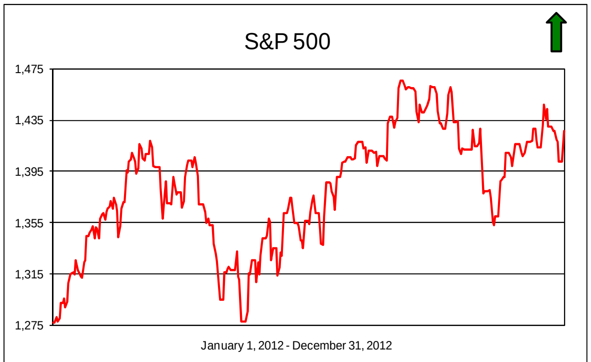
INDEPENDENT INVESTMENT COUNSEL

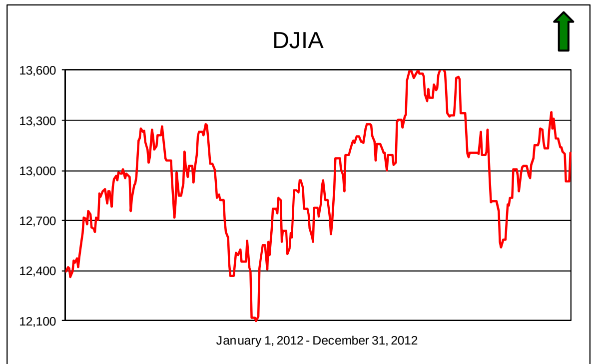
QUARTERLY REVIEW — *96th Edition* — *2012: Fourth Quarter*

