

#### Q4 Key Takeaways

- **Stocks shrugged off numerous worries to log a very good year in 2012.** The riskiest areas were the most profitable. Europe gained over 17% and emerging-markets stocks earned 19%. In the U.S., mid- and small-cap stocks increased 17.9% and 16.3%, respectively, outpacing large-cap stocks, 16.0%.
- **The bond side also saw riskier asset classes out-earning traditionally safer fixed income market sectors.** Various risk sectors of the bond markets such as emerging markets, high yield and leveraged loans saw returns in excess of 10% while investment-grade bonds returned 4%.
- **Our expectation of slow economic growth has largely been right on over the past four years.** Though there has been progress with deleveraging, the process is not nearly complete.
- **A key risk going forward is how our politicians deal with the problem of growing public sector debt.** The last-minute fiscal cliff compromise buys politicians a little time to address the more important longer-term fiscal issues, but does little to resolve them. Europe also made some progress in 2012, but most of that progress has been in the form of buying time by reducing borrowing costs.
- **The developed world continues to face significant debt-related challenges.** The solutions are not easy and there are no quick fixes. Failure could play out in various ways, from another financial crisis to sharply higher inflation several years down the road. A brighter spot is that developing countries are generally less indebted and growing faster. However, growth has slowed there as well, partly due to the impact of reduced demand from the heavily indebted developed countries.
- **Despite the challenges, we recognize that there are a variety of bullish factors that could drive stocks to strong returns over the next five years.** Valuations are below average and, one could argue, lower interest rates support above average valuations. In addition, there has been so much bad news on Europe and the U.S. debt, that any news on progress being made in these areas could provide a catalyst for stocks.

#### Q4 Investment Commentary

Can the markets continue to climb the proverbial wall of worry? Certainly the worries remain. The most immediate has to do with the spending side of the fiscal cliff. The cliff deal made permanent the Bush tax cuts for all but high-income taxpayers but it did not address spending. The threat of sequestration is still with us (these are the automatic across-the-board spending cuts), though delayed for two months. The timing now coincides with the need to extend the debt ceiling in March. So while the worst case of the cliff was avoided, the work is not nearly done. In the bigger picture, this immediate concern is a sideshow.

#### *Slow Growth As Expected—Now What?*

For several years we have said the most likely outcome for the developed world economy would be years of slow growth. This view was based on our assessment that excessive debt levels in the United States and around the developed world had to be reduced, and that this lengthy period of deleveraging would suppress spending and be a major drag on economic growth. Our expectation has largely been right over the past four years. Admittedly, we have been surprised at the strength of the stock market and corporate earnings rebound.

Here in the United States we have made some progress in reducing private sector debt:

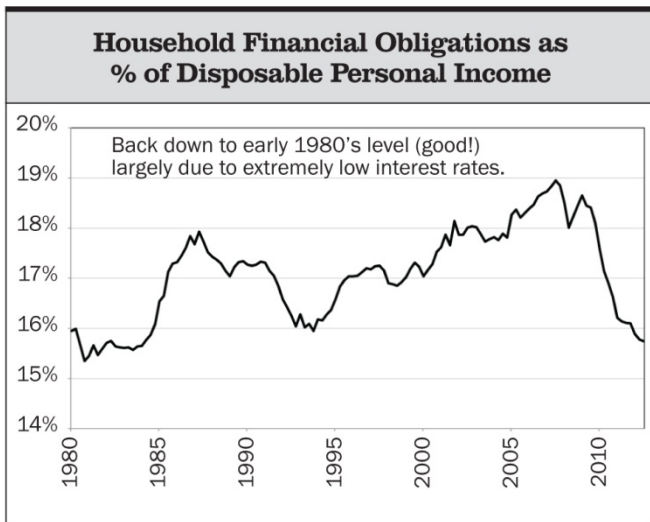
- The financial sector has completed most of its deleveraging.
- Household sector deleveraging has progressed, mostly through defaults. And importantly, financial obligations (debt service, vehicle leases, property taxes) relative to disposable income are near a 30-year low, largely due to the impact of extremely low interest rates on debt service.
- However, total household debt relative to income, while improved from a few years ago, remains historically high. This high relative level of debt suggests the household deleveraging process is not complete.

