VIGILANT Capital Management, LLC

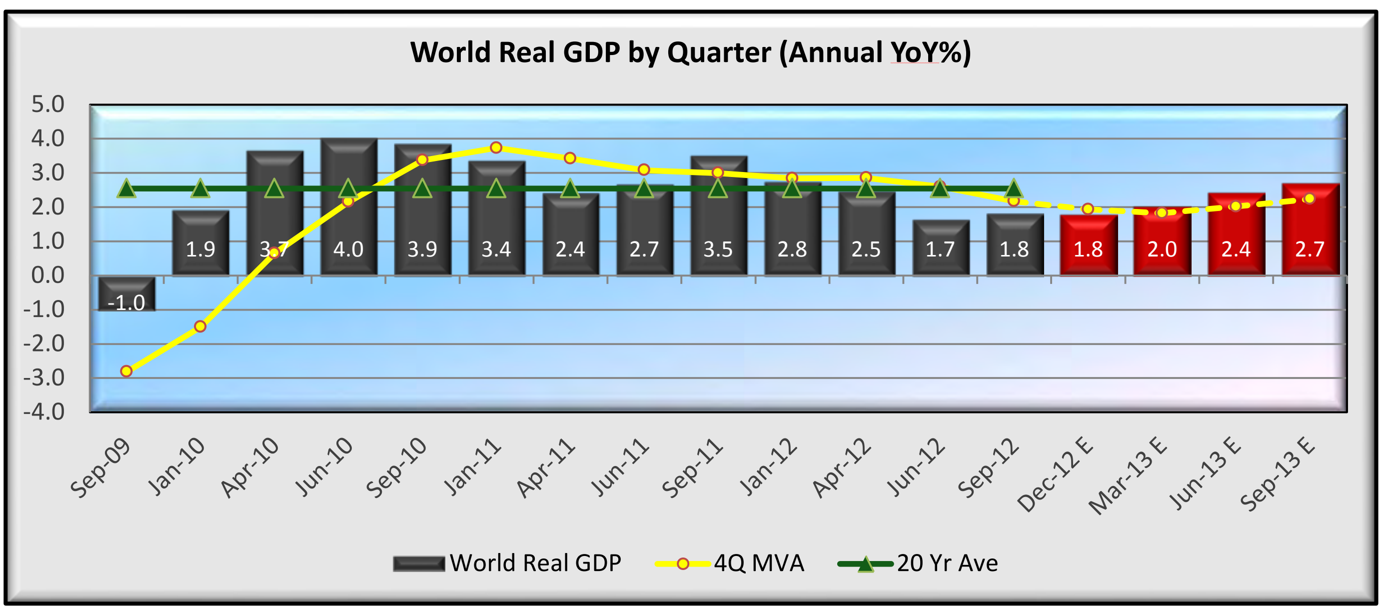
January 16, 2013

View from the Pier

With all of the attention focused on Washington politics, it is easy to overlook improving economic conditions domestically and abroad. The post-Great Recession recovery has been one of the weakest in a century's time as we never experienced the coiled-spring effect that usually occurs as an economy comes out of contraction. However, there are signs that the expansion may be poised to accelerate if politicians can manage anything even close to a reasonable conversation. Our enthusiasm for the prospect of global growth is tempered by the looming debt ceiling and sequestration debates in the United States, but if we are able to escape the rhetoric with minimal damage to consumer confidence, the momentum evidenced in recent data may lead to a considerably more robust economy than has been witnessed in some time.

Economies are very complex with myriad influences determining eventual outcomes. The health of the global economy is never determined by a single data point or event, and the present is no exception. Our optimism is derived from multiple catalysts, some of which are big-picture oriented and some of which we are observing within specific sectors. That said, our more constructive view of the near-to-intermediate term does not mask our longer-term concern; that the largest and most mature economies have excessive levels of sovereign debt and, unavoidably, their growth trajectories will be repressed. But, the series of after-shocks associated with the Great Recession are clearly abating, at least for now. And while the next financial crisis may eventually result from the unintended consequences of the extreme political and monetary policy actions taken to rescue the globe from the significant systemic risk, for now, the policies have had some of their desired stabilizing effects, and have bought time for normal supply-and-demand equilibrium to return. As a result, the opportunity for upside surprise over the near-to-intermediate term appears to be emerging.

