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Financial Market Commentary: 4th Quarter Summary and Year Review 2012

"Reports of my demise are greatly exaggerated"
Sincerely, the Global Economy

From the Mayan calendar to the "fiscal cliff", worst-case scenarios dominated the headlines during the fourth quarter however despite grim reports we are still standing. While 2012 wasn't the best performing year since the Great Recession, risk assets delivered positive returns. Throughout the year, the world economy dodged many risks that markets had anticipated at the beginning of the year: uncertainty in the Euro zone and in China, and the most overused word in the fourth quarter, the dreaded "fiscal cliff".

As mentioned last year around this time, the upward pace of the financial markets from the lows of March 2009 has been at times volatile and nerve-wrecking. Despite the bull market experienced in many parts of the world in 2012 there is still uncertainty about the global economic recovery yet such concerns seem to be overshadowed by the ever rising tide of Wall Street prosperity. Note, I said Wall Street prosperity which can't be said for all aspects of Main Street.

Yearly Financial Market Review

Q1: A great start to the year
Improving US and international economic data was front page news in the first three months of 2012. The U.S. was on a path of slow but steady growth. Positive news came from the employment market. Strong job growth was seen across the economy. Retail sales were promising in the quarter. U.S. corporate earnings reported in the quarter were robust as firms continued to expand profitability and produce respectable cash flows.

The European sovereign debt crisis continued to stabilize. After tense negotiations, Greece was able to secure another round of bailout financing and avoid a disorderly default by convincing private bondholders to take a big haircut and by passing austerity measures. The European Central Bank's pumping of liquidity into the banking system via three-year loans, launched in 2011, also proved to ease the European crisis.

There was talk of a hard landing for China because of falling exports, slowing retail sales, and downgraded growth targets. While these indicators are signs of a slowdown, China's economy continued to operate at a very high level.

Q2: The bulls succumbed to the bears as can-kicking made it difficult for investors
Congressional dysfunction threatened U.S. headwind made during the 1st Quarter as we moved closer toward a "fiscal cliff". Overseas, renewed threats of a Spanish banking crisis and a potential Greek exit of the Euro reignited risk concerns and caused many to avert risk altogether judging from the flow of funds into fixed income assets during the 2nd Quarter.

Despite concerns in the developed world, emerging economies gained traction as they continued to derive a greater share of growth from domestic investment, and internal demand, and decreasing export reliance to the developed world. Emerging countries' ability to make this transition work may prove in the long run to be the most important economic development of this decade.

3Q: Risk on once again
Investors who bought into a globally diversified portfolio with moderate risk accumulated a small fortune during the quarter. Global equities were the sweet spot, but even fixed income – not short-duration cash, but real bonds – performed well. The S&P 500 surged, bonds were up, volatility measured by the VIX plummeted, and the aforementioned moderate risk portfolio was up. This information is astounding compared to the anemic, near-zero cash rates being offered over the last year. The financial market performance during the quarter demonstrated, "Successful investing demands a choice between prudent risk control and outright risk avoidance."

4Q: A nail biting US presidential election, the "fiscal cliff", yet great strides in international financial markets
Most of us made it through the US Presidential election with our sanity intact. However we were immediately confronted by the "fiscal cliff", and yet another reminder of the dysfunction plaguing our nation's capital. Most people were at their brink concerning the year end economic Congressional talks and saga. It's a pity that our elected officials can't sit down to forge a compromise that costs both political sides short-term, but benefits all of us longer-term through a prudent and balanced fiscal policy.

As expected, financial markets were volatile in the fourth quarter as investors grappled with uncertainty. This was especially true in the U.S., as Congress waited until the New Year to pass legislation to avert the "fiscal cliff". Nevertheless, the S&P 500 index didn't give up much ground, while foreign stock markets delivered decent gains.

After a stumbling start to 2012, foreign stocks leapt to gains in the fourth quarter, with the MSCI EAFE Index of developed foreign stocks rising 6.57%. That showing outpaced the S&P 500 Index, which moved largely sideways during the same time. As in prior quarters, global equity returns bested those in the U.S. investment grade bond market, as the Barclays Capital Aggregate Bond Index inched only slightly higher during the fourth quarter of the year.

Potential Potholes Ahead

Uncertainties of 2013
Clearly, there are risks and uncertainties ahead. High debt levels in developing nations and the potential consequences of political decisions, and unfortunately indecision, are concerns. The outcome of the debt ceiling debates in the U.S. and the implementation of Euro Zone austerity measures are big and may potentially curtail global economic growth in 2013. The U.S. averted a contraction on January 1, 2013, by agreeing to provisions that took the nation on a hair raising bungee jump off the "fiscal cliff". Expect Congress to reach an agreement that will raise the debt limit. The deal, however, will probably only be reached in the nick of time likely late February or early March.

Conclusion: Keep Expectations Realistic While Remaining Optimistic

There are many supportive factors in the global economy, and these create a compelling environment for long-term investors. Giving credit to Mark Twain, it is fitting to end with one of his favorite sayings, "History doesn't repeat, but it rhymes." History shows volatility, uncertainty and unknowns have always been a part of the investing landscape. Economies expand and contract, and new problems are always surfacing just as the previous ones seem to be going away. In this environment, investors should continue to think globally and long term.

This is because while the negatives rhyme, it is the positives that produce the more resounding rhymes. These positives are what investors should focus on through the short-term volatility. Debates about the structure and role of government have occurred for thousands of years. They are a cornerstone of democracy. Even as political bickering grows tiresome, progress and prosperity continue around the world. The rise of the Emerging Market middle class as referenced in previous financial market commentaries, following the example of the American middle class on a grand scale, may be one of the greatest rhymes in human history.

As the Great Recession of 2008 and 2009 moves further back into the pages of history, it is important to focus on the positives that exist within the global economy which is likely to produce respectable results going forward.

Solid Bar	YTD Return as of 12/30/2012
Diagonal Bar	3 Year Average Return as of 12/30/2012
Horizontal Bar	5 Year Average Return as of 12/30/2012