

Newsletter – January 2013

MARKET TRENDS 12/31/12

<u>US Stock Markets</u>	<u>YTD</u>	<u>Q4</u>
S&P 500 Index	16.00%	-0.38%
S&P MidCap 400 Index	17.88%	3.61%
S&P SmallCap 600 Index	16.33%	2.22%

<u>Int'l Stock Markets</u>		
EAFE Index	17.32%	6.57%
Emerging Mkts Index	18.22%	5.58%

<u>Fixed Income</u>		
Barclays Intermediate Gov't/Credit Bond Index	3.89%	0.35%
Barclays Capital Muni Bond 3 Year Index	1.86%	-0.02%

<u>Commodities</u>		
SPDR Gold Shares (NAV)	6.60%	-5.96%
Goldman Sachs Commodities	0.08%	-3.28%

<u>Real Estate</u>		
Dow Jones US REIT Index	18.93%	1.98%

<u>Yields</u>	<u>12/31/2011</u>	<u>12/31/2012</u>
T-Bills	0.01%	0.04%
10 Yr UST	1.88%	1.76%

Sources: Total Returns from WSJ Market Data Group, Standard & Poor's, Barclays

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Fourth Quarter Market Recap

In the fourth quarter, equity markets generally finished in positive territory but retreated towards the end of December as fiscal cliff negotiations in Washington D.C. bogged down with no resolution in sight. International equity markets, developed (MSCI EAFE Index) and emerging (MSCI Emerging Market Index), had the strongest quarterly returns, up 6.6% and 5.6% respectively. For domestic equity markets, mid caps (S&P Mid Cap 400 Index +3.6%) and small caps (S&P Small Cap 600 Index +2.2%) led the way while large caps (the S&P 500 Index -0.4%) fell slightly. For 2012, the major equity markets returned over 15% with large caps +16%, mid caps +17.9%, small caps +16.3%, international developed +17.3% and emerging markets +18.2%. Even with double digit equity returns, December was the 20th consecutive month of net outflows from U.S. stock mutual funds or \$151.6 billion in 2012 (according to the Investment Company Institute). Overall, equity markets were extremely resilient in spite of the global economic slowdown, U.S. political gridlock and budget deficits, Euro Zone debt load, and political unrest in the Middle East. Volatility was low by historical standards, and the market seemed fatigued by the news flow. On a positive note, corporate earnings continued to be solid especially relative to valuations and dividend yields, which are still above U.S. treasury yields – generally a positive sign. However, we did see a significant reduction in earnings expectations in the quarter for the coming year which we are monitoring.

With the Federal Reserve continuing to hold down U.S. interest rates, returns on most types of bonds were generally anemic. During the fourth quarter, domestic government bond returns were flat while municipal bonds and mortgage-backed securities finished with slight losses. Domestic investment grade and high yield corporate bonds produced robust returns for the quarter and for 2012. International developed market bonds were negative for the quarter but still up over 4% for the year while emerging market bonds produced solid fourth quarter results and were up over 15% for the year helped by healthier economic fundamentals relative to their developed market counterparts. Bond mutual funds continued to receive significant cash inflows with an estimated \$306.2 billion for the year.

Commodities fell in the quarter as global economic activity slowed, with the Goldman Sachs Commodity Index -3.3% and gold -6% in the quarter. For 2012, gold was up 6.6% while the broader commodity index was flat for the year. Real estate had another stellar year with the Dow Jones U.S. Real Estate Index up 2% in the quarter and finished 2012 up 19% fueled by a real estate market resurgence.

From Brink to Brink – “Kinda Sorta”

The dysfunctional policymaking of Washington D.C. continues to reach new lows as a deal, “sorta”, was inked, “kinda”, on New Year’s Day, to avoid the most deleterious effects of the 12/31/12 fiscal cliff deadline. We have all heard politicians

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“...volatility actually went down.”

“Is this complacency dangerous?”

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compared to children these past few months, but most of the children we have met deal more reasonably with conflict resolution than our elected officials working in Washington. We have also seen massive mudslinging from both sides - “the crazy, conservative tea party,” tight fisted and without compassion, and “the crazy, free spending liberals” unaware of consequences - and of course both are accused of driving our country to ruin. Call us crazy, but we actually think people from both sides want what is best for our nation. Name calling and verbal parrying can be fun - just note the House debates in Spielberg’s *Lincoln* - but our belief at Shorepoint is that we could take our most far right and far left clients and have them come together and make a deal on most of these fiscal issues within 24-48 hours. In short, it seems as if our representative democracy is in a phase where the system itself generates a laborious process of haggling where progress, not real progress but “kinda sorta” progress, is achieved by deadlines, backroom late hour deals horse traded by old, longtime enemies (“kinda sorta”) like Vice President Joe Biden and Senator Mitch McConnell.

We know this is theater. Like pro wrestling fans and soap opera junkies, many of us still watch. Interestingly, the market has begun to yawn. There were a couple of significant rising and declining market days prior to the end of the year, but volatility actually went down. The VIX Index, which measures fear and volatility in the market, declined even as politicians blasphemed one another late into the last evenings of 2012. In other words, market participants assumed that U.S. politicians would come to a compromise before triggering the onerous dictates of the fiscal cliff. Is this complacency dangerous? Is it ludicrous to expect our leaders to deal with each other and make compromises as a course of normal business in the House and Senate? We will see as another “brink” awaits us shortly in the form of the upcoming U.S. Debt Ceiling debate - the second act of the play following Act I’s Fiscal Cliff. Does the nature of the American Dream and how we live day to day hang in the balance? “Kinda sorta”, so tune in!

