As in the past we struggle to explain what is different this time and why it's important, perhaps altering our understanding of traditional economic relationships. In the investing world these efforts can be influenced by *"Confirmation bias"* as mentioned earlier. We all want things to improve and we prefer it happen now! So with this in mind we have to be careful our *"Cogitative dissonance"* does not distort how we assess risk while investing. All the while we have to guard against "fighting windmills"…. Some confusing data:






SPX earnings surprises relative to beginning of quarter estimates
15%
10%
5%
0%
-5%
-10%
'09
'10
'11
'12


Cumulative Workers Added By Age Group ('000)
5,000
4,000
3,000
2,000
1,000
0
(1,000)
(2,000)
(3,000)
(4,000)
Jan-09
Apr-09
Jul-09
Oct-09
Jan-10
Apr-10
Jul-10
Oct-10
Jan-11
Apr-11
Jul-11
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Apr-12
Jul-12
Oct-12
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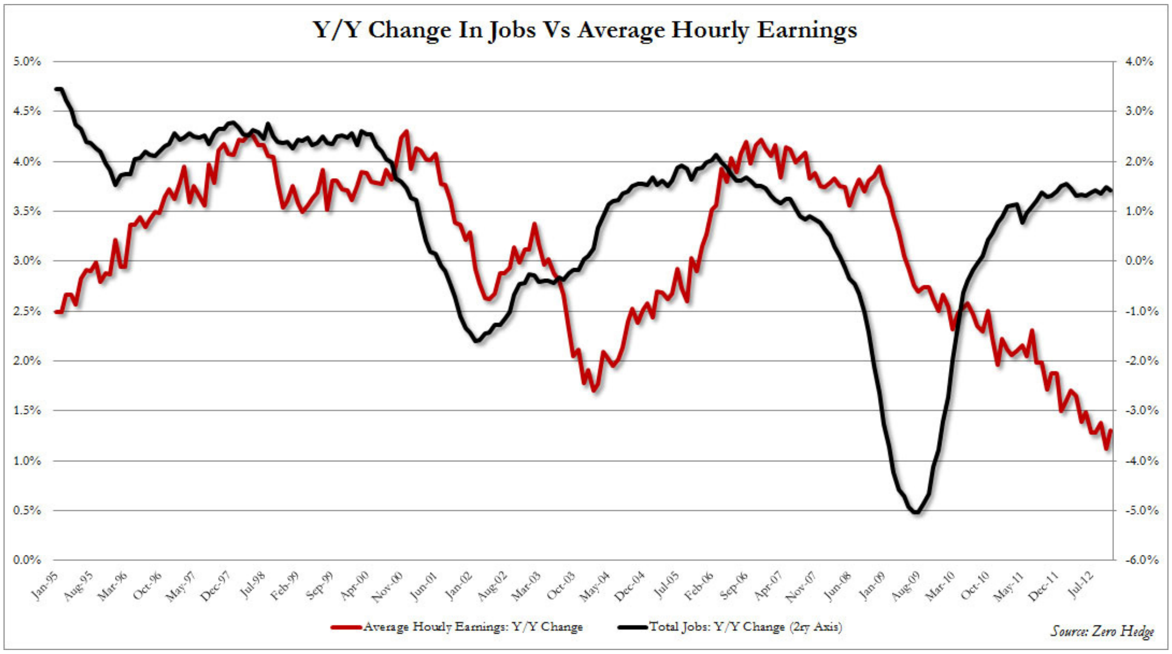
25-54
55-69
Source: BLS, Zero Hedge



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

Benjamin Graham
The Intelligent Investor