TW Advisors

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Second Quarter 2012

Stock markets retreated in the second quarter of 2012 but the damaged was minor due to a rally in June. After falling almost -9% by June 4th the S&P 500 ended the quarter off by only -2.75%. Our emphasis of Blue Chip stocks contributed to our outperformance during the quarter. Small and mid-cap stocks did a little worse, down around -4%, but the real damage continued to be European and emerging market stocks, falling by about -8% and -10%, respectively. The All World Index (ex US) fell over 16% (see chart below).

There were plenty of reasons for stocks to pull back as almost all the macro economic news was poor. Europe is a mess: Greece teetered on leaving the eurozone, Spanish and Italian yields marched higher, and European banks are under duress. China, once the bright light on the economic scene, is slowing much more quickly than previously thought. Despite increasingly poor data in the U.S., especially regarding employment, our elected officials are doing nothing about the fiscal cliff, which if not addressed could negatively impact growth next year by up to 5%. All of these headwinds finally started to affect corporate earnings as an unusually large number of companies lowered earnings forecasts.

One theme that emerged during the quarter was the relative haven status of U.S. Blue Chip stocks compared to other equity indices. At the bottom of the decline in the quarter the S&P 500 was still in positive territory for 2012 and was 15% higher than last year's lows. In contrast, several European and emerging markets were establishing new lows. Moreover, volatility is subdued compared to recent history. The S&P 500 has not had a daily move above 3%, for the first time since 2006. We think this statistic reflects the fact that individual investors have largely stayed away from stocks since the financial crisis, and thus are not providing the fuel for panic selling.

We took advantage of the pullback to buy several high quality stocks with the cash we had previously accumulated. Despite all the bad news detailed above we believed the worst of the sell-off was over, in part because sentiment had gotten so negative. We've already detailed the carnage in stocks worldwide, but the fear was even more evident in the credit markets. Germany even sold short-term Bunds at a negative interest rate! **There comes a point when most of the bad news is reflected in the price, and contrarians should turn bullish if prices are reasonable**. Our purchases were generally concentrated in dividend-paying companies riding secular growth trends, with strong balance sheets and attractive valuations.

Despite the gloom not all the news was bad. ADP's employment survey was much better than the government's and may be a better gauge of the health of hiring. Most U.S. states collected more revenue than forecasted, reducing budget deficits that have persisted since the recession. Lower oil prices are a real benefit to the middle-class. Several central banks, including China and the European Central Bank (ECB), lowered interest rates. Most importantly, euro leaders made meaningful changes at their last crisis meeting. The most important were the agreements to allow the eurozone's rescue funds to recapitalize vulnerable banks directly, which should break the mutually destructive links between banks and sovereigns. Additionally, the ECB will have responsibility for a new system of European banking supervision, as a step towards what many hope will be a true banking union, including euro-wide deposit insurance and the establishment of some form of euro bond market.

Obviously, the European debt crisis is a long way from being resolved and a multitude of things can go wrong from here. Plus, the markets have already had a nice rally from recent lows. All of which is to say that our message of the importance of navigating the markets is still paramount. If progress reverses in Europe, if we don't deal with the fiscal cliff in the U.S., or if prices rally too far, too fast, we will not hesitate to raise cash. But, in the meantime, we expect to continue to own a diversified portfolio of high-quality, dividend-paying stocks.

James Tillar, CFA   Steve Wenstrup

MSCI ALL-World Index (ex-U.S) fell over 16% from its peak in early March 2012

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Chart source: TheLeutholdGroup