# Market Commentary

4TH QUARTER 2012

## The World Doesn't End That Often

### Economic Summary

Contrary to Mayan prediction, the world did not end on December 21, 2012. Reading some newspaper headlines and watching the nightly news, you might think the world is going to end in 2013, though. The fiscal cliff, Euro-zone debt problems (AGAIN), trouble flaring up in the Middle East (AGAIN), the President's re-election and the impending implementation of Obamacare, the aftermath of Hurricane Sandy, and a cloudy forecast for U.S. GDP growth all combine to create a grim outlook. This "sky-is-falling" mentality has many market participants nervous. Although confidence levels have been low across the board, they are starting to improve.

Despite this negative backdrop and uncertainty, the stock market produced pretty decent returns for 2012 (CHART 1). Not bad for a year when the world was supposed to end. (NOTE: THE LONG-TERM AVERAGE RETURN FOR STOCKS IS ABOUT 10%).

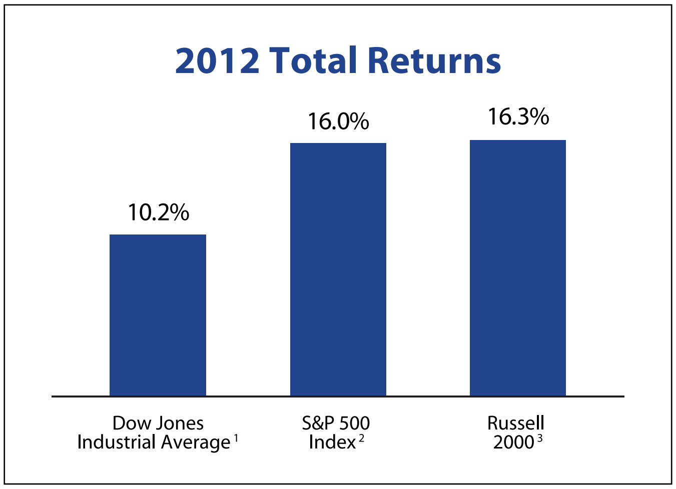


**Chart 1**

Many clients have asked what our investment policy will be in view of the 2012 election results. Pro-growth capitalists like us were disappointed on November 6th, but life goes on. Importantly, corporate profits are continuing to grow, albeit more slowly than they might have under a new administration. Despite excessive regulations which restrain profit margins and growth, earnings are progressing modestly, at least for now. Other signs of hope include jobs growing again and the housing industry bottoming out after enduring depression-like conditions for the past four years.

**Past performance does not guarantee future results.** [1] The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ. [2]The S&P 500® Index is a capitalization weighted unmanaged index of 500 widely traded stocks, created by Standard & Poor's. The index is considered to represent the performance of the stock market in general. [3]The Russell 2000® Index is an unmanaged index of the smallest 2,000 stocks in the Russell 3000® Index. You cannot invest directly in an index.

## Economic Summary (CONTINUED)

It remains to be seen whether higher tax rates on upper income earners will actually result in more revenues flowing into the Treasury. Since no reduction in government spending is apparently planned, the national debt (CURRENTLY $16+ TRILLION) will continue to expand.

Political bickering is reflective of the leadership vacuum that has existed for the past four years. With the President's re-election, it is unlikely statesmanship will be restored any time soon. While the fiscal cliff has dominated the headlines for weeks, the longer-term issues of the massive deficit spending and growing national debt are much bigger and more important issues. Unless there are reforms to the entitlement programs, no progress will be made on these bigger issues. The Federal Reserve's latest round of quantitative easing (DUBBED QE-TERNITY) has been designed to keep interest rates artificially low for the foreseeable future. We have doubts about the efficacy of this plan. Inflation will be coming back, probably sooner rather than later. The market may drive interest rates up before the Fed does, especially longer-term rates. The near-zero interest rates of the last few years, the stock market volatility and the massive money printing by central banks around the world have combined to create a lot of fear. Investors have suffered from very low levels of confidence. As a result, they have withdrawn enormous amounts of money from stock mutual funds and poured money into bond mutual funds seeking the supposed safety of bonds (CHART 2).