CAPITAL MARKETS SCOREBOARD

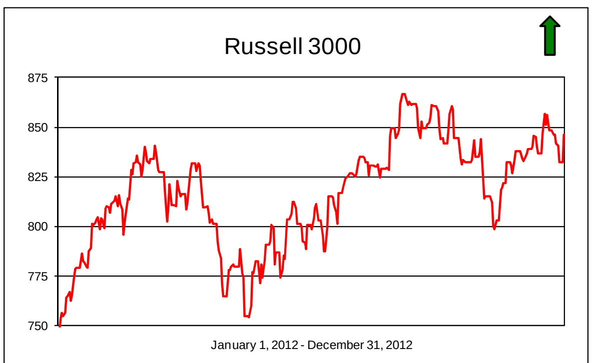
January 1, 2012 – December 31, 2012



4th Qtr -0.4% YTD 16.0%

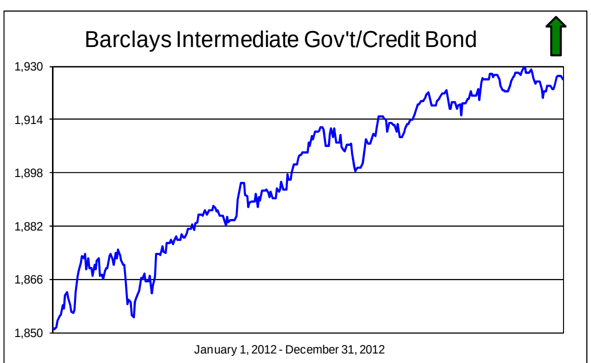


4th Qtr -1.8% YTD 10.1%

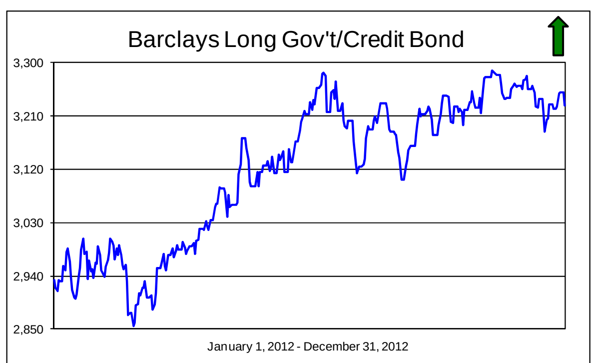


4th Qtr 0.3% YTD 16.4%

4th Qtr -2.5% YTD 17.7%



4th Qtr 0.4% YTD 3.9%



4th Qtr 0.5% YTD 8.8%

Performance Numbers Reflect Total Returns

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EQUITIES

Equity Market Performance

The Standard & Poor's 500 (S&P 500) posted a price gain of 13.4% and a total return of 16.0% including dividends for 2012. This gain came despite heightened uncertainty including concerns about Europe, a major drought and months of debate about the fiscal cliff. While 2012 marks the fourth year in a row that the market has posted a positive total return, the S&P 500 total return over the past five years has averaged only 1.66% per year. As the accompanying chart indicates, leading sectors in 2012 included Financials and Consumer Discretion. Leading detractors included Energy and Utilities. Internationally, the Morgan Stanley Capital International Europe, Australasia, and Far East Index (EAFE) posted a total return of 17.6% and the MSCI Emerging Markets Index returned 18.2%, despite recession-like conditions in several countries. On a comparative basis to other asset classes, the Barclays Capital Aggregate Bond Index returned 4.2% and the S&P Goldman Sachs Commodity Index returned 0.26%.

S&P 500 by GICS Sector	Price Return (%)	
	4Q12	**YTD**
Financials	5.3	26.3
Consumer Discretion	1.6	21.9
Healthcare	-0.5	15.2
Information Technology	-6.2	13.2
Telecommunications	-7.1	12.5
Industrials	3.0	12.5
Materials	2.0	12.2
Consumer Staples	-2.5	7.5
Energy	-3.3	2.3
Utilities	-3.9	-2.9
S&P 500 Index	**-1.0**	**13.4**

Earnings Outlook

When the final tally is in for 2012, it is expected that earnings for the S&P 500 will have declined by 1%. Wall Street analysts expect a rebound in 2013 of 7%. A few economists expect a mild recession in 2013 and there is some support for this argument. In the most recent earnings report, 61% of S&P 500 companies missed sales expectations, a figure seen in the depths of the last recession. While S&P 500 earnings are expected to increase in 2013, recent estimates reflect a lower number than originally forecast. As the last quarter of 2012 came to a close, earnings per share dropped to $107 from $120. There is growing concern that the debt ceiling and tax negotiations have started to slow business investment and hiring. Recessions in the U.S. are determined by the National Bureau of Economic Research. This organization monitors trends in industrial production, real income, employment and real retail sales and typically sets the beginning of a recession date when these economic indicators slow materially and simultaneously. While the economic data reported by the government is often revised, these economic indicators presently do not show signs of a recession. The strength of holiday retail sales can set the tone for business trends in the following year, so the sales reports from retailers in early January will be closely monitored.

