EPIC
INVESTMENT MANAGEMENT

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2012 -- Same Old Story

Nothing much happened in the past year. Really.

Oh sure, stocks rose, interest rates declined, credit spreads narrowed. The US economy expanded modestly, the job market improved grudgingly. Commodities were mixed -- gold advanced, oil declined, and natural gas remains abundant. Corporate profits grew to record levels, as did corporate bond issuance. In the housing market, US home ownership fell to a 15-year low, apartment vacancies reached an 11-year low, and mortgage interest rates dropped to all-time lows. Stockton became California's largest city to file bankruptcy, but not its last. They really are different out there on the left coast.

Overseas, Europe and Japan remain mired in economic quicksand, both saddled by enormous debt burdens and challenging demographics. The Euro currency, and its concept of economic union, survived another year. Its long-term viability remains an open issue. In Europe's more responsible nations -- Germany, Switzerland, Denmark and Finland -- short term interest rates fell below zero, proving that people will pay to store their money in a safe place. Cyprus became the fifth EuroZone nation to need a bailout. This led to a mad rush to locate Cyprus on Google Maps.

China continues to serve as the world's economic growth engine, just with a bit less horsepower. Throughout the year, global economic forecasts proved to be overly optimistic. As yearend approached, the International Monetary Fund warned of an "alarmingly high" risk of a steep slowdown in global growth. When bureaucrats with little skin in the game employ the phrase "alarmingly high", people should take notice.

In Washington, policy debates morph into political theater, moving from government bailouts to debt ceiling limits, to credit downgrades, to fiscal cliff deadlines. A noxious blend of irresponsible behavior and dysfunctional institutions has become the norm. The Federal Reserve, ascending to the fourth branch of government, continues to run its printing press, acting as enabler to the spendthrifts of Congress and the White House. All the while, in a nation bloated by over-spending, savers are punished with ultra-low interest rates.

So why the dismissive headline?
Because, with few exceptions, these are either normal outcomes, or static conditions.

Stocks typically rise, advancing in two out-of-every three years. Interest rates have been falling for 30 years. Commodities are generally a mixed bag, and corporate profits seem to be a new levitation act. Japan has been in and out of recession for two decades. Europe, always its own worst enemy, alternates between growth, stagnation, and crisis. And why not? Its standard solution to every problem includes larger institutions, higher taxes, and tighter regulation. In a competitive global marketplace, that simply doesn't work.

Back home, our economy has underperformed its potential for five straight years, and cumulatively for over a decade. The "new normal" is not so new, but it is real, and it is painful. And Washington.. well, that is no way to run a government. As the fiscal time-bomb keeps ticking away, politicians plot a larger role for government while planning for their re-election. If you are going to do something not just poorly, but abysmally, at least have the decency to keep it small. Yet the beast just gets bigger and bigger.

So perhaps we misspoke. It's not that nothing much happened, just that nothing much changed.

Still, investors made money in 2012, and therein lie a few lessons.

First, markets can zig while economies zag. If stocks entered the year offering cheap prices and prepared for the worst, then the status quo was an acceptable outcome. The US economy grew, the global economy too, and Europe's issues, while ongoing, were contained. No problems were solved, but nobody imploded.

Second, there were notable exceptions to our domestic malaise. Housing values rose about six percent, the first advance in six years, while sales of existing homes reached a two-year high. The auto industry continued its US revival, with unit sales reaching the highest level since early 2008. Employment improved a bit, and apparently every little bit counts. The US consumer somehow found the strength and fortitude to keep spending. Don't ask how they do it, and don't ask about household balance sheets. Just hope it continues.

Finally, consider US corporate profits, at record levels and nearly two trillion dollars. There are exceptions to this statement, but for the most part it holds true:
As equity investors, we do not invest in nations or their economies. We invest in companies. Those record profits tell us companies have done quite well since the crisis of the great recession. So too their investors.

The challenge then, is to repeat. With nothing much changed, that is no easy task.

Happy New Year!!

Source:
Bloomberg
Wall Street Journal
Zillow

Tidbits..

Low wage businesses consider sub-30 hour employee workweeks to avoid Obamacare costs.
Unintended consequences, but not unforeseen.

Select corporate debt trades at lower yields than US Treasurys.
Why not, they are more credit-worthy.

EuroZone growth forecast cut again, 2013 expected to show stagnant economy.
US and global growth forecasts also cut.

US to become world's largest energy producer by 2017, says International Energy Agency.

Federal Reserve adopts latest version of quantitative easing, "QE4".
..try, try again.

US Postal Service reports 16 billion dollar loss for 2012, triple prior year.
Government in a nutshell: run a monopoly, lose big money.

Hewlett-Packard takes nine billion dollar write down of Autonomy purchase, alleges faulty accounting.
Not to mention weak due diligence, and a bad idea to begin with.

Companies use cash hoards plus bond issuance to fund accelerated dividends ahead of tax hike.

US slips from list of ten most prosperous nations.

Britain's tax hike on "millionaires" reduces millionaires, inadvertently cuts revenues.
No national borders for basic economics, government ineptitude.

