Marathon Investment Management

MAY 2012

"Anything is possible and the unexpected is inevitable. Proceed accordingly" – Jason Zweig

Wow!

We have all heard the phrase 'the market likes to climb a wall of worry.' Well, it has so far this year! We have witnessed the biggest first quarter advance since 1998 for the Standard & Poor's 500 (S&P 500) Index. More than $3.6 trillion was restored to U.S. equity values since the S&P 500 hit last year's low in October[1]. Up 8.1% for the quarter, the Dow Jones Industrial Average (DJIA) closed at 13,212, its best first quarter point gain in its long history[2]. The tech-heavy NASDAQ Composite closed at 3,091, leaving it up 18.7%[3]. Please review the following table[4]:

Index	**3/31/2012 Close**	**1st Quarter Return**
DJIA	13,212	8.1%
NASDAQ Composite	3,091	18.7%
S&P 500	1,408	12.0%
S&P Mid-Cap 400	994	13.1%
Russell 2000 (Small-Cap)	830	12.1%
Total Stock Market (formerly Wilshire 5000)	14,753	12.5%

International challenges seem to continue to evolve but not necessarily improve. On January 30, twenty-five of the twenty-seven European Union countries agreed to a German-sponsored pact designed to ensure budget discipline among Europe's economies. The goal was to restore financial market confidence in the outlying EU nations – Ireland, Portugal, Greece, Spain, Italy, and France. By achieving this, all of the above will be able to continue to finance their debt at reasonably low interest rates while gradually reaching a balance between government spending and revenue.

Recently, Spain however, is attempting to back out of its commitments for 2012. In the Netherlands, a coalition government fell due to the EU terms while the unions in Ireland have come out opposing the treaty in an upcoming referendum. Finally, in France, with an upcoming May 6 presidential election, the challenger Hollande, who leads in the polls, has come out for renegotiation of the EU pact. On April 24, the Bank of Greece forecast that the Greek economy will shrink by about 5% in 2012 – its fifth consecutive year of contraction[5]. Unemployment for Greece may rise to 19% for the year, slightly better than the 24% projected for Spain.

Last year the Dow Jones Global Index (ex. U.S.) fell 16.3% yet consider the results for the 2012 first quarter[6]:

Index	**3/31/2012 Close**	**1st Quarter Return**
DJ Global	255	11.5%
DJ Global (ex. U.S.)	205	10.8%
Americas:		
Brazil – Sao Paulo Bovespa	64,510	13.7%
Canada – Toronto TSE 300	12,392	3.7%
Mexico – IPC All-Share	39,521	6.6%
Chile – Santiago IPSA	4,671	11.8%
Europe:		
France – CAC40	3,423	8.4%
Germany – DAX	6,946	17.8%
Israel – Tel Aviv	1,124	3.6%
Italy – FTSE MIB	15,980	5.9%
Spain – IBEX	8,008	-6.5%
U.K. – FTSE 100	5,768	3.5%
Asia:		
China – Shanghai Composite	2,262	2.9%
Hong Kong – Hang Seng	20,555	11.5%
India – Bombay Sensex	17,404	12.6%
Japan – Nikkei	10,083	19.3%
Singapore – Straits Times	3,010	13.8%
South Korea – Kospi	2.014	10.3%
Taiwan – Weighted	7,933	12.2%

Despite a slowing Chinese economy; despite European disunity and growing debt, unemployment, recession, and political uncertainties; despite simmering disputes with Iran and Russia, and despite expectations of lower corporate earnings growth here and overseas, the markets have shown their defiance to normative expectations. In fact, the S&P 500 from an October 3, 2011 low of 1,099 rose gradually to a recent high April 2, 2012 of 1,419 or 29.11%. How many market analysts predicted that?

Going Forward

On Friday, April 27th the Commerce Department reported U.S. gross domestic product grew by 2.2%[7]; expectations were 2.5% by Wall Street analysts. So far first quarter earnings for companies that make up the S&P 500, of which 275 have reported, have grown 7.1%. Nearly three-quarters have beat analyst expectations[8]. We are seeing U.S. companies – and have reported such in previous letters – more productive, more profitable, and flush with cash and less burdened by debt at high interest rates. An analysis by the Wall Street Journal of corporate financial reports found that "cumulative sales, profits and employment last year and members of the S&P 500 stock index exceeded the totals of 2007, before the recession and financial crisis[9]."

