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Fourth Quarter 2012

"There are only two kinds of forecasters – those who don't know and those who don't know they don't know"
-John Kenneth Galbraith

There is a saying that bull markets often climb a 'wall of worry' and that was certainly the case in 2012. As investors worried about the fiscal cliff, inflation, Europe, a weak US economy and high unemployment, the S&P 500 Index rose +16% - a very good year by any standard. It is worth noting that most of that return came in the first two months of the year, as the market was up only 6.4% from March to December. Most of the heavy lifting was done by US Federal Reserve Chairman, Ben Bernanke, and his counterpart in the European Central Bank, Mario Draghi. In July Draghi stated, "…the ECB is ready to do whatever it takes to preserve the euro…" and initiated massive bond buying programs which brought the weaker European countries back from the brink and fueled a substantial rally in European financial assets. The Greek stock market rose 33% in 2012! Interestingly, the Dow Jones Industrial Average was up only about +10%, which partially reflects the sizable contribution Apple made to the performance of the S&P 500 (Apple is not in the Dow). Even after falling -24% during the 4th quarter, Apple (the largest weight in the S&P 500) still ended the year up +26%. Below we provided some thoughts on 2013 market forecasts, improvements in the US Economy and steps the Federal Reserve is taking to help prop up the US Economy.

Forecasters' Folly

It is that time again when stock market prognosticators issue their forecasts for the upcoming year. As always, we've decided to leave this to the 'professionals'. The table below from Barron's shows that 2013 market forecasts range widely from a modest increase of +1% to +16% gain. The average of these estimates calls for a +9% rise in the S&P 500 and six out of ten strategists call for the market to be up at least +10%, while only two are forecasting a rise of less than +5%. The most accurate forecasters for 2012 were Thomas Lee (1430) and John Praveen (1430) and Jeffrey Knight (1420).

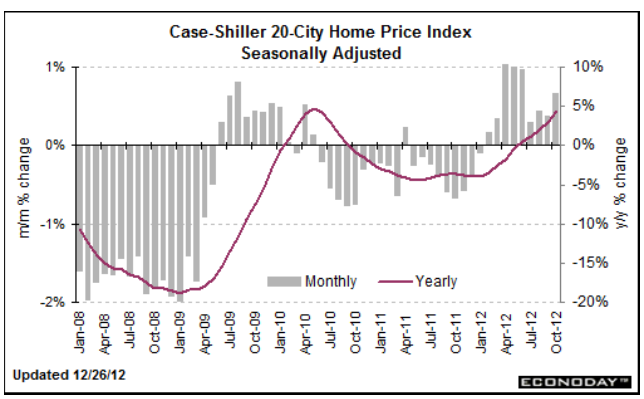
2013 Estimates	S&P 500	% Gain	EPS	US GDP
Steve Auth, Federated Investors	1660	16%	$106	1.4%
Tobias Levkovich, Citibank	1615	13%	$108	1.6%
John Praveen, Prudential	1600	12%	$110	2.5%
Savita Subramanian, Bank of America	1600	12%	$110	1.5%
Thomas Lee, JP Morgan	1580	11%	$110	2.0%
David Kostin, Goldman Sachs	1575	10%	$107	1.8%
Russ Koesterich, BlackRock	1545	8%	$115	2.0%
Barry Knapp, Barclays Capital	1525	7%	$105	2.1%
Jeffrey Knight, Putnam	1490	4%	$110	2.25%
Adam Parker, Morgan Stanley	1434	1%	$99	1.4%
Average:	**1562**	**9%**	**$108**	**1.9%**

Index, EPS and GDP data provided by Barron's as of 12/17/2012

Former Solomon Brothers executive and president of the research firm Birinyi Associates, Laszlo Birinyi, believes the bull market that began in March 2009 resembles advances that pushed equities up more than threefold in the 1980s and fourfold in the 1990s.[1] He believes there is a better than 50% chance the S&P surpasses its record high of 1565 as investors rebalance asset allocation and stop moving money out of stocks and into bonds. To his point, in 2012 taxable bonds funds had inflows of $263 billion (exceeded only in 2009) while actively managed stock funds experienced $134 billion of outflows (the worst year ever).[2] Nuveen Asset Management's Chief Equity Strategist, Bob Doll (formerly with Blackrock), also predicts the markets will reach a new all time high in 2013. Some of his others predictions for 2013 are that the US economy will continue to muddle through with weak growth, the US government will pass a $2-$3 trillion ten-year budget deal, Europe may begin to exit recession near year end, the nascent US manufacturing renaissance will continue (fueled by cheap natural gas) and dividends will increase at a double-digit rate as payout ratios rise.[3]

What about the Economy?

While the fiscal cliff negotiations have dominated the headlines, there are some positive signs for the US economy. Third quarter annualized GDP growth was revised higher to 3.1% from an initial estimate of only 2.0%. This exceeded market expectations for a 2.8% advance and is up from second quarter growth of only 1.3%. As the chart to the left shows, many strategists are calling for GDP growth of only about 2% in 2013. Historically, housing has been a growth driver for the US economy following recessions. After this past recession, housing has remained weak, until recently. The Pending Home Sales Index rose 1.6 points to 106.4, marking one of the highest readings since 2007. The chart below shows the Case-Shiller 20-City Home Price Index has been gradually improving with prices up 4.3% in October from a year ago, as buyers take advantage of record low mortgage rates and homeowners recover some of the housing wealth lost in the recession.