Source: Strategas Research Partners

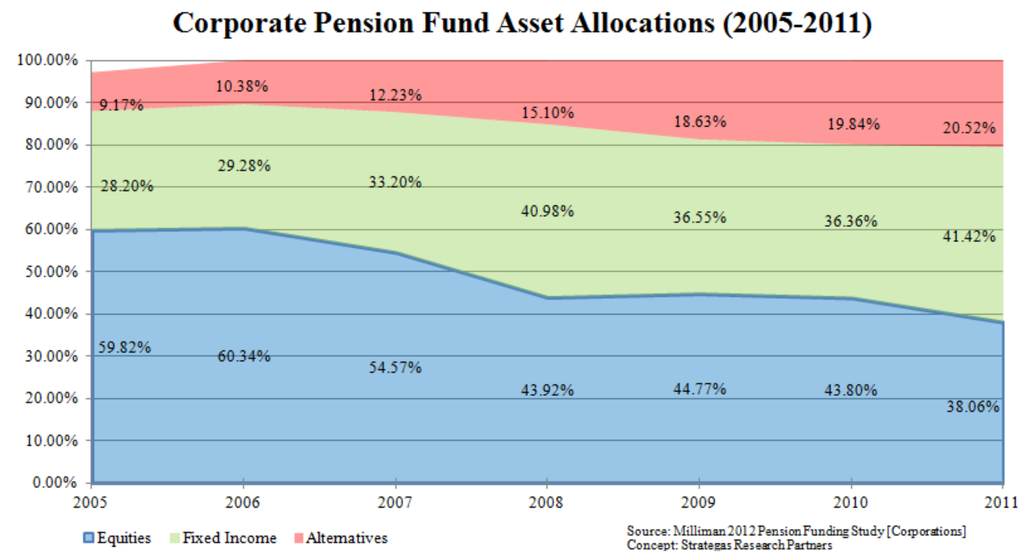
High Frequency Trading Debate

By some estimates, 70% of the volume traded on the U.S. stock exchanges is attributable to high-frequency traders. These traders typically use powerful computer algorithms to profit from small price changes in individual securities, thousands of times a day. The growth in this type of investing has caused the average holding period of stocks to fall from eight years during the 1960's to well under one year during this decade. Proponents of high-frequency trading argue that overall market liquidity has improved because of the participation of these traders. Opponents argue that market volatility has increased and specifically point to the "flash crash" of 2010, when the market fell 9% within 5 minutes only to recover all its losses in the following 20 minutes. These opponents also claim increased volatility in the equity markets is perhaps why market returns over the past decade have been lackluster and why individual investors continue to lose interest in the equity markets. By this same logic, equities should have provided robust returns during the 1960's and the 1970's when the holding period was much longer than today. However, the data shows that the S&P 500 fluctuated between 60 and 120 from 1960 to 1980. When program trading took off in the 1980's

and the 1990's, the market rose eightfold, despite a fall in the holding period. Since the year 2000, the S&P 500 has fluctuated between 683 and 1562, but select securities have done quite well despite heavy trading volumes. As such, the empirical evidence draws no discernible correlation between high-frequency trading and long-term returns.

Pension Fund Managers' Asset Allocation Decisions

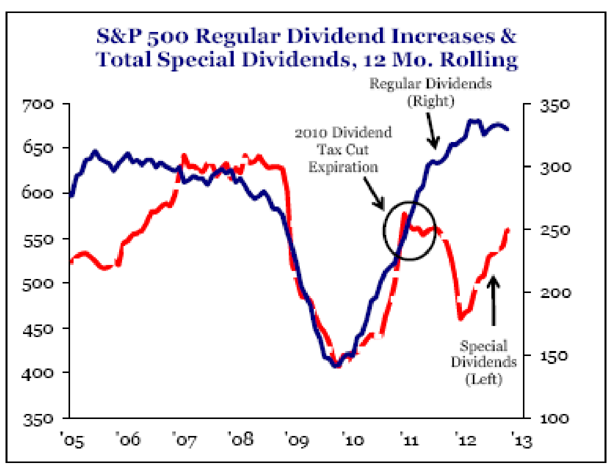
Pension fund managers are charged with investing the cash set aside by a company to ensure that it can fulfill its post-employment promises to hundreds or thousands of current and former employees. In essence, pension fund managers have the same ultimate goal as 401(k) participants, but materially more time and resources available to them to achieve the goal. However, this does not always mean they will generate superior results. Not that long ago, many pension funds were underfunded due to negative returns experienced in the equities market. Milliman's 2012 Pension Funding Study covering 100 U.S. public companies with the largest defined benefit corporate pension funds provides allocation metrics on the exposure of these funds to asset classes. Alternative investments such as real estate and commodities have grown in exposure. There is concern, however, in some circles about the increased level of this exposure. Further, in light of the relative value differential between equities (stocks) and fixed income (bonds) discussed elsewhere in this newsletter, pension funds' decisions to expand fixed income from 28% of assets to 41% of assets while simultaneously reducing equity exposure from 60% to 38% is surprising.



Year-End Special Dividends

As the fourth quarter of 2012 drew to a close and the fiscal cliff loomed large, a number of corporate boards chose to pay regularly scheduled dividends in late 2012 instead of early 2013, pay a special one-time dividend or do both. The reason: higher tax rates on dividends in 2013. The diverse list included instantly recognizable companies such as Costco (COST), Wal-Mart (WMT) and Caterpillar (CAT), although AT&T (T), ExxonMobil (XOM), Microsoft (MSFT) and Apple (AAPL) eschewed the trend. Lesser-known companies like Brown-Forman (BF.B) and Las Vegas Sands (LVS) also participated in the acceleration. It is fairly easy to conclude that paying a regularly scheduled dividend early to enable shareholders to avoid higher taxes is of benefit to shareholders, assuming the cost of moving up the payment does not exceed the estimated tax benefits to shareholders.