Consumers are the engine of the U.S. economy, accounting for about 70% of economic demand. For March, retail sales increased 0.8% after a 1% gain in February – more than double forecasts by Wall Street. Oil prices along with auto sales also spiked in March. Light car and truck sales rose nearly 13% higher than a year ago[10]. General Motors said it sold more than 100,000 cars that get 30 or more miles per gallon, its highest ever and nearly half of the 231,052 vehicles it sold[11].

The March retail sales jump was led by a 3% gain at stores selling building material and garden equipment. Other impressive gains were realized in furniture, gas station sales, and at electronics chains. Home-improvement sales were 14% higher in March than from a year earlier – the biggest annual rise in more than six years[12].

Interest rates are remaining relatively calm with a slight increase for the quarter. Since January, the Federal Reserve has been saying it will keep its easy-money policies in place until late 2014. The goal remains to keep interest rates for businesses and households low in an effort to spur borrowing and economic growth. As of quarter end, the 10-year Treasury note closed with a yield of 2.22%; the yield as of year-end 2011 was 1.87%[13]. Please refer to the following[14]:

Bond	**3/28/12 Yield**	**12/28/11 Yield**	**3/30/11 Yield**
6-month CD	0.22%	0.22%	0.29%
1-year CD	0.34%	0.34%	0.47%
5-year CD	1.15%	1.15%	1.31%
3-month T-bill	0.08%	0.01%	0.09%
6-month T-bill	0.14%	0.05%	0.17%
5-year T-note	1.03%	0.91%	2.20%
10-year T-note (inflation protected)	-0.13%	-0.11%	0.98%
30-year T-bond	3.31%	2.92%	4.50%
Corporate Industrial 25- 30-year A rated	4.39%	4.26%	5.50%
Corporate Financial 10-year A rated	3.65%	4.17%	4.70%
Tax-exempt 1-year G.O. A rated	1.04%	1.06%	1.15%
Tax-exempt 1-year G.O. AAA rated	0.19%	0.22%	0.33%

Due to the low domestic rates investors have been buying not only dividend paying stocks both domestic and international, but foreign bonds as well. Demand for emerging market debt has soared over the last 12 months. Over the last year ending April 16th, the JP Morgan Emerging Market Bond Global Diversified Index, an index of emerging-market hard currency debt, has returned 10.9% in dollars[15]. Unlike Europe, U.S. investors and managers are becoming more confident with emerging market debt from high growth nations such as Brazil and Turkey.

Demand by investors for low quality "junk" issues has also continued to grow. Some 130 U.S. "junk-rated" companies – from CIT Group to Hertz Global Holdings – have sold $75 billion in "junk" bonds this quarter, according to Thomson Reuters[16]. This issuance is a record for any quarter going back to 1980[17].

Concerns going forward that further create ongoing uncertainty for both the equity and debt markets include:

1. Tepid consumer confidence. The index according to the Conference Board fell to 69.2 in April from a revised March reading of 69.5[18].
2. Real estate values. Home prices dropped in February in most major U.S. cities for a sixth straight month[19]. Furthermore, home prices have fallen 35% since the housing bust according to Standard & Poor's /Case-Shiller[20].
3. Continued deficit spending and a growing debt of more than $15 trillion.
4. GDP growth rate at a very mild 2 – 2.5% for 2012[21]. The initial estimate for the first quarter came in at 2.2%[22]. The U.S. has not had a single quarter of 4% GDP growth for a record six straight years[23].

The Challenge

The March employment report was like "a shot across the bow," as the nation created just 120,000 jobs – or little more than half the forecasted increase of 205,000[24]. Global predictions of GDP growth for 2012 are 3.2% according to Kiplinger[25]. Even after a rather steady incline for the first quarter, we anticipate greater market volatility going forward. As the market rose in March, we witnessed investors withdraw $9.6 billion from stock funds[26]. Our clients hear from us regularly about the opportunity cost of market timing!

The recommendation is straight forward: save and invest more. We continuously read studies of ours and younger generation Americans who are not saving enough for retirement or for even maintaining a quality lifestyle for future decades. We have clients who are earning six digit figures and still "need" to make withdrawals out of their investment accounts. Why?