Unfortunately, our more optimistic view of the 2013 economic outlook is shared by many. The following chart illustrates the World Real GDP by Quarter over the past four years (black) and forward year (red), highlighting the consensus belief that global GDP has bottomed and is expected to accelerate into 2013. While being aligned with consensus is usually an uncomfortable position for us, the data are encouraging and suggest possible upside as we move into the second half of the year.



Source: Bloomberg

While there are a number of factors supporting our more constructive view of the global economy, perhaps the most significant, and simplest, is the passage of time. Over the past four years, many of the financial after-shocks have played out and the system has been able to digest much of the policy response, particularly from the various central banks responding to systemic risk factors. This has been essential as it has allowed the normal supply-and-demand dynamics to move back toward equilibrium from their extremely disrupted levels. The financial after-shocks should not be underestimated as they were regular reminders to skittish consumers and businesses of the ever-present risks, which caused decisions to be delayed and the recovery to be muted. With those risks diminished, decisions to consume and deploy investment capital can return.

Over the course of the last few years, the global economy has struggled, in particular, with three big-picture uncertainties. Because many elements of these uncertainties have cleared, we enter 2013 with a cautious optimism.

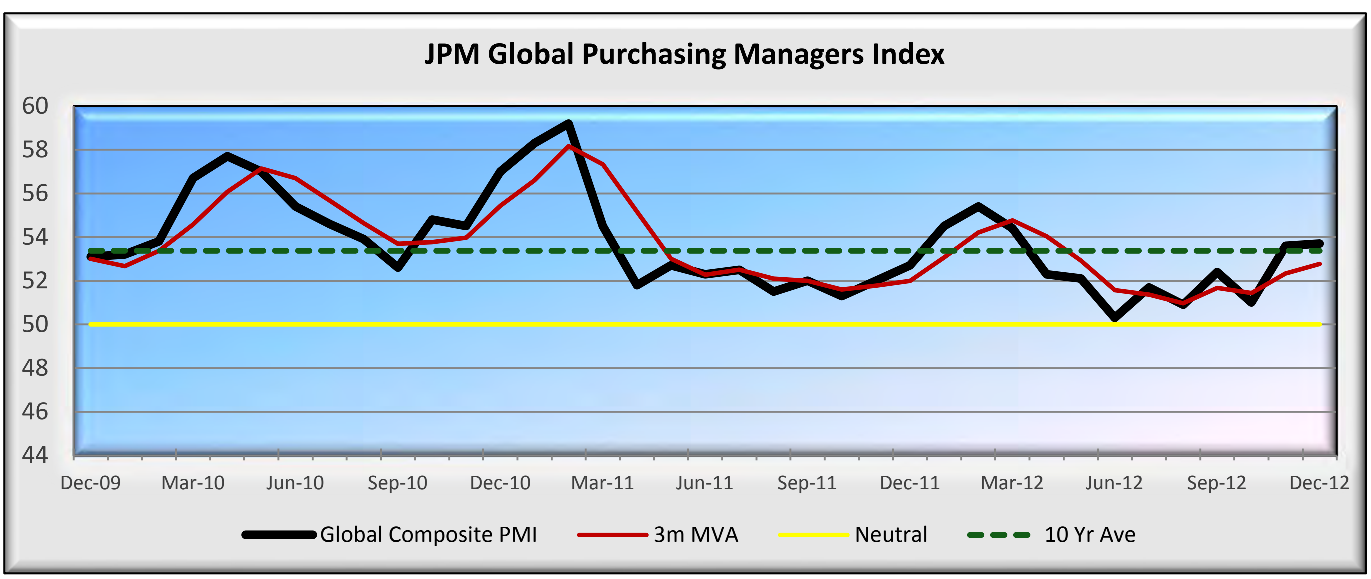
The first uncertainty that has cleared is around China's ability to navigate an economic "soft landing", which they appear to have accomplished. China enters 2013 having transitioned its leadership at the Central Committee and within its 18th Politburo, a process that has historically coincided with improving economic fundamentals. In fact, since the November 2012 appointments, Chinese economic data has improved to nine-month highs, suggesting that the country's growth trajectory may be stabilizing and spilling over to other regional peers. The Asia Pacific region is a significant source of global activity and its healing is a critical component of our outlook.

The second uncertainty that has been [somewhat] resolved is within the Eurozone. While Europe is likely to experience a prolonged period of sub-par economic growth as it struggles with extremely high levels of sovereign debt and a flawed membership structure, important political progress was made during 2012. Specifically, actions were agreed upon, the effects of which were to renew the commitment by members to the region as an economic block and to more consistent and centralized banking powers – critical to the stability of the currency and the region's financial system. Severe austerity will certainly cost the Eurozone an opportunity to experience real economic growth in the near term but, at this stage, mere stability is a positive to take into 2013. We should note that our expectations for Europe include Spain finally succumbing to the EU bailout provisions, an event that we believe markets already anticipate.

