Looking Back to Look Ahead…
December 21, 2012

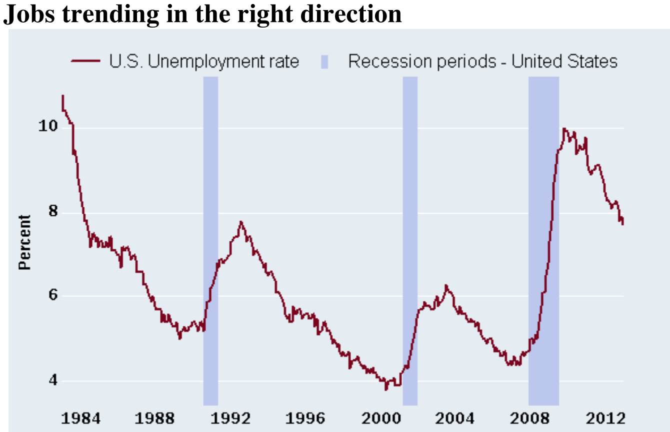
As the year draws to a close, it is time to once again pause and ponder many aspects of life. Winston Churchill said, "***Those that fail to learn from history are doomed to repeat it.***"

This week's Market Insight is a **look back and a look ahead,** using excerpts from Chief Economist Liz Sanders at Charles Schwab.

The Market: Year -to- date gains of 13% for US stocks and 4% for bonds are not bad based on history and considering a slow economic environment. But that doesn't tell the whole story of 2012. A more in-depth look at the year may offer some lessons to use for investing in 2013 and beyond.

Unemployment rate at 8.5% was the first reading on unemployment for 2012. It has now dropped to 7.7%. Although moving in the right direction, it is still well above the 4% level of the late 1990's. Virtually nobody is happy with 7.7% unemployment, but the fact that the trend has been heading lower has provided support for the stock market.

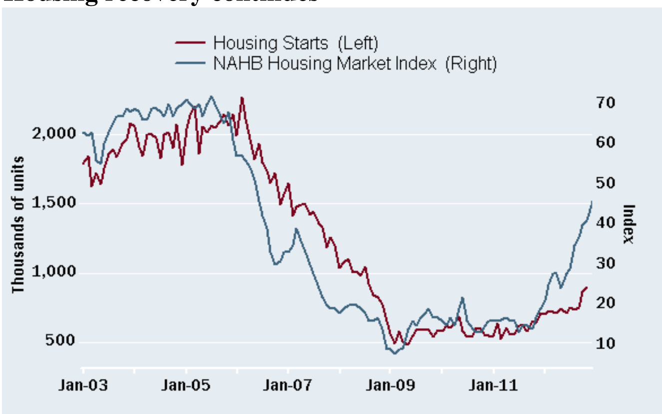
Jobs trending in the right direction



2013…
Looking ahead, there is virtually no doubt that the US, regardless of the outcome of the current fiscal cliff negotiations, will undergo some form of fiscal tightening and will result in a net drag on economic growth in 2013. The chief drag is the anticipation and implementation of the Affordable Care Act. Already numerous executives have indicated the new health care plan will significantly impact their decisions on expanding business and adding to payrolls. In addition, lack of focus on growth is the missing element in many of the ongoing discussions in Washington.

On a positive note however, any clarity on fiscal policy will give businesses more confidence to begin to invest in delayed projects, which in turn would boost the economy. Also, housing now appears to be firmly in recovery mode and there remains ample pent-up demand that should contribute to continued housing growth which could also offset some of the impact from tightening on the fiscal side.

Housing recovery continues



Fed appears locked in …

The Federal Reserve continues to do everything in its power to foster economic growth, and it seems unlikely to change that stance in the near future, despite the evidence that its impact may be diminishing. Most recently, the Fed replaced the expiring "Operation Twist" with additional purchases of long-term Treasury securities in the amount of $45 billion per month to start 2013. That will be in addition to the $40 billion of mortgage-backed securities (MBS) they are buying through QE3.

The Fed did surprise the market a bit by moving to economic targets. Specifically, it appears any form of tightening won't occur as long as inflation stays below 2.5% and the unemployment rate above 6.5%. There are risks at staying at the party too long, but 2013 looks to be shaping up similarly to 2012 with monetary policy a huge support for the market.