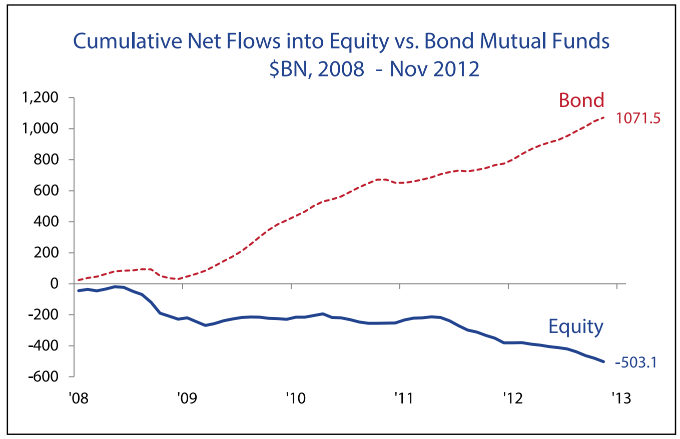


**Chart 2**

SOURCE: STRATEGAS RESEARCH PARTNERS
"QUARTERLY REVIEW IN CHARTS", JANUARY 2, 2013

For over 30 years, bonds have provided excellent returns, thanks to massively declining interest rates. Remember 15% US Treasury rates in 1981? (BOND PRICES RISE WHEN INTEREST RATES FALL AND VICE VERSA). Under current market conditions, this cannot happen again. Interest rates near zero cannot mathematically drop much more, if at all. We believe bonds currently have much more price risk than many investors realize.

**Past performance does not guarantee future results.**

## Economic Summary (CONTINUED)

Given the dysfunctional U.S. Government, it's a wonder that interest rates aren't significantly higher. The reason is the Fed's quantitative easing efforts. From here the great risk, in our opinion, is that inflation could spike unexpectedly, and interest rates rise to their natural levels. In an inflationary environment, bond prices will plummet with longer maturity bonds being hurt the most. Many bond investors will be surprised how much money they can lose investing in bonds. For these reasons, we have kept fixed-income maturities short and quality high.

Since we view inflation as an inevitable outgrowth of the unprecedented and ongoing monetary stimulation, the best path for serious investors may be to invest in common stocks of strong companies with pricing power. In our opinion, growing companies with strong market positions, low debt and high profit margins offer the potential for meaningful capital appreciation. Stocks are relatively cheap, too – especially when compared with bonds (CHARTS 3 AND 4).

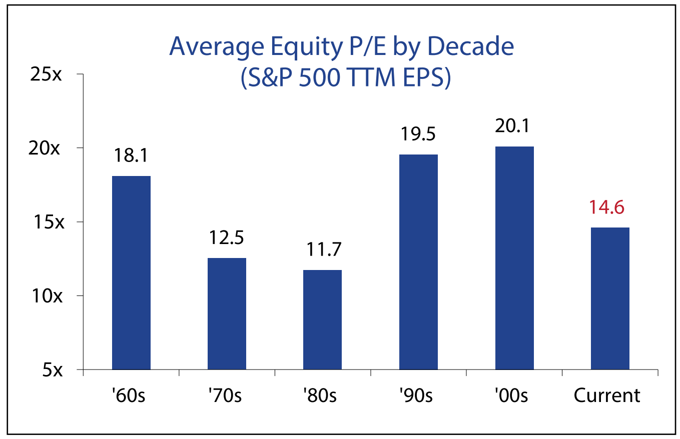


**Chart 3**

SOURCE: STRATEGAS RESEARCH PARTNERS
"QUARTERLY REVIEW IN CHARTS", JANUARY 2, 2013

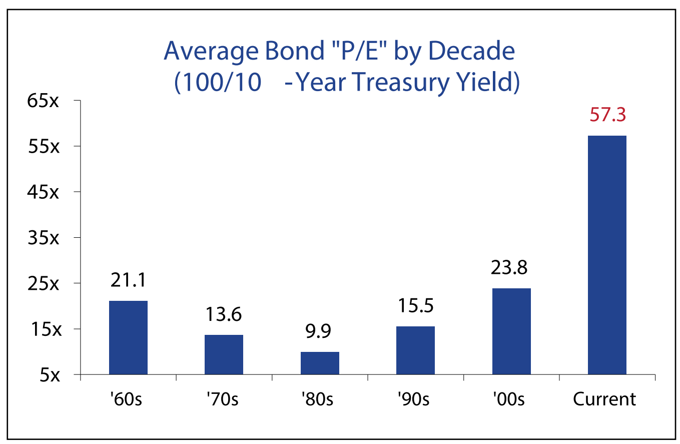


**Chart 4**

SOURCE: STRATEGAS RESEARCH PARTNERS
"QUARTERLY REVIEW IN CHARTS", JANUARY 2, 2013

### *There May Be a Light at the End of the Tunnel*

There are several indications the economy is not as bad as it may seem. Consumer confidence is showing signs of life (CHART 5 ON PAGE 4). Many well-run corporations are producing record profits and holding lots of cash. Corporate debt has been paid down, dividends increased and shares repurchased. Most U.S. corporate balance sheets are in very strong condition. In addition, personal balance sheets have been strengthened by debt reduction and increased savings. There exists today a pent up demand for autos, housing, appliances and other consumer durables. If confidence continues to edge upward, personal consumption expenditures could escalate rather sharply, providing a nice boost to the economy.