Investment grade debt issuance in US tops one trillion dollars for 2012, annual record.
Global corporate debt issuance nears four trillion dollars, also a record.

US Treasury sells remaining holdings in AIG, acquired in 182 billion dollar bailout; agrees to sell holdings in GM, acquired in 'bankruptcy bailout', over next 15 months.
Moving away from the ownership game. Finally.

IntercontinentalExchange to acquire Big Board owner NYSE Euronext.
Teen-age startup to own centuries-old icon New York Stock Exchange.

OPEC annual oil revenues top one trillion dollars for first time.

Equities

With clockwork precision, US equities rose early in the year, suffered a meaningful correction, then rallied to close the year up nicely. Most major indices advanced by double-digit percentages.

SP 500 Index 2010-2012

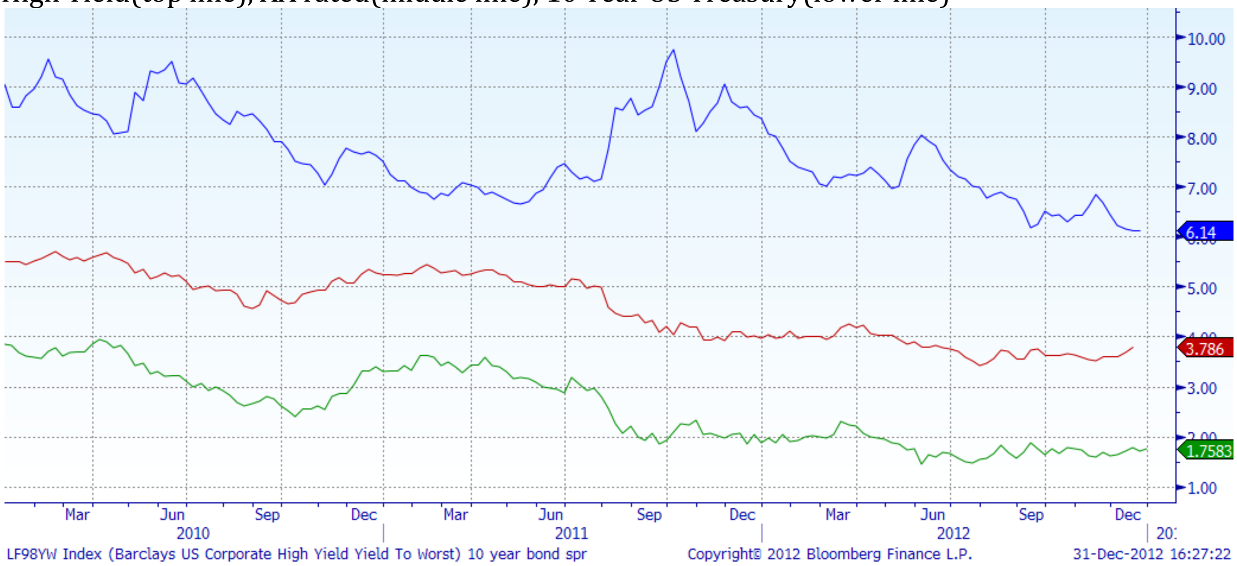
In one of the great high-wire acts, Europe, balanced on a tight-rope and bound by recession, avoided disaster. European stocks rallied out of their bear market and recorded gains similar to US markets.

Euro STOXX 50 index 2010-2012

Bonds

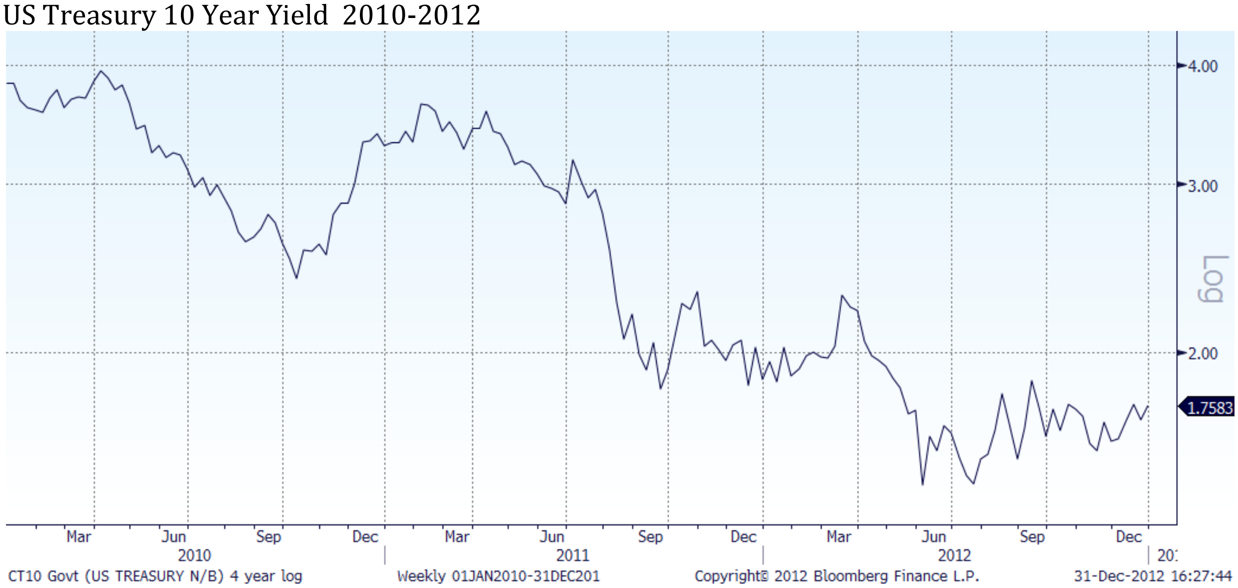
Confounding most experts, bond yields, with nowhere to go but up, continued to decline. High yield rates are at record lows, but still offer tempting spreads to yield-starved investors.