The final uncertainty that is in the process of being resolved is in the United States where the fiscal cliff resolution has provided substantial tax clarity to millions of consumers and small businesses. And while we have the debt ceiling and sequestration arguments in front of us, which will likely damage near-term psyche, we believe that the certainty that will come to the vast majority of Americans will result in improved confidence. Critical sectors of the U.S. economy are clearly recovering in meaningful ways from exceptionally deep troughs; specifically, the strength of residential real estate and construction markets, strong auto sales, a resurgence of U.S. energy prowess, a healthier financial sector, and above all else, slow but steady progress on the employment front, all of which have an opportunity to expand significantly further.

Finally, we note several other positives: infrastructure spending in Brazil is set to rise materially in 2013 as the country prepares to host the World Cup (2014) and the Olympics (2016), adding a boost to an already diverse set of economic drivers. Japan is getting more aggressive on reflation efforts. And Canada and Mexico have been two of the most consistent regions in recent years as they have been the beneficiaries of their large trade activity with a gradually-improving United States.

As our regular readers know, the global PMI's represent one of our favorite sets of economic data given the remarkably high correlation with GDP and the pricing mechanisms within the financial markets. The trajectory on the far right side of the chart has just pierced the series' 10-year average to the upside and, with many of the financial risk factors abating, the momentum is trending in a positive direction. Contributions are coming from a wider array of participants than they have since pre-2008, which gives us more confidence that the series has a better opportunity to maintain its strength.