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## Economic Summary (continued)

Another huge potential plus for the U.S. economy is the domestic energy situation. Some experts predict that the oil and gas drilling technology of fracking will allow the United States to become energy independent within the next decade. This would be a game changer for our economy that could result in a major competitive advantage vs. the rest of the developed world. Job growth could be enormous. Energy costs, especially natural gas are already far cheaper in the U.S. than abroad, and if drilling is allowed to continue, it could be a boon for domestic manufacturing. Increasingly, companies are announcing plans to bring manufacturing back to this country. This is good news, no matter how you cut it.

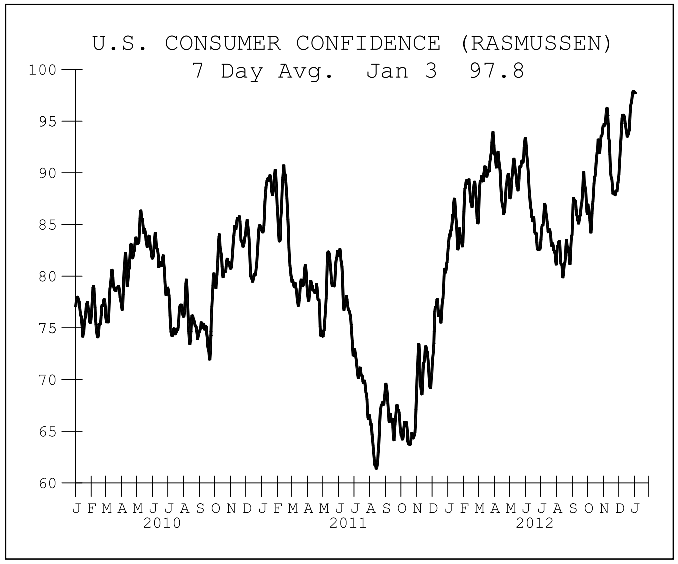


**Chart 5**

SOURCE: ISI GROUP
"DAILY ECONOMIC REPORT", JANUARY 3, 2013

Another area where there are signs of an upturn is housing. Despite all of the government intervention which delayed the bottoming process, it finally appears the housing industry has turned the corner. Household formation, housing starts, rent rates, and mortgage rates are all currently favorable. The big, national homebuilders have gone through painful restructurings and are positioned to benefit from these trends.

Dividend-paying stocks with capital appreciation potential are still attractive. A large percentage of the stock market is yielding more than the 10-Year Treasury (CHART 6).

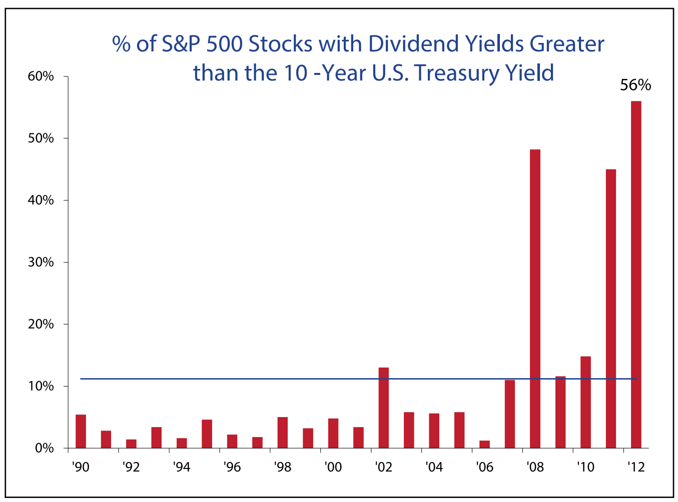


**Chart 6**

SOURCE: STRATEGAS RESEARCH PARTNERS
"QUARTERLY REVIEW IN CHARTS", JANUARY 2, 2013

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**Economic Summary** (CONTINUED)

These are difficult times for fiscal conservatives. Notwithstanding, our team of investment professionals will soldier on, pursuing investment opportunities which meet our Funds' investment objectives. Although a recession in 2013 is not out of the question, we have positioned our portfolios in a defensive manner. In general, they are concentrated in what we consider to be exceptionally high quality businesses, which are less dependent on the economic cycles than the average corporation. We feel these companies are more in control of their own destiny than most. They tend to have proprietary products and services, which gives them pricing power and an enduring competitive advantage. In addition, their share prices are undervalued in relation to fundamentals.

Overall, we're optimistic about the investment outlook for 2013, in a muted sort of way. This will not be a year for elevated expectations, but we feel that our funds should still do relatively well.

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