## JUNE 2012 INVESTMENT COMMENTARY

### INVESTORS "UNLIKED" EQUITIES IN MAY, BUT CONSUMERS "LIKED" LOWER GAS PRICES

The month of May turned out to be a needed correction after seven consecutive monthly advances for the S&P 500. Many technicians have been calling for this type of correction for the last several months. Not surprising however, was that it took Greece and a predictable anti-austerity movement in Europe to finally give nervous investors reason enough to run further away from the perceived risk of equities to the comfort of U.S. Treasury securities, which are now priced at historically high prices.

Our only regret in May is that most accounts had limited "dry powder" necessary to add to positions into the correction. That being said, we do not see this correction mirroring last year's, which lasted five months. A combination of likely scenarios in Europe and a continuation of mediocre economic performance domestically should bring this correction to an abrupt end in June. The mid-June elections in Greece are likely, in our opinion, to create a coalition government that will be willing to continue with needed fiscal reforms in that country, while European Union members are likely to moderate their previous "austerity only" stance in favor of a slightly more balanced approach of fiscal reforms and economic stimulus actions.

Temporarily taking European headline risk off the table will likely breathe renewed life into the equity markets by the end of June, and second quarter corporate earnings reports should bolster the outlook for stocks supporting valuations as we go through the summer months. Of course these are the known issues that equity investors must address at this point in the year. There is always a possibility for unknown or unlikely issues which could manifest themselves at any point. It is for this reason that we invest based upon what we know to be true today and what we believe to be likely going forward.

That would seem to indicate that we would be among the consensus, but we find that our independent analysis leads us to conclusions, more times than not, which are contrary to current consensus opinion. In the current example of Greece, our opinion differs from what the equity market has discounted over the last month, which is a disorderly exit from the European Union. Even though the probability of a disorderly exit from the European Union is still a low probability "tail risk" in our opinion, the markets have keyed in on the posturing rhetoric emanating from the anti-austerity faction of the Greek government and from Chancellor Merkel of Germany who has been taking a hard line with Greece throughout this drawn-out saga. Tail risks, the unknown and the unlikely, need to be accounted for when executing an investment strategy. For this reason, we routinely utilize a carefully designed and back-tested allocation to "alternative asset classes" in order to mitigate the effects of unknown or unlikely events on our client portfolios.

Amidst all of the fearful news coming out of Europe in regard to negative reinforcing consequences of austerity budgets in countries such as Spain and Greece, as well as the European Union now officially falling back into a recession, here in the U.S our latest reading of consumer confidence is the highest in more than 4 ½ years. AP reporter Christopher S. Rugaber said in his May 25,

2012 article titled U.S. Consumer Confidence Highest in 4 ½ Years, "A better hiring outlook and lower gas prices pushed a measure of U.S. consumer confidence to its highest level in four and a half years." He pointed to evidence from this most recent Thomson Reuters survey on consumer confidence that "a high proportion of consumers say they are hearing about job gains rather than losses. The number of those who say they heard of job losses dropped to its lowest point since mid-2007. Gas prices have also fallen steadily in recent weeks, freeing up more money for other purchases".

When assessing future economic assumptions, we attempt to guard against contagion paranoia. Global economics present complex cause and effect relationships that are not easily understood. Many times this complexity can lead U.S. investors, and even some economists, to draw parallels, which may only serve to suite their pre-conceived bias. For example, it has been commonplace for investors to abruptly reduce risk in their portfolios at the mention of Greece leaving the European Union or when signs of further economic stress in Europe emerge. What we recognize is that European economies are suffering from largely self inflicted friction to growth, which has slowed domestic consumption, leaving only economies that are export oriented, such as Germany, able to grow because of continued economic expansion in the U.S and other large economies such as China and South American economies. Because of the nature of the weakness in Europe, and the fact that the U.S. runs a trade deficit with most of these countries, their weakness, as long as it remains moderate, should allow the U.S. economy to continue to grow. At this time last year we anticipated the high likelihood of European Union recession. Instead of joining the echo chamber of economic and market pundits who formed the conventional wisdom last year that we were headed for another recession if European growth stagnated or worse, we determined that the U.S. economy could grow in spite of European weakness or recession. In economics speak, this outlook would be known as decoupling. For us, it is not Europe, it is China, and by extension Canada and South America, that acts as our economic barometer.

