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# Fourth Quarter 2012


**Fig. 1 – S&P 500**

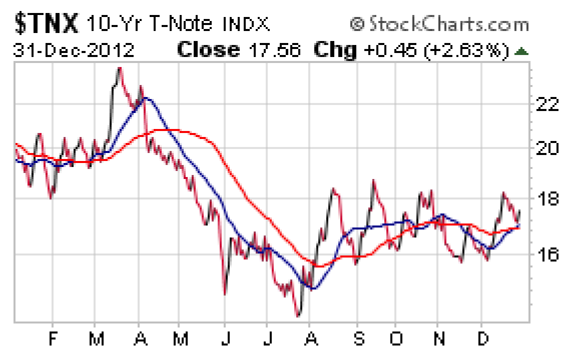


**Fig. 2 – 10 Year U.S. Treasury Yield**

US stocks posted mixed results in the fourth quarter as investors turned cautious towards the end of the year. The large cap S&P 500 fell 1.0% (**Figure 1**) while the S&P Small Cap 600 index rose 1.8%. Most international markets posted gains. The MSCI Europe, Australia and Far East Index rose 5.4%, and MSCI's Emerging Markets Index gained 6.1%. For the year, the S&P 500 and S&P Small Cap 600 advanced 13.4% and 14.8%, respectively.

Roughly 70% of S&P 500 companies exceeded third quarter earnings expectations, but aggregate earnings fell 0.9% over last year as materials and energy companies struggled with price declines. The financial sector had the strongest earnings growth, boosted by improving consumer and commercial credit metrics and firming home prices.

The U.S. elections in November dominated news early in the quarter, creating uncertainty that weighed on U.S. stocks. In addition, investors began to look ahead to the automatic tax increases and spending cuts that would take effect in 2013, unless our government reaches agreement on future tax rates. The uncertainty surrounding this impending "fiscal cliff" hurt investor sentiment, and stocks fell from late October through early November. Businesses pulled back on spending and investment early in the quarter. Consumer confidence, however, remained high until December, when retail sales figures showed signs of slowing.

U.S. economic reports in the quarter reflected this uncertainty. Manufacturing surveys generally declined, although service industry reports suggested relative strength. In addition, employment numbers were better than expected, with fewer new jobless claims reported and more new jobs created. The housing sector continued to firm. Home prices rose more than expected, and home builder confidence reached the highest levels in six years.

Overseas, stock performance picked up in the fourth quarter. Both developed and emerging economy indices posted solid gains. Investors appeared to look beyond the current sluggish European economy, and scooped up attractively valued foreign equities.

***Index returns taken from Standard & Poors and MSCI*.**

In what has been a hallmark of Chairman Bernanke's tenure, the Federal Reserve Board of Governors provided further clarity on its current bond purchasing program. They indicated their intention to maintain monthly purchases of mortgages until U.S. unemployment reaches 6.5%. This program will keep interest rates low, supporting both business and consumer lending, until investors have greater confidence in the economic recovery.

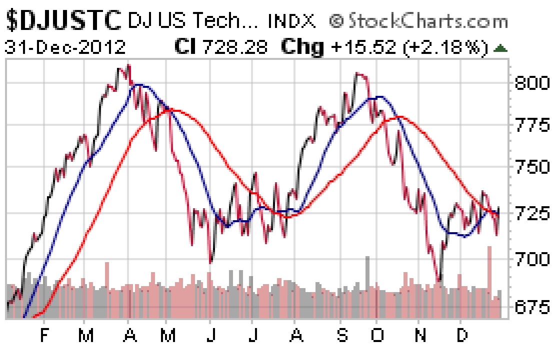

**Fig. 3 - Dow Jones U.S. Technology**

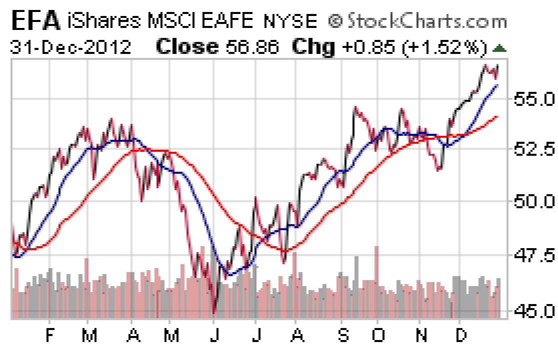

**Fig. 4 - MSCI Europe, Far East & Australia**

The outlook for 2013 has been clouded by at least three major concerns: the fiscal cliff, China and Europe. As of this writing, the U.S. Congress has passed a compromise bill that will remove much of that uncertainty. Though the increase in some tax rates may crimp consumer spending, the bill provides the certainty needed for businesses to plan their expenditures in the coming year. This may fuel greater spending on capital projects and productivity, helping technology stocks, many of which fell significantly in the fourth quarter (**Figure 3**).

In China, new leadership has pledged to maintain growth, and manufacturing surveys over the last three months have confirmed an acceleration of activity. European economies remain sluggish, with some in recession, but investors may have reason to look to the future with cautious optimism. The European Central Bank continues to play an activist role, supporting sovereign borrowing, and aid extended to weaker Eurozone members including Greece has helped the continent avoid financial meldown. International stocks have lagged the U.S. for most of the past three years, but with valuations generally lower and yields often higher than comparable domestic equities, international indices may be poised for another strong year (**Figure 4**).

Bonds posted solid returns in 2013, led by strong advances in investment grade and high yield corporates as well as international fixed income. However, with the U.S. 10 Year Treasury yield perched at 1.8% (**Figure 2**), bonds may have little room to appreciate, and investors may have to satisfy themselves with the returns supplied by interest payments. While the Federal Reserve's actions should help maintain a floor on bond prices, we recognize that bond returns may be muted in 2013.

We hope that your 2012 ended peacefully, and wish you a happy and healthy 2013. We look forward to speaking with you in the coming months.

Sincerely,

Kenneth M. Bernard, CFA