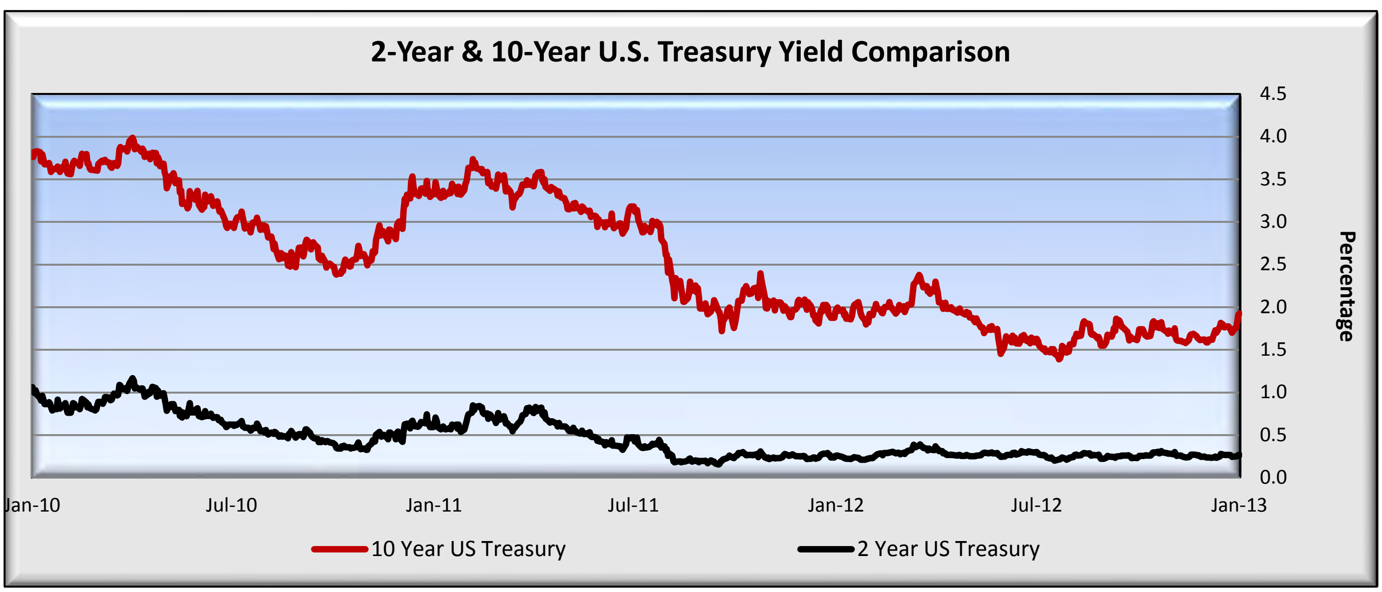


Source: Bloomberg

We do expect the economic data in the United States to get better as the year progresses, but it may prove volatile early on. The first half will be held back by the recent fiscal cliff resolution that will cost the U.S. consumer roughly $160 billion in 2013, mostly via the resumption of the 6.2% payroll tax, a 2% increase. The consumer is also vulnerable to a rattling of confidence as Washington debates the debt ceiling and the mandatory spending cuts associated with the sequestration. However, our confidence comes from the belief that tax certainty and any path that helps close the deficit gap will ultimately lead to more confidence and an eventual unleashing of capital, particularly from business investment which has been dormant for too long. Durable goods spending as a percentage of GDP has fallen to a 50-year low and capital spending and research and development are near their lows as a percentage of corporate revenue; both are metrics that we believe have to rebound (think again of the concept of passage of time) and could provide substantial upside to the economy. And capital is finally available as a significantly healthier U.S. financial sector should be considerably more aggressive deploying excess reserves in the pursuit of returns.

Bond yields have historically been a highly-valued economic indicator, rising when economies improve and falling when they contract. But massive central bank interventions may be creating artificial impressions. At its December meeting, the Federal Reserve elected to extend its bond buying operations at a rate of $85 billion per month indefinitely, a strategy with myriad potential implications, both good and bad. Buyers that large, particularly those that are price insensitive, are sure to cause disruption to the value of reading yield curves for economic purposes.

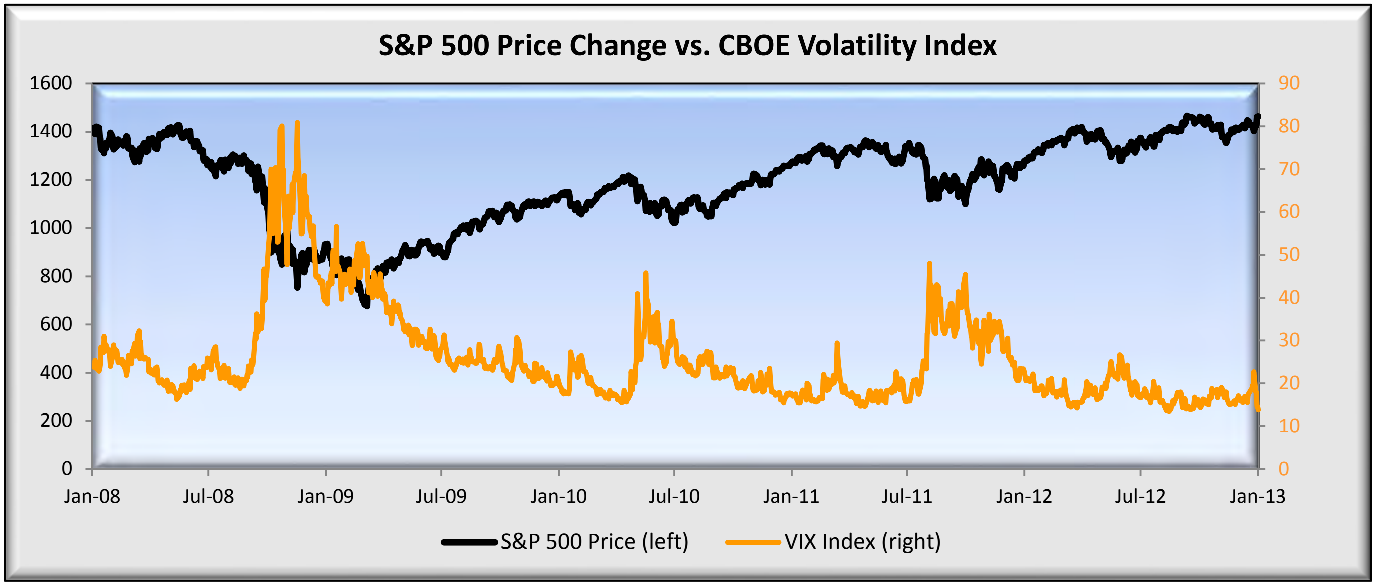
The Federal Reserve has not acted alone as central banks around the globe have unleashed unprecedented liquidity programs in an effort to ignite growth against the backdrop of fiscal austerity and consumer deleveraging. The various rate-cut and asset-purchase programs have resulted in exceptionally low yields on fixed-income investments from cash to long-term bonds, an exercise of financial repression. As the chart below depicts, yields on government bonds are at dismal levels and, when viewed within the context of long-term inflation, the purchasing power of capital invested in this sector is highly likely to erode over time. This is not to suggest that bonds as an asset class should be avoided, for there are important attributes to bonds that can prove very valuable to an overall investment strategy, but active management should prove extremely valuable over more passive strategies when yields start to reset to normal supply-and-demand dynamics.