As we all know, the public sector's debt (i.e. government debt) has grown, and is a significant problem. We are all aware of the longer-term challenge: how to reduce deficits so we can maintain public sector debt at a sustainable and affordable level,

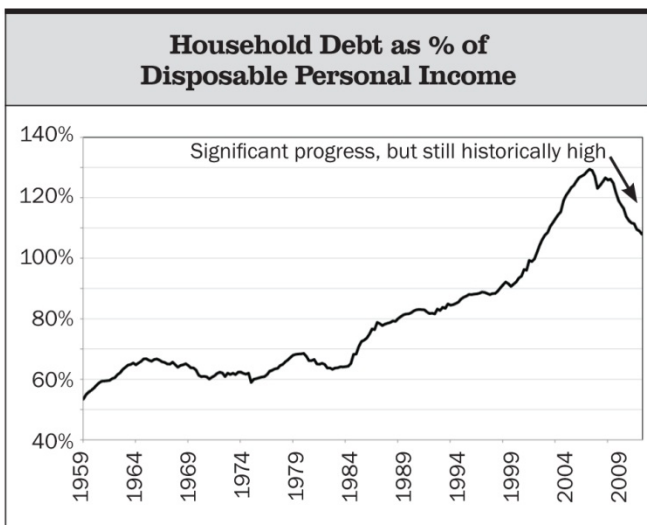
while avoiding a fiscal retrenchment that will do excessive damage to the economy. The challenge is made even more difficult by 1) current high debt levels 2) the impact of millions of retiring baby boomers and the resulting demands on entitlements for seniors and 3) the high rate of health care inflation which impacts Medicare and Medicaid. (The Congressional Budget Office forecasts that without changes, by 2030, one in three dollars of federal spending will go to health care.) This requires hard decisions about how much government we can afford, what our priorities should be, and ultimately a philosophical debate about the role of government.

Deleveraging has consequences to the overall economy. We are in a “paradox of thrift” world. This refers to a situation where individuals voluntarily or out of necessity become thrifty (saving more/borrowing less), but the impact on the overall economy is actually less savings and spending. This happens because what is good for the individual is not necessarily good for the economy. In the overall economy, more saving means less spending, which means less immediate demand for goods and services, which result in fewer jobs, which means lower income, which means less ability to spend and save. This vicious circle is what is happening in many parts of the developed world.

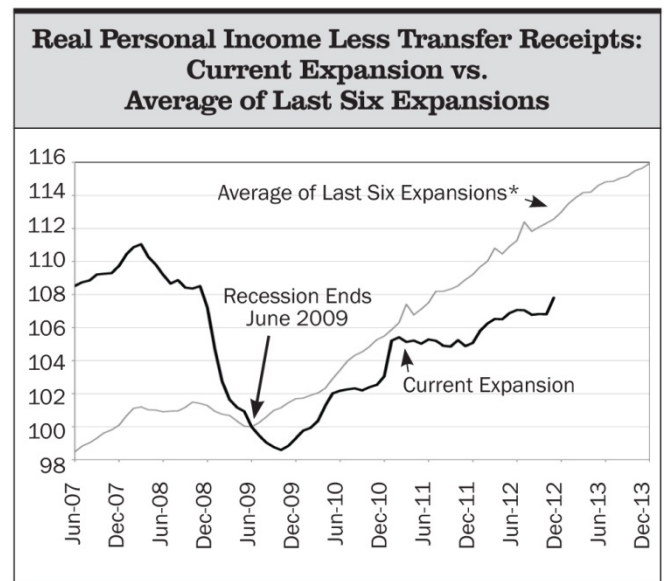
In the United States we can see it in the very slow growth of disposable income and consumption. Both have been abnormally low relative to past recoveries. This phenomenon is expected in the aftermath of a major financial crisis.



Source: Board of Governor's of the Federal Reserve System. (Data as of 9/30/12.)



Source: Board of Governors of the Federal Reserve System/Bureau of Economic Analysis. (Data as of 9/30/12.)



\*Dates used for previous expansions provided by the National Bureau of Economic Research. Source: Bureau of Economic Analysis. (Data as of 11/1/12.)

And now fiscal stimulus is winding down and this shift means that reduced government spending (though still high) will offer less support to the economy relative to recent years. A reduced rate of spending growth will continue to serve as an economic headwind as we attempt to rein in the growth of public spending. This same dynamic is playing out in much of the developed world.

A key risk going forward is how our politicians deal with the problem of growing public sector debt. Reducing the growth of

debt at the right pace and in the right way is necessary, but not easily achieved. 2013 will be an important year as politicians are charged with putting in place a viable longer-term plan.

### *Europe*

Europe also made some progress in 2012—but most of that progress has been in the form of buying time by reducing borrowing costs and thereby lessening the “tail risk” of an imminent eurozone breakup. There has been some improvement in the peripheral countries as most seem likely to have current account surpluses in 2013; capital flight appears to have stopped, and there are signs that the push for austerity may soften a bit.