Acknowledging the truth about spending and saving (investing) is always the first step to rectification.

A June 2011 study conducted by Principal Insurance showed that 73% of their clients stretched the truth when claiming they were living within their means, while their high level of personal debt came in second[27]. Today, people tend to make decisions for immediate gratification unlike previous generations. According to the Principal study, many young people view retirement as an 'abstract concept.' With a slow growth economy and higher inflation looming, we all need to reevaluate where we are now, where we are headed, whether our goals are realistic, and determine our game plan to achieve those goals. We're ready to help! Call us!

Closing Thoughts

I met with a relatively new client this afternoon. She mentioned to me that her accountant felt it was timely to start building up a portfolio of dividend paying stocks and stock funds. I smiled when I heard that. Just days before our meeting, Exxon Mobil announced its $10.7 billion annual dividend distribution, making it the largest dividend payer worldwide[28]. Exxon Mobil is raising its dividend 21% this year and has increased its dividend for 30 consecutive years.

Last month Apple Inc. initiated its dividend payout announcing a $9.9 billion distribution, while IBM enhanced its quarterly payment by 13% to $0.85 a share from $0.75. For IBM this will be its 17th consecutive year raising its dividend. According to Standard & Poor's the S&P 500 index, on average, will raise its cumulative dividend 15% this year[29]! I told my client, based on our approach for total return, her accountant was 'right on the mark.' Of course we have been promoting total return investing for many years – not just for retirement and growth of income, but for a more conservative equity growth strategy over time.

On behalf of our staff and myself we wish you an enjoyable and financially successful summer season!

Yours,
George Gumbiner

Footnotes

[1] www.bloomberg.com, "S&P500 Posts Biggest First-Quarter Gain Since 1998," 4/1/12
[2] The Denver Post, "Stocks Rack up Stellar Gains as First Quarter Draws to End," pg. 7K, 4/1/12
[3] ibid.
[4] Wall Street Journal, "Major U.S. Stock-Market Indexes," pg. C4, 4/2/12
[5] money.msn.com, "Can a French Socialist Save Europe," 4/20/12
[6] Wall Street Journal, "International Stock Indexes," pg. C4, 4/20/12
[7] Barron's, "Apple and Amazon Help Lift NASDAQ 2.3%," pg. M3, 4/30/12
[8] ibid.
[9] Wall Street Journal, "U.S. Firms Emerge Stronger," pg. A1, 4/9/12
[10] Wall Street Journal, "U.S. Auto Sales Sizzle" pg. B1, 4/4/12
[11] ibid.
[12] Investors Business Daily, "Retail Sales Strong in March," pg. A1, 4/17/12
[13] Wall Street Journal, "Corporate Borrow Rates at Yields," pg. B5, 1/1/12
[14] Value Line Selection, "Opinion Selected Yields," pg. 1661, 4/6/12
[15] Wall Street Journal, "Emerging Markets: The Allure of Bonds," pg. R5, 4/30/12
[16] Wall Street Journal, "Junk Bonds Feed a Hungry Market," pg. A1, 3/30/12
[17] ibid.
[18] www.marketwatch.com, "April Consumer Confidence Declines," 4/24/12
[19] www.yahoo.com/finance, "U.S. Home Prices Drop for 6th Straight Month," 4/24/12
[20] ibid.
[21] The Kiplinger Letter, "Economic Forecasts," Vol. 89, No 16, pg. 1, 4/20/12
[22] Investors Business Daily, "GDP Growth Slows as Investment Falls," pg. A1, 4/30/12
[23] ibid.
[24] The Value Line, Investment Survey Selection & Opinion," pg. 1629, 4/20/12
[25] The Kiplinger Letter, Vol 89, No 17, pg. 1, 4/27/10
[26] Investors Business Daily, "Stock Fund Outflow Hits 9.62 Bil," pg. A11, 4/27/12
[27] www.investmentnews.com, "Advisors' Two Toughest Words: "Save More," 7/24/12
[28] Barrons, "It's a ??," pg. 22, 4/30/12
[29] www.smartmoney.com, "Dividend Investors to Get 15% Raise," 3/20/12