Source: Bloomberg

Our generally more optimistic view of the global growth trajectory does not necessarily translate into robust financial markets. For bond markets, a stronger economy may cause central banks to reverse course sooner than expected and, while we do not anticipate the kind of economic strength that would push yields significantly higher and cause double-digit price declines, we do foresee yields leaking higher over time and subtracting from the returns experienced in recent years.

Despite the weaker macro trends recorded in the global economy, stocks booked solid returns in 2012, mostly the result of declining risk premiums in the latter part of the year associated with reduced concerns regarding the three uncertainties we highlighted above: China's ability to navigate a soft landing, Europe's sovereign debt crisis, and the Fiscal Cliff debate in the U.S. It is the removal of these uncertainties and the corresponding appreciation of stock prices to finish 2012 that dampen our enthusiasm for stock returns in 2013 as the P/E multiple has already advanced, leaving stock returns more dependent on the earnings trajectory and less on multiple expansion. The chart below, specifically the right side, illustrates how calm the ascent of stocks actually was with the volatility index dropping to near all-time lows, despite the Fiscal Cliff rhetoric. Maybe investors understand the theater, or perhaps the ongoing political banter is leading to fatigue and disinterest.



Source: Bloomberg

We expect stocks to provide mid-to-high single digit price appreciation plus a dividend yield of slightly above 2% in 2013. While an improving economy, particularly during the second half of the year, will add much needed revenue growth, corporate profit margins are near record levels already and the pace of profit advancement has slowed of late, thereby leaving the earnings growth rate slightly more muted in 2013. The following table helps illustrate the relationship between earnings and the P/E multiple that market participants are willing to pay for those profits. On the left hand column are a range of earnings estimates for the S&P 500 for 2013, with consensus expectations currently at $112. A range of P/E multiples is assigned across the top row, allowing an investor to consider a mix of these two variables to determine an approximate fair value for the S&P 500. We would expect that an actual earnings result below the current consensus of $112 would move multiples to the left (disappointment), while earnings above $112 would move the multiple to the right (upside surprise). Keep in mind that earnings and multiples can extend well beyond this sample matrix and it should not be relied upon as a recommendation to buy or sell securities; the graph is for illustrative purposes only.

	12x	13x	14x	15x	16x
$106	1,272	1,378	1,484	1,590	1,696
$108	1,296	1,404	1,512	1,620	1,728
$110	1,320	1,430	1,540	1,650	1,760
$112	1,344	1,456 *	1,568	1,680	1,792
$114	1,368	1,482	1,596	1,710	1,824
$116	1,392	1,508	1,624	1,740	1,856
$118	1,416	1,534	1,652	1,770	1,888

*Current S&P level 1,470

Source: Vigilant Capital Management

The path to year-end stock market values is likely to be very uneven and, with the volatility index near all-time lows, we would not be surprised to see volatility rise, perhaps significantly during 1Q13, as consumer paychecks shrink (payroll tax) and Washington fiddles. But if economic momentum resumes on a global basis, lower market values may provide the opportunity to make important tactical shifts to stock portfolios and we eagerly await that chance, given our more optimistic view for the second half of the year. Hard assets, too, should benefit from stronger global growth. We expect industrial metals to firm up from a softer 2012, but the agricultural commodities are where real upside action may occur, particularly if any of the planting seasons are disrupted by weather around the world. Timber is another commodity sector that is likely to see strength as housing and general fixed-structure construction continue their comeback.

We have generally been cautious about global growth and the fundamentals of the global economy over the past five-plus years. Many of our concerns remain over the longer-term as sovereign debt levels have not been addressed, but we have identified a path of prosperity for the intermediate term which we believe has a reasonable probability of occurring as emerging markets re accelerate, critical sectors rebound from trough levels and demand for durable goods and infrastructure improve. Washington DC remains the wild card and its impact could easily alter the positive course, which would be a shame as so many stakeholders stand to benefit from a real economic expansion, especially one that may include more meaningful job creation and reasonable wage growth.

We are grateful for the opportunity to bring you the View from the Pier and, as always, we welcome your questions and comments.

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