The problems in Europe ultimately reflect competitive imbalances. After the launch of the euro in 1999, interest rates for historically less-fiscally sound peripheral countries dropped to Germany’s levels. This set off a borrowing (and lending) binge to fund consumption, and in some countries (such as Ireland and Spain) led to housing bubbles that have not all fully burst yet. Because the peripheral countries were not competitive with Europe’s core, largely due to labor costs, they ran large trade and current-account deficits. This greatly benefited Germany’s export market. Lenders were lax in their underwriting and ultimately banks were saddled with bad loans leading to a severe banking crisis and the need for bank bailouts—this part of the story is still unfolding. In Ireland, huge bailouts essentially bankrupted the government. Spain is threatened with the same outcome, which is why there has been a desire to allow European bailout money to go directly to the banks, rather than through the government (to avoid forcing the government to take on so much debt). The problems of the banking crisis are exacerbated because the banking sector is huge in Europe—much bigger than in the United States. Also exacerbating the problem is that European banks are heavily leveraged and not heavily funded by deposits, which are the most stable funding source. Unlike in the United States, European banks have not deleveraged and this too will be a problem for growth.

In August, the European Central Bank stepped up with outright monetary transactions, or OMTs, the open-ended program to purchase distressed eurozone government bonds. So far the program has been successful (without yet deploying any funds) in relieving market fears of a eurozone breakup and reducing sovereign bond yields in the periphery. This is a very important accomplishment. However, while it buys time for these

countries, it does not solve the underlying problems of too much debt, a lack of growth, and the competitive imbalance between core and periphery Europe.

Europe is now back in recession. Severe austerity has taken a toll on growth and appears to be counterproductive. It remains an open question whether European governments will be able to make the right decisions with respect to: growth policies, pursuing competitive balance, debt relief, and the fiscal and banking integration that is needed to hold together the single currency over the long run. As challenging as the politics are in the United States, the challenges are even greater in Europe where countries with different cultures and economic characteristics are being asked to give up some of their economic sovereignty. Solving these problems will take a long time and along the way they could trigger more serious social unrest. As in the United States, Europe’s problems are all about debt-related economic headwinds and the threat of political mishandling of a fragile economy. But in Europe, the problems are more complicated because the weaker countries don’t have the option of devaluing their currencies to improve their competitive position relative to Germany. Instead they must accomplish this with structural changes such as labor market reforms and real-wage cuts. One important distinction between the investment prospects for the United States and Europe is that European stocks are cheaper.

### *Japan*

Japan has not been in the headlines like Europe, but its government debt relative to GDP is about twice the level of Europe or the United States, and close to twice as high as it was 10 years ago. Private sector debt is also high. However, the country has largely been able to self-finance thanks to a high savings rate. But as the population ages, the savings rate is declining and the country is beginning to rely more heavily on foreign lenders. Moreover, having struggled with deflation off and on for many years, Japan is trying to reflate. While ending the long period of deflation is clearly a desirable goal, a byproduct of this period has been extremely low interest rates. Long-term government bond yields are under 1%. If inflation returns, Japan risks being caught in a debt trap where even a relatively modest rise in the borrowing rate on its massive government debt could result in sharply higher debt service costs that would widen its deficit and increase the rate of debt growth.

So the developed world continues to face significant debt-

related challenges. The solutions are not easy and there are no quick fixes. Failure could play out in various ways, from another financial crisis to sharply higher inflation several years down the road. A brighter spot is that developing countries are generally less indebted and growing faster. However, growth has slowed there as well, partly due to the impact of reduced demand from the heavily indebted developed countries. Then, of course, there is the Middle East—always a wild card and perhaps even more so right now with continued shifting sands from the Arab Spring, and the possibility of military conflict with Iran that would likely lead to an oil shock.

### *On an Optimistic Note*

An important part of our investment discipline is to challenge our own conclusions through lots of debate among our team and exposing ourselves to alternative points of view through our reading and working our extensive industry network. We recognize a variety of bullish factors that could drive stocks to strong returns over the next five years. These include:

- As we move further along in the deleveraging process, expected returns for stocks have improved as we anticipate a return to more normal earnings growth in the later years of our analysis.
- The passage of time has also meant that an enormous amount of froth has been taken out of stock prices. The stock market, as measured by the S&P 500, is at a level first reached 13 years ago and multiples are much more reasonable than they were.
- The risk of another financial crisis that leads to deflation has declined. Time has allowed for some healing, some deleveraging has happened, and Europe has made some progress. Over time, this should have some impact on investor risk-taking, especially if this trend continues.
- Relative valuations driven by the Fed's low interest-rate policies could continue to play a big role in stock returns going forward. Valuations are in a fair-value range on many absolute measures. If economic growth gradually improves, tail-risk fears subside, and as time further distances investors from the financial crisis, investors could find stocks far more appealing than bonds or cash.
- If politicians can agree upon a credible plan for long-term deficit reduction, that could go a long way toward mitigating concerns about future debt build-up and related policy errors. In the United States, the corporate sector is sitting on a lot of cash that could be

used for capital investment and hiring as some of the uncertainty recedes. In Europe, while fear of policy errors is justified, it is also possible that 2013 could see progress toward banking and fiscal union and a return to growth later in the year.