Europe still a risk, but less so…

The euro zone also went on a wild ride in 2012, with Greece receiving a second and third bailout, and fears of a Greek exit. The European Central Bank (ECB) undertook several non-standard measures, beginning with several long-term refinancing operations (LTROs). However, the ECB's real influence came during the summer, with ECB President Mario Draghi's "do whatever it takes" to save the euro comment; and subsequent announcement of potential bond purchases through Outright Monetary Transactions (OMT). The OMT provides a safety net that significantly reduces the possibility of a break-up in the euro and associated downside risks, in our opinion.

So have things improved in the euro zone? Well, yes and no. European banks received the LTROs, which eased funding and liquidity pressures; but likely remain undercapitalized and in the early innings of deleveraging in our view. With the banking system still hobbled, lending could remain under pressure, and therefore economic growth could continue to struggle.

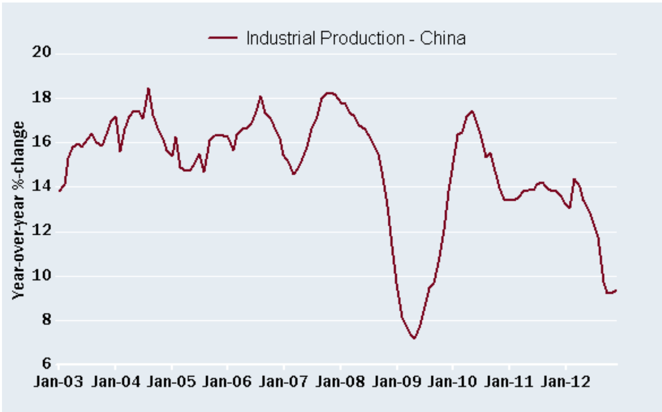
Depressed lending weighs on euro zone growth

Economically, the slowdown that started in the peripheral PIIGS (Portugal, Ireland, Italy, Greece and Spain) has spread to the core of Europe, with even the stronghold of Germany possibly entering negative gross domestic product (GDP) territory in the fourth quarter of 2012. However, there have been "positive" surprises in the euro zone. Overall economic growth hasn't fallen off the cliff, and reforms and austerity have started in many nations. In sum, Europe's economy is likely to remain a weak link in 2013 and there is the risk of volatility returning.

China bottoming, but recovery could disappoint…

China's economic slowdown in 2012 was sharper than expected and new stimulus lagged expectations. It appears China's government may be comfortable with slower growth, particularly as workforce expansion is slowing due to over 30 years of a one-child policy, reducing job creation needs. However, China's economy appears to be bottoming, led by a pickup in infrastructure spending by the government. Infrastructure spending is China's "automatic" stabilizer – picking up when economic growth slows. However, a high reliance on investment (in factories, infrastructure, and real estate) in China's economy has created imbalances.

China's industrial production downshifted?



China's new leadership will be transitioning the economy, with a goal of addressing income inequalities and improving the livelihood of the population. This will be a slow and lengthy process, but is likely to be accompanied by slower growth during the transition. <u>Slower growth is the new normal in China.</u>

New Dawn in Japan?

A new theme for 2013 is likely the addition of Japan to the investment discussion due to a transition in leadership of both the government and central bank; with both possibly targeting a weaker yen. Japan's economy remains stagnant under the weight of deflation and government debt, and trade has shifted to a negative from a positive factor. The hope is that by weakening the yen and targeting inflation, exports and domestic growth will be stimulated. <u>It remains to be seen whether Japanese policymakers have the willpower and ability to execute a weaker yen policy.</u>

In Summary…

Putting the pieces together for 2013 gives a picture of an unremarkable economic landscape, which means **<u>the markets will be driven more by valuation, sentiment, and supply/demand factors than economic growth</u>.** As of this writing**, each of these factors gives a positive bias for financial asset prices to climb higher in 2013.**

Portfolio Strategy:

It is through assessing <u>all</u> the economic and technical factors mentioned above, combined with thoroughly understanding each client's goals and risk tolerance that provide a solid foundation to build durable portfolio strategies. With this, each portfolio is designed to ride through market volatility and provide consistent return.

This time of year is indeed a time to reflect but also a time to celebrate and give thanks for the many, many blessings God has so graciously given. Not everyone celebrates Christmas, but for me, this is what Christmas is all about.

May the blessings of Christmas fill your heart and home!

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