MARKET OVERVIEW Q4 2012

Looking back, 2012 was the year of the incredulous rally, as investors resiliently shed various uncertainties to finish with the third best equity returns of the past ten calendar years. After substantial gains in the third quarter, the stock market slipped off its highs in October and sold off through the election. Ultimately, equities bottomed in mid-November as the country hurdled towards the Fiscal Cliff, but resumed their upward path as hope of a compromise materialized. The S&P 500 Index rallied near prior period highs to finish the quarter moderately lower, -0.38%, bringing the 2012 return to 16.00%.

For fixed income assets, although interest rates moved higher in December, the fourth quarter remained positive. The taxable Merrill Lynch US Corporate & Government 1-10Yr Index rose 1.17% in the quarter, leaving it up 3.06% at year end, and the municipal Barclays Managed Money Short/Intermediate Index rose 1.53% on the quarter, bringing it to 2.90% for the year. The 5Yr to 10Yr section of the Treasury curve backed up by 15bps to 20bps from early to mid/late December, with municipals moving in sympathy, and the ratio firmly entrenched in the 90%-100% range. Corporate bond spreads steadily tightened as demand surged and issuance reached new heights, as corporations took advantage of historically low rates and extremely high demand to lower borrowing costs. GDP growth is expected to remain benign, which will help keep a lid on intermediate rates. The yield curve, after flattening for much of 2012, could steepen later in the year if the U.S. economy stays on track and growth expectations improve.

The year began amidst improving economic data, albeit with several unsettling geopolitical issues at hand. The debt crisis in Europe reemerged as public protests of austerity measures drew headlines and made investors wary of resolutions being implemented. Meanwhile, China's slowing growth raised concerns of a hard landing for their economy. Fears of inflation, waning production and demand, as well as a pending regime change all weighed on investors. Here in the U.S., politicians began posturing ahead of the upcoming elections and the well-publicized Fiscal Cliff. As the year rolled on, central bank moves by the ECB helped waylay concerns in Europe and markets responded, sending sovereign debt yields of the troubled Euro nations significantly lower. Economic numbers in China appeared to bottom during the fourth quarter and the Shanghai Index responded, rallying nearly 16% in December alone. Of these three overhangs, which we have discussed at length in prior letters, the only one that had not yet been addressed heading into year-end was the Fiscal Cliff.

The Fiscal Cliff impacted the markets and investor confidence long before the actual cliff deadline on January 1, 2013. After several months of positive stock performance fueled by central bank accommodation, October brought an earnings season full of gloom. With the uncertainty of the upcoming election and Fiscal Cliff, companies became paralyzed with the fear of the unknown and issued guidance that corresponded. What were healthcare costs going to look like? What was going happen with taxes? Was government spending going to be slashed? With their coffers full after years of cutting costs and gaining efficiencies, companies certainly had the ability to spend but not the willingness. Investors became nervous and sold stocks throughout October. In early November, Election Day brought answers, but not the ones the stock market was hoping for, and further gridlock was likely heading into the final months of the year. Once it became apparent that there would be no substantial changes to the composition of the White House and Congress, investors feared that further gridlock was likely heading into the final two months of the year. The S&P traded down over 5% in the week following the election, as all eyes turned to the Fiscal Cliff.

The much-publicized Fiscal Cliff was debated both behind closed doors and in front of cameras as politicians looked to jockey for position. It was feared that the Fiscal Cliff, a combination of automatic spending cuts, and increased taxes, would force our economy back into recession. However, the stock market rallied 8% over the final six weeks of the year as investors optimistically believed a compromise would be reached, in spite of legislators' prior inability to do so.

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Congress, always one for brinksmanship, got down to work in the final week of the year and came to an agreement on January 1st. Highlights of the American Taxpayer Relief Act of 2012 include: for married couples making more than $450,000 per year, a higher marginal tax rate (39.6%, up from 35%) and higher dividend and capital gains tax rates (20%, up from 15%), estate taxes up to 40% from 35% on estates valued at over $5 million, unemployment benefits extended for one year, and a phase out of deductions and credits for couples making more than $300,000 per year. More important than what was included in the deal, was what was not incorporated in the agreement.

Unfortunately, the eleventh hour compromise neglected certain items and failed to materially address the spending side of the equation. The budget cuts set to begin on January 1, 2013 were delayed for two months to give Congress more time to negotiate the deficit reduction. Excluded were the two year old payroll tax cut (2%) and a rise in the debt ceiling. The 2% payroll tax increase impacts every wage earner in the country and threatens to hamper consumer spending. Meanwhile, the country is on course to exceed its borrowing limit sometime in the latter half of February; many anticipate that the debate over the debt ceiling will be far worse than the tax policy talks we just emerged from. Market participants will be particularly focused on these negotiations and how ratings agencies like S&P and Moody's respond. We remember all too well the summer of 2011, which is the last time our elected leaders brought the country to the brink of the debt ceiling. The country's debt was downgraded for the first time in history and markets suffered steep losses. The circus in Washington will be front and center for the first quarter of the new year.

Despite Congress and the White House showing little to no ability to work things out, there are a number of positive catalysts that could drive the market higher. The nascent housing recovery continues to show signs of life as prices have stabilized and housing starts continue to rise. The latest ISM survey number was back above 50, signaling expansion in the manufacturing sector. China continues to show signs of recovery while in Europe, sovereign debt yields are dropping as the crisis seems to have abated. The natural gas boom that we are experiencing in the U.S. could add meaningful jobs, lower energy prices, and looking further ahead, potentially turn the United States into an energy exporter. Finally, we would be remiss not to mention the accommodative stance taken by the Fed and other Central Banks around the world. Recently, the Fed has given the public specific unemployment and inflation targets and has pledged to remain accommodative until well after these target rates have been achieved. These are all potential catalysts to equity appreciation, if investors can become comfortable with the lingering issues in Washington.

While little has truly changed from a political standpoint, putting at least some uncertainty in the rearview mirror may have effectively untethered the financial markets a bit. Thus, if GDP and other economic numbers continue to provide some positive indications, the stock market could move briskly higher as investors seek out higher risk assets. Ideally, more simplistic tax reform and spending refinement could truly spur optimism. However, if government spending continues unchecked and job growth flounders, worry could set back in quickly. We anticipate further volatility in the months ahead as debate and deliberation grip Washington. We will continue our focus on broad balanced cyclical recovery trends, but still have reservations about the political hurdles ahead.

After twenty years here at 45 Milk Street in Boston, at the end of February, our offices will be moving just down the street to One Post Office Square. Change of address information will be sent separately soon. The growth of our firm has led us to seek new space to accommodate our expansion and we are very excited about this new location and what it means for the progress and future of our firm. If you find yourself in Boston, we hope you would be our guest and visit us. As always, we welcome your comments and questions. Please contact us if there are any changes to your financial situation or investment objectives. Best wishes for a healthy and prosperous New Year.

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