## THE VIEW FROM THE CLIFF CAN BE SCARY, BUT WE WON'T FALL OFF

The next known issue that the markets will need to grapple with is the so-called fiscal cliff, which the U.S. economy is facing at the end of this year. Corporate earnings will dominate the attention of investors in July and August, but come September, all eyes will be on the election and the "fiscal cliff". The fiscal cliff is the expiration of the Bush tax cuts, which include tax rates on income, capital gains and dividends, payroll tax cuts, which were originally passed as part of the 2009 stimulus plan, as well as approximately $70 billion in spending cuts resulting from last year's debt ceiling debacle.

As we analyze the potential outcome of the fiscal cliff, we believe that it is highly probable that the payroll tax cuts will be allowed to expire and the currently expired Alternative Minimum Tax fix will be extended again for the 2012 and 2013 tax year. As far as the fate of the Bush era tax cuts and the mandated spending cuts from last year's debt ceiling agreement, the results of the November elections will largely determine the outcome. Broadly, there are two possible outcomes that we envision regarding the Bush tax cuts and the mandated spending cuts. One outcome is that the Bush era tax cuts are extended or made permanent and the mandated spending cuts are deferred and/or re-negotiated. The other outcome is that Bush tax cuts for higher income tax payers will be allowed to expire, leaving tax rates as they are for most Americans, while spending cuts will be implemented with minor modifications. The scenario that we see as a very low probability is the actual fiscal cliff occurring, where all tax rates rise and all spending cuts occurring without modification. Although this is the lowest probability event in our opinion, it is the event that will most affect our markets later in the year.

As we have stated on many occasions, risks which are well known and understood rarely unfold in ways which cannot be managed; however we have all learned that for the markets, strife and hyperbole leading up to an important legislative event are far more apt to move markets than the enactment of legislation itself. This presents a challenge for our approach to investing; we effectively ignore noise and Washington hyperbole and media sensationalism is generally just noise which acts to create publicity for the purveyors and volatility for investors. The fiscal cliff is something which will certainly be sensationalized by the media and will definitely divert investor's attention in the second half of the year. Politicians will stake out their positions and markets will react, but the chance of our politicians failing to address

the year-end fiscal flash point is a very remote possibility. We will treat it as such. Volatility and corrections, which will likely result from the fiscal cliff discussion, will be treated as opportunity, not economic Armageddon as it will be portrayed by politicians and the media.

### FACEBOOK - VALUE TRUMPS HYPE

We cannot end this month's commentary without mentioning the Facebook IPO. Avoiding this IPO is something that we are proud to say we did, as we did not count ourselves among those who believed that Facebook should be valued with a market cap that is $20 billion greater than The Disney Company. Looking at it another way, at $38 per share, Facebook was being valued greater than: McDonalds, Caterpillar or Boeing. With a market cap of $100 billion at the IPO price, Facebook was being valued for more than Ford Motor Company, Alcoa, Texas Instruments, and The Hershey Company combined. Those willing to buy into the IPO frenzy missed the fact that investors were being asked to pay 16X more for Facebook, than the market cap of largest non-governmental land owner in the U.S., Plum Creek Timber Company.

We are not inherently anti-Facebook or anti-IPO; in fact we believe that Facebook is a transformational company and its IPO should have been a shining example of how our capital markets work in the most innovative nation in the world. Instead, again ego and greed interfered and tainted what should have been a monumental day for Facebook and for our investment banking system. We are actually relieved that the IPO failed to live up to the hype on day one. Had the share price spiked to $60 or $70 per share in the first few days of trading, investors with a get rich quick mentality would have clamored for as many shares as they could, only to see the share price plummet back to more realistic levels. Instead, this IPO bolstered those who believe that the market can still function more like a weighing machine, as opposed to a voting machine.

We hope that everyone enjoyed their Memorial Day weekend and is looking forward to the Summer months as much as we are. We plan on taking an opportunity to get together with all of our clients to review accounts and spend some time getting caught up on matters of family, business and leisure activities. As most everyone knows, StaufferWilliams Asset Management greatly values the close relationship that we have developed with all of our clients over the years and it is that relationship which enables the unique trust relationship which allows us to execute our strategies and most effectively manage each individual's exposure to risk and realization of desired returns.

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