INVESTMENT ASSESSMENT
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From Craig F. Cooper

The Wall Street pros, featured in *Barron's* December 19, 2011 issue, could not have gotten the short-term 2012 market forecast more wrong. The Dow Jones business and financial weekly titled their December Outlook "Buckle Up!" The message – the ten top Wall Street strategists forecast stocks rising in 2012, but only after a rough first half. The consensus was that the S&P500 would end the year at about 1360, or up about 12% for the full year.

So what happened? The S&P500 surged 12% higher in the first quarter of 2012 while the DJIA advanced 8%. The S&P500 ended the quarter at 1408, substantially higher than the *Barron's* market strategists predicted for the full year. The catalyst: institutional investors piled into the market viewing signs of a brighter economic picture, some solid job gains, and an improving level of consumer confidence. The market's first quarter gain turned out to be the best since 1998.

Our outlook for the first quarter of 2012 and our investment position were more bullish and more accurate. We thought the traditional seasonal pattern would hold in 2012. This would produce an up-down-up pattern for stock prices for the full year with the first quarter or perhaps even the first four months registering solid gains. In *Outlook 2012* we suggested that the market would likely give back gains after mid-year with a news backdrop that would include the uncertainty of the national election outcome and additional possible defaults relating to the excessive debt in Europe.

Let's examine the current market climate:

The Positives for 2012

The US economy seems to be getting better. Jobless claims are trending lower, vehicle sales are at their best level in four years, consumer confidence is improving, and interest rates remain at historically low levels. This last point cannot be over-emphasized. We have a liquidity driven stock market rally. All of the world's major central banks are printing money. Our Federal Reserve has committed to keeping short-term rates near zero out to late 2014. Although individual investors remain skeptical, institutional investors have been piling into risk assets.

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The Challenges - Risk and Uncertainty

Much of the risk to US investors is from abroad. The European Central Bank has taken center stage, pumping over a trillion dollars into the financial system over the last few months. This has temporarily stabilized the financial meltdown in Greece, but now Spain seems to be the center of financial distress. Spain is in recession with the unemployment rate at 25%. Spain's commitment to reducing their deficit relative to GDP will miss the mark. The Spanish government has already stepped in with public money to support banks, realizing that financially, Spain is in jeopardy. In another part of the world, the Chinese economy has been slowing down. This is the result of the Chinese government's intention to bring down the rate of inflation. The question is whether the Chinese policy makers can pull off a soft landing, or whether something more severe can have a ripple effect on the rest of the world.

Here at home, a major uncertainty facing investors is the outcome of the national election. Linked to this, is the fact that without Congressional action, on January 1, 2013 there is going to be a combination of large spending cuts and tax increases that will impact all of us. Without Congressional action, the payroll tax holiday will come to a halt and trigger an immediate tax increase for all working Americans. The Bush tax cuts that lowered dividends from 35% to 15% and capital gains from 20% to 15% will end. Domestic and defense spending resulting from a failure to cut 1.2 billion in spending will kick in. Since it is considered extremely unlikely that Congress will do anything to act prior to the election in November, it would seem that this uncertainty could really rattle the financial markets in late summer or early fall.

Strategy for Managed Portfolios

Our last move to increase equity positions was on December 5, 2011, when our indicators suggested that the stock market correction of 2011 was over and would be followed by a rally in stock prices. That rally occurred, and just over three months later, on March 16, 2012 we wrote to you reporting that we had acted to reduce stock market exposure. Our overall strategy remains the same: we are in a range-bound market and we believe that the appropriate investment strategy is to buy short-term market weakness and sell short-term market strength. From a technical standpoint the major indices, the DJIA and S&P500, are both within 10% of the major double tops registered in 2000 and again in 2008. The next significant investment opportunity will occur if the typical seasonal pattern of stock prices unfolds with market weakness in summer and late fall. In the near-term, the stock market is at risk of correcting in the next few weeks. Sentiment is too optimistic and our technical indicators are diverging. It's an election year, so we are looking for a short-term market correction and not a new Bear market.

So the question now is how much risk is appropriate in an investment portfolio? The facts seem to say that they are not good enough to be fully invested and the risk/reward relationship is not as good as it was in the fall of 2011.