Special dividends can also create shareholder concerns. For example, is a special dividend the best use of corporate cash? If the Board of Directors had been seriously considering a special dividend before the fiscal cliff issue, then it behooves shareholders to receive it at a lower tax rate. However, issuing a special dividend just to avoid increasing tax rates may be an inadequate reason to take action. Costco, for one, issued $3.5 billion in debt to make the special dividend payment. Some analysts would argue that changing the capital structure in favor of more debt increases the underlying risk profile of the company. Brown-Forman's special dividend raised an additional concern[1] because the amount of the dividend exceeded the company's cash balance. The company also looked to the debt markets to raise (admittedly cheap) capital with which to pay the special dividend.



Source: Strategas Research Partners

[1] As referenced by Suzanne McGee, a contributing editor at YCharts.com

NYSE Euronext Exchange to be Acquired

The InterContinentalExchange (ICE) recently announced it will be acquiring the NYSE Euronext Exchange (NYSE) to form one of the largest and most diversified exchanges in the world. The combined company will enable investors to trade futures, options and credit-default swaps around the world, in addition to traditional equities. After 200 years of independence, the sale of the NYSE to an electronic exchange is an important milestone in financial history. The days of gentleman trading simple equities by reading a ticker tape are long gone. Investors increasingly are demanding access to a wide range of investment products, irrespective of geography and outside normal trading hours. Also, after the 2008 financial crisis, regulators insisted that the major brokerage firms move the trading of exotic financial instruments such as credit-default swaps from private exchanges to public exchanges in order to better account for the value of these instruments. Finally, global companies increasingly need access to new and sophisticated investment products to manage foreign exchange risks, commodity risks and interest-rate risks, without posting substantial amounts of collateral.

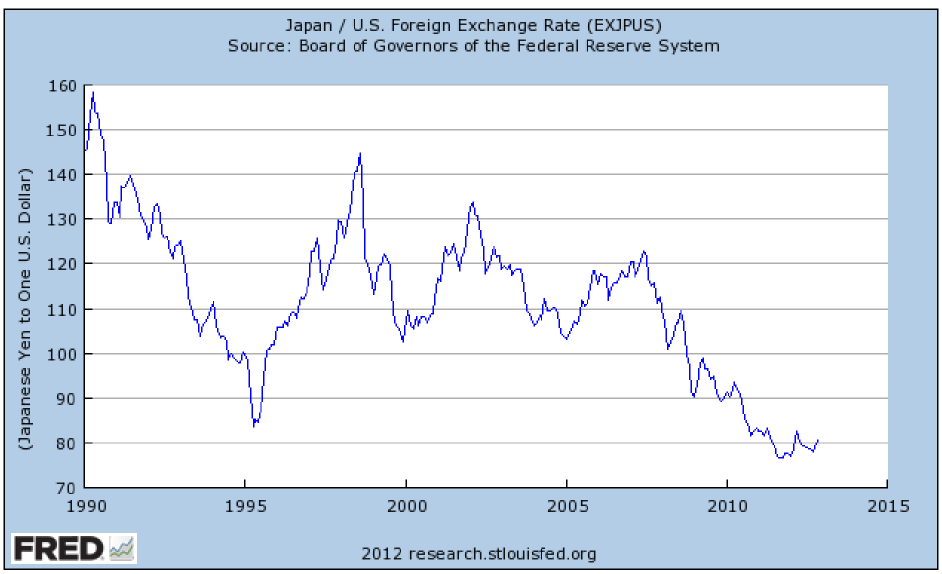
ECONOMICS AND FIXED INCOME

Fixed Income Market Performance

The hunt for yield rewarded investors willing to hold bonds with more credit risk during 2012. For example, the Barclays Capital (BarCap) Intermediate Government / Credit Index returned 3.9% for the year, while its corporate-only cousin, the Intermediate Investment Grade Credit Index, rose 8.1%. Bonds rated below investment grade (below BBB ratings) generated even higher returns as the Bank of America / Merrill Lynch (BOA / ML) U.S. High Yield Index rose 15.6%. The hunt for yield also rewarded those investors willing to take more duration (interest rate) risk as the rate of return generated by holding longer-term U.S. Treasury bonds once again outpaced its shorter-term counterparts. Municipal bonds also performed well in 2012, ending the year up by 7.3% according to the U.S. Municipal Securities Index.

