BELL TOWER
ADVISORS

01/03/13: A Year of Anxiety (And Excellent Returns)!

Many of you reading this may be surprised to discover that 2012 was a great year to be an investor. Amid all the unhappy headlines, anxiety over America's finances, a highly-partisan presidential election, worries about the Eurozone and the potential for recession, stocks quietly rewarded patient investors with double-digit gains. Both here and abroad.

The Wilshire 5000--the broadest measure of U.S. stocks and bonds--rose 16.06% for the year. The comparable Russell 3000 index rose 16.42% in 2012.

The other stock market sectors moved in a very similar pattern. Large cap stocks, represented by the Wilshire U.S. Large Cap index, were up 15.74% for the year. The Russell 1000 large-cap index gained 16.42%, while the widely-quoted S&P 500 index of large company stocks gained 13.41% in 2012.

Meanwhile, the Wilshire U.S. Mid-Cap index rose 16.25% after gaining 3.92% in value in the fourth quarter of the year. The Russell midcap index was up 17.28% for the year.

Small company stocks also posted significant gains. The Wilshire U.S. Small-Cap finished the year up 18.76%. The Russell 2000 small-cap index finished the year up 16.35%. The technology-heavy Nasdaq Composite Index was up 15.91% for the year.

Every single industry sector in the S&P 500 except utilities posted gains in calendar 2012, led by telecommunication stocks (up 12.50%), information technology (up 13.15%), consumer discretionary goods manufacturers (up 21.87%), and financial stocks (26.26% gains for the year).

International stocks provided comparable returns. The broad-based EAFE index of larger companies in developed economies rose 13.56% for year, after a strong 5.38% quarterly return. The stocks across the Eurozone economies returned a robust 17.45% for the year, outpacing the Far East economies (9.11% for 2012). The EAFE Emerging Markets index of lesser-developed economies rose 15.21% for the year.

The dark clouds were relatively small. Commodities barely eked out positive returns, with the S&P GSCI index rising 0.08% for the year, led by agriculture (up 6.46%) and precious metals (up 6.21%). Energy stocks were down 1.37%.

Real estate investments were among the biggest gainers, with the Wilshire REIT index posting a 17.59% gain for the year.

Investors who believed the negative headlines and pulled their money out of equities into safer havens suffered accordingly. Treasury bonds are still moored in near-record low-return territory; if you lend the U.S. government money by purchasing a 2-year Treasury, your current coupon rate is 0.25% a year.

BELL TOWER
ADVISORS

Five-year yields are still below 1% (0.72%), and 10-year (1.76%/year) and 30-year (2.95%) T-bonds are not in danger of enriching their purchasers. Muni bonds are sporting aggregate yields of 0.20% (1-year), 0.29% (2-year), 0.84% (5-year) and 1.69% (10-year). The aggregate of all AAA corporate bonds is yielding 0.72% for bonds with a five-year maturity; 1.76% if you go out ten years.

It is helpful to remember that the year started off with dire predictions and a lot of uncertainty about the prospects for the U.S. and global economies. The housing market was weak, unemployment was high, the Euro economies were in recession (or, in the case of Greece, bankrupt), and it was not hard to find blogs and even economic reports that predicted a catastrophic year. Investors who ignored the gloom and doom were rewarded with returns approximately twice as high as the historical averages.

Meanwhile, America is breathing a sigh of relief at the just-passed "fiscal cliff" deal in Washington. As you know by now, the Senate passed a measure which would avoid a return to the tax rates of 2001 and impose spending reductions across the federal government--which the Congressional Budget Office has estimated would reduce American economic activity by four percentage points, almost certainly leading to a recession. Details are just out, and it appears that our lawmakers are creeping closer to reality about how to define "the rich;" rather than the $200,000 threshold (single taxpayers) or $250,000 in adjusted gross income (joint returns), included in many prior proposals, "the rich" are now defined as making more than $400,000 (single) or $450,000 (joint). Those persons will see their highest marginal tax rates go up to 39.6%, and pay capital gains and taxes on dividends received at a 20% tax rate, rather than the previous 15%.

The Senate bill also maintains the current $5 million estate tax exemption ($10 million for couples), but would raise the tax rate for money transferred to heirs above that amount. It also eliminates the two percentage point cut in the Social Security payroll tax--a stimulus measure enacted in 2010--and makes $24 billion in federal spending cuts, while giving Congress two additional months to decide what to do about $109 billion of automatic spending cuts that were scheduled to begin taking effect at the start of the year.

It is clear that the U.S. and global economy are still in a slow-growth recovery period, but there is some reason to be optimistic that 2013 could be a turning point in the long climb out of the Great Recession. After six years of decline, the housing market appears to have finally bottomed out in 2012. The inventory of homes on the market is down 20% or more from a year ago, and sales of existing single-family homes jumped 11% in 2012. Bank of America Merrill Lynch economies expect at least a 3% gain from the housing sector this year, which would flip this large sector of the economy from a drag on economic growth to a boost, along the way creating construction jobs and boosting sales of appliances and other products that go with home purchases.

At the same time, the National Association for Business Economics is forecasting a slow but steady increase in employment this year, and consumer debt is shrinking. The still-weak global economy seems unlikely to cause gas prices to rise dramatically, and some economists have pointed to the record amount of money parked in Treasuries (hence the low rates), which, if people become more confident in the stock market, could be redeployed into equities and cause prices to rise.

None of this, of course, is guaranteed, and it would be nice if our government policymakers would finally settle on a plan to reduce the federal debt without wrecking the economy in the process. But those who ignored the optimistic outlook for 2012, and looked at the headlines instead of the millions of workers who got up every day and went to work to build (or rebuild) the economy, probably regret it today. Just remember, the same could be true for 2013. Does it make sense to risk missing it?

Wilshire index data: http://www.wilshire.com/Indexes/calculator/

Russell index data: http://www.russell.com/indexes/data/daily_total_returns_us.asp

S&P index data: http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usduf--p-us-l--

Nasdaq index data: http://quicktake.morningstar.com/Index/IndexCharts.aspx?Symbol=COMP

International indices:
http://www.mscibarra.com/products/indices/international_equity_indices/performance.html

Commodities index data: http://www.standardandpoors.com/indices/sp-gsci/en/us/?indexId=spgscirg--usd----sp------

Treasury market rates: http://www.bloomberg.com/markets/rates-bonds/government-bonds/us/

Aggregate corporate bond rates: http://finance.yahoo.com/bonds/composite_bond_rates

Employment rate: http://www.washingtonpost.com/business/economy/us-adds-96000-jobs-in-august-unemployment-rate-drops-to-81-percent/2012/09/07/30374bfa-f8e9-11e1-8398-0327ab83ab91_story.html

Economic data: http://www.usnews.com/news/blogs/rick-newman/2012/12/17/how-the-2013-economy-will-be-different

http://money.cnn.com/2012/12/01/pf/economic-outlook-2013.moneymag/index.html

Margie