- The global economy has experienced some encouraging macro developments. In the United States, housing is now a driver of growth rather than a drag on growth. Credit markets also continue to improve with easier lending standards. And the labor market is slowly healing, though it remains historically weak. Outside the United States, the growth slowdown in the emerging markets may have ended and there are numerous signs that China's economy is picking up (though not to previous growth levels). Even Europe, currently in recession, could start growing again in the second half of 2013.

The odds of the bullish case playing out may be increasing. However, there is no easy road out of our debt bind and there are consequences to that reality. The only easy road would be robust growth, but this is close to a mutually exclusive condition with a deleveraging global economy. So despite somewhat improved odds of the bullish scenario, it is more likely that we see a slow-growth environment with a continuation of some aversion to risk. In this environment, corporate earnings will be challenged as growth through cost cutting has largely played out. Revenue growth will need to be a driver and ultimately that will depend on demand.

As to the point of low interest rates making stocks look cheap, we know that rates can't stay this low indefinitely, but if they do for many years it will mean that the economy has continued to be very weak, which ties back to our expectations for low earnings growth. And while we believe the risk of another financial crisis has declined, it remains higher than we would like it to be. We are reliant on public policy to make wise decisions in a highly politicized world. In Europe, solutions require one country's taxpayers bailing out another's (or several others'). And it requires populations sacrificing their standard of living to obtain those bailouts. This may work out in the end, but we don't think we should be quick to assume a happy ending. In the United States it requires compromise between Republicans and Democrats.

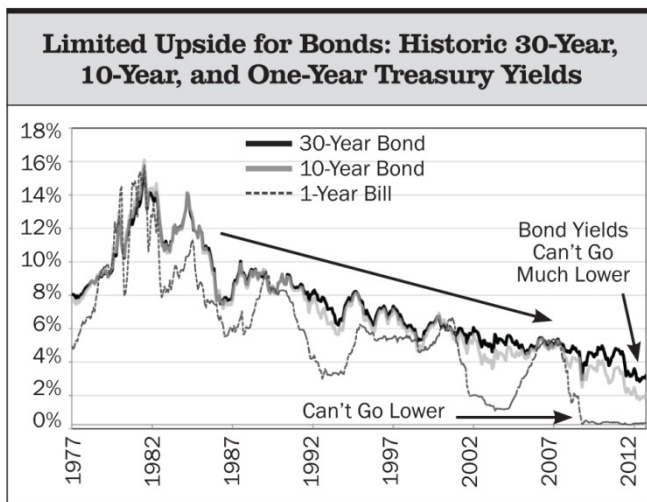


### Fixed Income

During 2012, our fixed-income positions added enormous value to our portfolios and helped to offset the impact of conservative equity positions in most of our portfolios. Our view is that there is still sizable potential for excess returns from our fixed-income positions in coming years, but the magnitude is likely to be less than what we captured in 2012.

What would shift our outlook toward a more bullish scenario? One factor would be policy decisions that credibly address the structural problems relating to debt and the need for economic growth. Positive surprises with respect to economic fundamentals would also be a significant development and would help us foresee an easier path to debt reduction.

We wish you a happy and profitable 2013.



Source: Yahoo! Finance. (Data as of 12/3/12.)

Most of the bond funds we hold pay much higher yields than the bond index and have less interest-rate risk. The lower-interest-rate risk is a function of lower duration and more credit exposure, which is likely to perform better in a rising interest-rate environment. However, yields have come down and this means lower potential returns than what we were able to capture in 2012 and over the past several years.

### Looking Ahead

The weight of the evidence still suggests global deleveraging will create an environment that will mute returns relative to its historical averages. And we also are aware that some policies already in place are virtual experiments—specifically Federal Reserve monetary policy. As the Fed buys assets their balance sheet is growing. Currently, their balance sheet equals 18% of GDP and heading much higher given their commitment to continue to buy Treasury and mortgage securities each month. These policies are unprecedented and are influencing financial asset returns higher. We all hope they will be effective and can ultimately be reversed without causing a harmful inflation problem down the road. But while we are not concerned about this risk in the near term, longer-term we can't be confident how this will play out.

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