The Japanese Yen

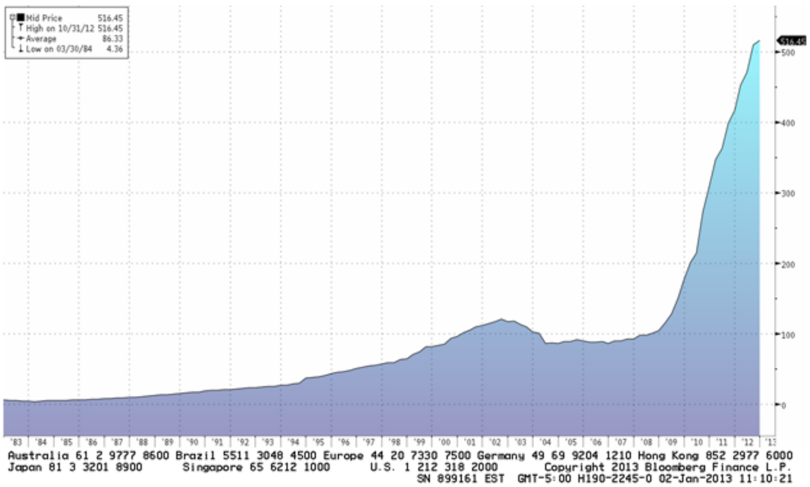
If a tourist visiting Japan in 1990 had converted $100 U.S. dollars into Japanese yen, he or she would have received approximately 16,000 yen. If they held this 16,000 yen, it would be worth $190 U.S. dollars today. The yen has appreciated by 2.8% per year since 1990 and this appreciation is a major source of frustration for Japanese politicians. (To explain the accompanying graph, the decline is reflective of the fact that a higher Japanese yen relative to the U.S. dollar means it takes less yen to purchase a dollar.) An appreciating yen has increased the cost of Japanese exports and visiting the country becomes more expensive for tourists. This has negatively impacted economic growth. While a portion of the economy does indeed suffer from a stronger currency, the majority of Japanese consumers and businesses benefit as they are able to import goods at lower prices. Japan recently elected its eighth prime minister in 12 years with the hope that he will finally solve Japan's economic woes. A key component of Prime Minister Shinzo Abe's economic plan is to target an inflation rate of up to 3% by forcing the Bank of Japan to print an almost unlimited quantity of yen. The yen fell 5% in 2012 in anticipation of such a policy and investors are increasingly convinced that this trend will continue. One key challenge for the government will be to ensure that this new inflation target does not trigger a significant rise in interest rates. With debt at a level of 220% of Gross Domestic Product (GDP), Japan is heavily dependent on local investors to continue to finance the government. As is the case in the U.S., Japan faces a growing wave of baby boomers who will begin to receive retirement and healthcare benefits, but there will be fewer workers to fund these programs. As a result, the financing needs of the government are likely to grow. While Japan spends less than 25% of its annual tax revenues on interest expense, an aggressive inflation policy may raise the government's financing costs and "crowd-out" other areas of government spending.