Intermediate Bond Yields 2010-2012
High Yield(top line), AA rated(middle line), 10 Year US Treasury(lower line)



Once again, Treasury yields dropped to historic lows, with the Federal Reserve providing ongoing support. Short and intermediate-term Treasurys are yielding less than inflation. One of these years, Treasury investors will be severely burned, but the timing is far from certain.

US Treasury 10 Year Yield 2010-2012



Commodities

With so much slack in the global economy, commodity inflation is not even part of the discussion.

CRB Commodity Price Index 2010-2012

Gold has advanced for 12 straight years, but prices peaked over a year ago. Globally, conditions still favor gold, but prices matter. Eventually the last buyer will be exhausted and the gold trade will come to an end. When that will occur is anybody's guess.

Gold Spot Price 2010-2012

Oil became less of a global commodity in 2012. US-based WTI prices were weak for much of the year, while Europe-based Brent Oil ended the year up slightly, and at a 19 dollar premium to WTI Oil. For US consumers, oil prices are not cheap, but the outlook has become benign.. a welcomed change.

West Texas Intermediate Oil Price 2010-2012

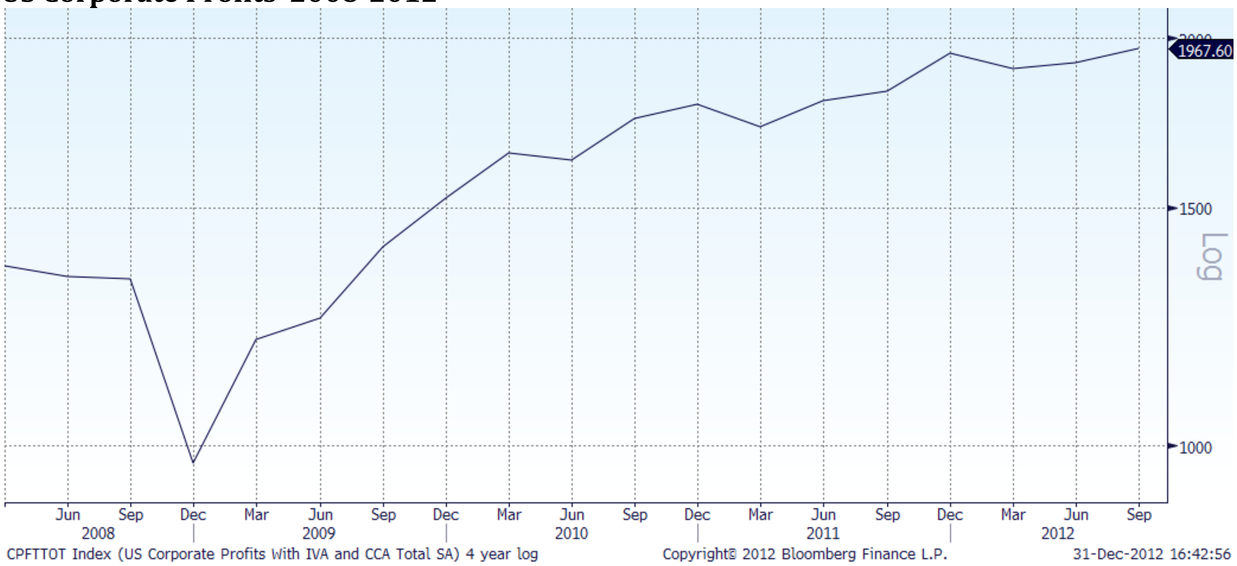
Brent Crude Oil Price 2010-2012

Advances in drilling technology and big capital investments continue to assure natural gas supplies are domestic, plentiful, and inexpensive.

Natural Gas Spot Price 2010-2012

Affordable US energy? Yes, compared to our global competitors. Thank a feeble economy for demand destruction, and energy companies' drilling for supply growth. The US is projected to become the world's largest energy producer within five years. Government efforts -- be it called conservation, green energy, or targeted investments -- are a side-show.

US Corporate Profits 2008-2012



US corporate profits, approaching two trillion dollars, have doubled since their recession bottom. Recently, profit growth has slowed to a crawl. Any stumble will endanger stock prices.

S&P Case-Shiller Composite Home Price Index 2008-2012

Housing prices -- after falling one-third from peak to trough -- have finally turned.
With low mortgage rates and a favorable own-versus-rent equation, the upturn is likely sustainable.