But first let’s review what actually happened from the compromise of the fiscal cliff - The Taxpayers Relief Act - wink, wink, nudge, nudge; ***taxes are actually going up on just about everyone in 2013*** and U.S. deficit projections increase by \$4 trillion over the next ten years, according to the Congressional Budget Office.

Major Details of Deal

As part of the year-end “fiscal cliff” negotiations, a deal was reached to maintain permanently the 2012 tax rates on all but high income earners. Long term capital gain and dividend tax rates remained at 15% for couples making less than \$450,000. However, couples making more than \$450,000 will be taxed at 20% and may also be subject to an additional 3.8% net investment tax. Couples earning over \$450,000 will be taxed at 39.6% on ordinary income. For couples making over \$300,000, personal exemptions and deductions (e.g. mortgage interest and charitable contributions) will be reduced. ***One major positive for all income earners is the permanent fix to the AMT (alternative minimum tax), now indexed to inflation and thus avoiding the annual “patch”.*** However, the

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temporary payroll tax reduction of 2% was not extended, which may be a drag on discretionary spending. Other major changes are reflected in the accompanying table including tax increases resulting from the Affordable Care Act. Obviously, the impact of the American Taxpayer Relief Act of 2012 to individual client situations is complex, and we encourage clients to discuss what it means to them with their tax advisor.

New Tax Rates

	<u>2012</u>	<u>2013</u>
Ordinary Income, max. rate	35.0%	39.6% ²
Income Threshold	\$388,350	\$450,000 ¹
Dividends & Long Term Capital Gains, max. rate	15.0%	20.0% ²
Income Threshold	Above \$70,000	\$450,000 ¹
Medicare Tax on Investment Income	--	3.8%
Income Level	--	Above \$250,000
Hospital Insurance Tax	1.45%	2.35%
Income Level	All	Above \$250,000
Phase-out of Personal Exemption and Deductions	--	\$300,000
Federal Estate & Gift Tax Exemption	\$5,250,000	\$5,250,000
Max Rate above \$5m	35.0%	40.0%
Payroll Tax	4.2%	6.2%
Employer Health FLEX Plan Contribution Limit	\$5,000	\$2,500
Medical Itemized Deductions	Above 7.5% of AGI	Above 10% of AGI

¹For couples.

²Plus net investment income tax of 3.8% for certain high income taxpayers, due to Affordable Care Act.

The Next Brink — Debt Ceiling

The compromise on tax rates addressed the immediate tax expirations but does not address the broader budget issues of deficits which will require spending cuts and entitlement reform. The January 1st deal delays the sequestration, a series of automatic, across the board cuts in federal spending, for two months. The sequestration will be a major battle to this year’s docket of apparently inevitable congressional squabbles over money with the other two being the debt ceiling and a continuing budget resolution. The political and fiscal uncertainty in the U.S. appears to be inhibiting business confidence, spending and hiring. This inevitably may lead to increased volatility in the financial markets as a deal is unlikely to be consummated until absolutely needed or on the next brink.

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What it means for our clients?

Although government negotiations have become a larger part of the daily news, the VIX being so low might indicate investor complacency and the potential for profit taking or a market correction. However, the market might rightly assume again that leaders will deliver compromise(s). We do not believe in altering long-term allocations for clients based on these short-term, unpredictable factors.

While the budget negotiations add tension to the markets, we want to highlight some macro positives. We are starting to see **a rebound in the housing market** - prices are increasing and activity is starting to pick up. The impact to the economy from a housing pick up may be **significant for employment, for the construction industry and for other indirect beneficiaries such as: financial services, furniture and appliances, building products, etc.** Other positives are the **rebound in the auto industry, the growth in the energy infrastructure and the return of some manufacturing back to the U.S which should lead to U.S. job and economic growth.** The Federal Reserve continues to be committed to keeping interest rates low. While a negative for savers, it does keep **lending rates low for consumers (house and car financing) and businesses.** The other impact of low interest rates on investments is that eventually investors may assume more risk, initially moving from cash (money markets and CDs), to bond mutual funds and then to equities. We may be experiencing the beginning of this process as equity mutual funds just had the first positive weekly cash inflow since 2007. For the most part, tax increases on investment income (dividends and capital gains) were less than the worst case scenarios and continue to make dividend paying stocks attractive. **We believe that our focus on dividends lowers portfolio risk and fulfills a clear need for clients – income generation.**

As we discussed in the last newsletter, Shorepoint tries to be disciplined and use corrections as opportunities to position your portfolio for the future while considering your individual goals and objectives. We continue to be mindful of the macro issues in the markets as we compose and manage your portfolio. Markets will still correct which is a normal functioning of financial markets. After all, we had almost 10% correction in 2012, but still finished up over 16%. As we have stated previously, the market climbs “a wall of worry” - in other words - markets go up when worries are plentiful and not the reverse. Overall, more clarity on the fiscal issues may lead to a boost in business spending and hiring following a deferral period by corporations over the last couple of years.