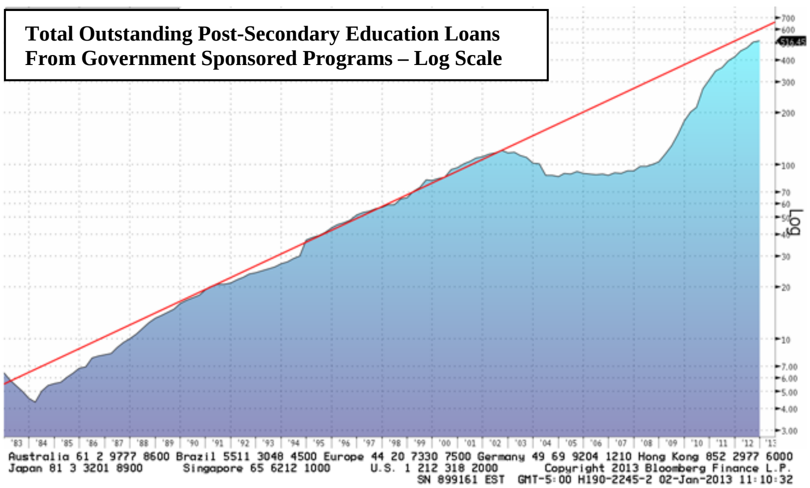


Source: Federal Reserve Bank of St. Louis; *Federal Reserve Economic Data (FRED) system*; http://research.stlouisfed.org/fred2/

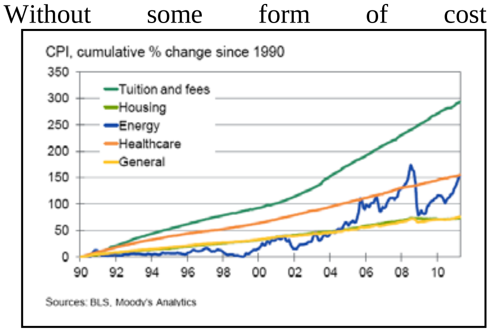
Reviewing Student Loan Growth – The Importance of Scale

There has been a lot of discussion lately about the amount of student loans outstanding. A recent study published by the Pew Research Center indicated that 20% of all families now have student loans, up from 15% in 2007 and more than double the number from two decades ago. A staggering 40% of all families with households headed by someone younger than age 35 carry student loan debt. The first chart to the left depicts student loan growth for post-secondary education. It is based on quarterly data points of total student loan amounts in billions of U.S. dollars from the beginning of 1983 through the third quarter of 2012. The sharp increase starting in 2009 is quite alarming since debt more than quintupled. Yet, a linear-scaled chart depicting a parabolic rise almost certainly obscures the real data trend. The second chart to the left shows the same data using a log (base 10) scale; certainly a different view than provided by the linear graph and one that suggests a return to trend (the red line) rather than an ominous "debt explosion". Still, the trend in student loans is problematic. Without some form of cost inflation relief, colleges run the risk of pricing themselves past the point where the value of a college degree is no longer perceived to be worth the cost of obtaining the degree. As the third chart above shows, college tuition cost increases have dramatically outpaced wage growth and even health care cost inflation.