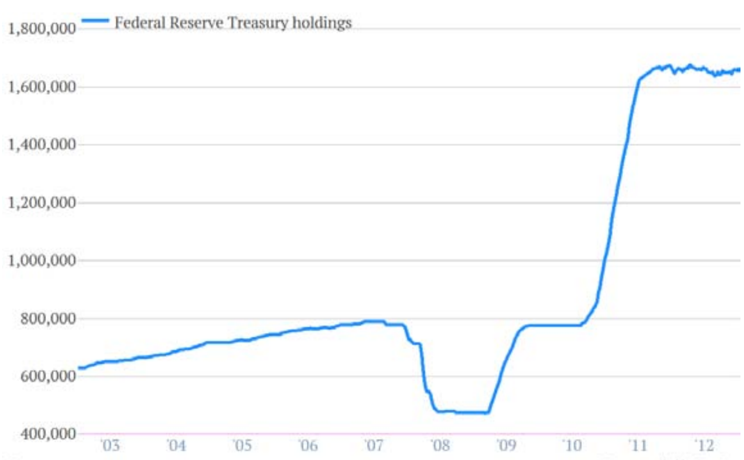


The increase in housing activity is also reflective of a rising Consumer Confidence Index, which notched a new recovery high of 73.7 in November but ticked down to 65.1 in December over concerns about the fiscal cliff.

Finally, we note the significant oil and natural gas discoveries in places like Pennsylvania, Ohio and particularly North Dakota, where the unemployment rate is only 3%. The US actually has more natural gas reserves than any other country in the world and so our prices are 70% below Europe and 80% below China and Japan.[4] Natural gas is often the fuel of choice to power manufacturing output so the US has a tremendous cost advantage which is driving some manufacturing back home from places like Germany, China, Canada, Europe, Mexico and Japan. For example, Volkswagen can actually produce its Passat model for $20,000 in the US versus $28,000 in Germany.[4] Natural gas in an important input for everything from steel production to fertilizer and electricity, so the trickledown effect on job creation should aid in the economic recovery. Washington would be smart to responsibly nurture this rapidly growing domestic industry to help grow the economy and bridge the gap to a future with more alternative fuels.

Three Card Monte

We mentioned earlier that Ben Bernanke has been doing most of the heavy lifting to keep the US economy growing. The Fed has primarily supported the economy in two ways: buying troubled assets during the financial crisis and buying bonds which helps keep interest rates low. To put the magnitude of these bond purchases in perspective, the Federal Reserve is currently the largest holder of US Treasury debt, exceeding both China and Japan which hold around $1 trillion each.[5]



Interestingly, the Fed is restricted by law from directly funding the operations of the US Government (buying Government bonds directly from the Treasury), so it buys them indirectly from investors. Like a game of *Three Card Monte*, the Treasury issues bonds and then the Fed buys some of those bonds from investors. The Treasury then pays the Fed interest on the bonds and finally the Fed pays that money back to the Treasury. By law, the Fed must pay all of its profits back to the US Treasury. To put the magnitude of this in perspective, it is estimated that the US Federal Reserve will pay $89 billion in profits to the US Treasury in 2012.[5] That is more money than Apple and Exxon made in 2012 combined! One must wonder where interest rates would normalize without this massive involvement by the Federal Reserve.

PCM welcomes Adrian A. Duran and Amy L. Leck

We are pleased to announce that Adrian Duran has joined Private Capital Management as an Investment Advisor and member of the Investment Committee. Adrian has over nine years of investment experience working as a Financial Representative at Country Financial. He holds Bachelor of Science in Business Administration (Finance and Economics) and a Master of Business Administration from The Helzberg School of Management at Rockhurst University. He is a native of Colorado and serves on the board of the Littleton YMCA and The Wishbone Foundation. Amy L. Leck also joined PCM as an Assistant Relationship Manager. Prior to joining PCM, Amy was an Investment Analyst at Sagebrush Capital Management and served as a Key Account Manager for the Financial Planning Association in Denver. She has a Bachelor of Arts in Journalism from the University of Northern Colorado and brings extensive client relationship experience to our team. Welcome aboard!

Thank you!

As we reflect on the year passed, we are very grateful for the support of our clients as we became the Investment Management division of Guaranty Bank and Trust. We wish you a Happy, Healthy and Prosperous New Year!

By the numbers…

Index	**Close**	**4th Quarter**	**2012**
S&P 500	1426	-0.4%	+16.0%
Dow Jones Industrial Average	13,104	-1.7%	+10.2%
MSCI EAFE	1604	+6.6%	+17.3%
MSCI Emerging Markets	1055	+5.6%	+18.2%
Barclay's US Aggregate Bond	-	+0.2%	+4.2%
DJ|UBS Commodity	139	-6.3%	-1.1%

Data provided by Morningstar as of 12/31/2012

1 Whitney Kisling "*Birinyi Odds Favor S&P 500 Record as Individuals Return*" Bloomberg 12/31/12
2 Data provided by Morningstar as of 12/31/12
3 Robert C. Doll "*2013 Ten Predictions*" Nuveen Asset Management, LLC 1/4/13
4 Larry Hungerford "*Will U.S. energy boom spark manufacturing renaissance?*" Winston/Salem Journal 12/9/2012
5 Matt Phillips "The US Fed had a greater profit than Apple and Exxon combined last year" www.qz.com 1/10/13