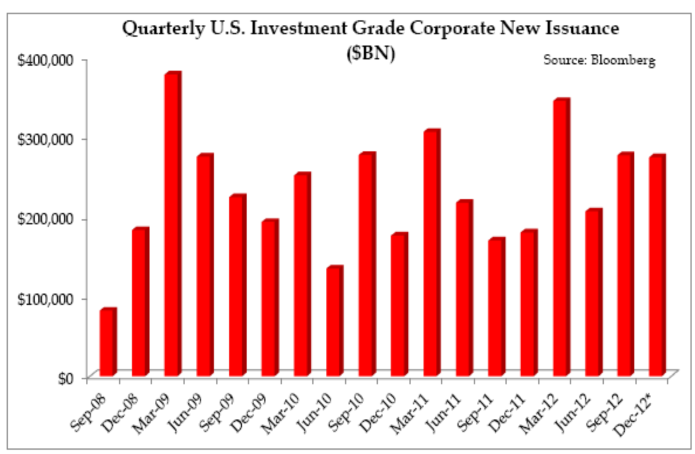


Source: Bloomberg Professional Service



Corporate Debt Issuance in 2012

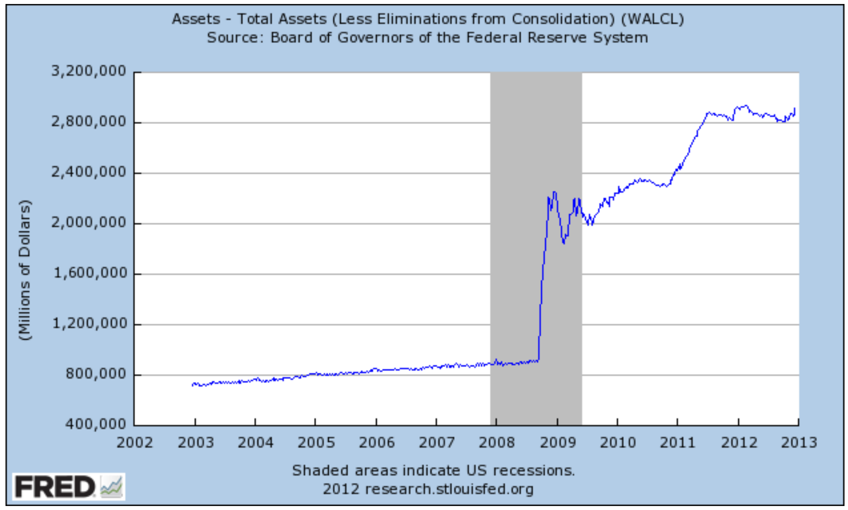
Low-yielding fixed income securities may be the bane of investors, but they are a boon to corporations across the credit quality spectrum. The low price of money enticed U.S. corporations with investment grade ratings to issue a record-setting $1.5 trillion in debt in 2012, 29% higher than 2010's $1.2 trillion. The previous record was set in 2009 when the U.S. Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program backed new bonds issued by financial institutions as part of an effort to address the Great Recession. In addition, high-yield debt issued by companies with below investment grade ratings equaled $354 billion, exceeding 2010's record by 23%. As a result of this activity, the average corporate bond coupon rate declined 0.39% to 5.66% even as borrowers extended their respective maturity schedules.



Source: Strategas Research Partners, Bloomberg Professional Service

The Federal Reserve Bank's (the Fed) Growing Balance Sheet (Problem)

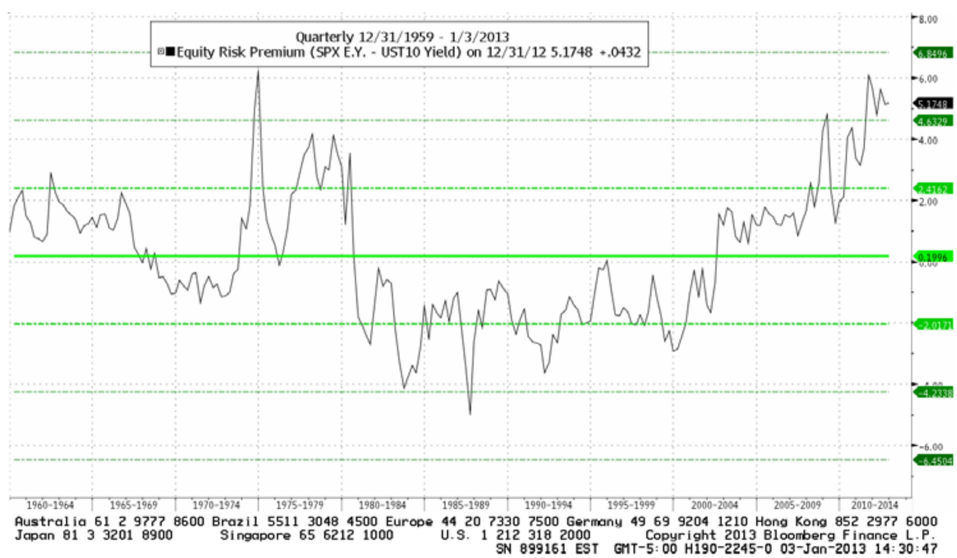
On September 13th, the Fed announced it will be increasing the size of its asset purchases by $40 billion a month, or $480 billion a year, via buying mortgage-backed securities. A short three months later, the Fed announced it will also be buying $45 billion a month of long-dated U.S. Treasuries, or $540 billion a year, starting in January of 2013. Together, these two programs will add approximately $1 trillion a year to the Fed's balance sheet and will continue at this pace until unemployment reaches a targeted rate (set by the Fed) of 6.5%. The purpose of these asset purchases is to drive interest rates lower and ultimately stimulate the economically sensitive sectors of the economy and the labor market. The Fed previously engaged in asset purchases in late 2008 (also known as QE1) and in late 2010 (QE2) with limited impact on the economy. Thus, it remains to be seen if the third major asset purchase program (QE3) has its desired effect. What is clear is that the Fed's balance sheet has taken on an extraordinary level of risk. Prior to the recession of 2008, the Fed's assets consisted of $800 billion of short-term U.S. Treasuries. By the end of 2013, the Fed's assets will have ballooned to almost $4 trillion dollars supported by $54 billion of equity, or a leverage ratio of 74x. Furthermore, the assets of the Fed now consist of longer-dated securities, so a small rise in long-term interest rates will adversely impact the value of these holdings. The Fed has further compounded the risk of its portfolio by purchasing mortgage-backed securities, which may or may not be backed by a deficit-ridden U.S. government. The Fed is not alone in expanding its balance sheet. The Bank of Japan, the European Central Bank, the Bank of England and the Swiss National Bank have all engaged in large-scale asset purchases.



Source: Federal Reserve Bank of St. Louis; *Federal Reserve Economic Data (FRED) system*; http://research.stlouisfed.org/fred2/

Stocks v. Bonds – Which is Relatively Cheaper?

Wallington's third quarter newsletter noted the continued influx of assets into fixed income mutual funds. The latest Investment Company Institute data show the trend continuing. Fixed income funds posted net inflows in October, November and the first three weeks of December, while equity funds experienced net outflows during the same periods. This is in spite of the fact that equities appear to be the better value, at least based upon a comparison between the S&P 500 (SPX) and the 10-year U.S. Treasury (UST10). The relative value of these two securities is commonly analyzed by inverting the SPX's Price/Earnings ratio (P/E) to generate what is known as an earnings yield. The accompanying chart shows the difference between the SPX's earnings yield and the yield on the 10-year U.S. Treasury. This is often referred to as the Equity Risk Premium (ERP). The accompanying chart also shows the average of the ERP and the three standard deviation ranges. At the end of 2012, the ERP was more than two standard deviations higher than the average value since 1960, indicating that equities are the cheapest they have been relative to U.S. government debt since the mid-1970s. This does not mean stocks will outperform bonds. All one has to do is look back at their relative performance in the 1970s. However, as Morningstar's Institutional Credit Research states about fixed income investing in 2013, "…it will be



Source: Bloomberg Professional Service; Concept: Strategas Research Partners mathematically very difficult to enjoy anywhere near the same return [in 2013 versus 2012] unless one assumes that either credit spreads return to the tightest levels recorded (February 2007) or interest rates…drop significantly below [current levels, which are] already near the lowest on record."

The Other Cliff

After months of negotiation, on January 1, 2013, Congress agreed to raise tax rates for individuals making over $400,000 per year and for married couples whose income is above $450,000 per year. In order to fund various healthcare programs, the U.S. government will impose a variety of other taxes on individuals earning over $200,000 per year and on married couples earning over $250,000 per year. These taxes range from 0.9% of total income to 3.8% of investment income. There are two key aspects of the budget deal that may pose a further headwind to the economy. First, the payroll tax rate will increase by 2% for wages below $113,700. For an average household making $50,000 per year, this will amount to a $1,000 annual reduction in their take-home pay which could have been used for spending of some sort. A second economic headwind will likely come from cuts to government spending. Congress has until the second half of February to raise the federal debt ceiling in order to avoid defaulting on the debt. If the ceiling isn't raised by March 1st, the government will automatically be forced to cut spending on a variety of programs. If the debt ceiling is raised, politicians and rating agencies will still demand some cuts to spending to ensure that the debt remains manageable. Interestingly, Congress is in session for only 5 days in January and 11 days in February. The drama around the January 1st fiscal cliff was, perhaps, only the opening act.

COMMENTARY: Jobs, Where Art Thou?

December, 2012 marked the fifth anniversary of the start of the Great Recession, which ended in June 2009. The economic downturn which started in December, 2007 is called the Great Recession because of its severity including the fact that the U.S. economy lost almost nine million jobs between January 2008 and early 2010. As was often discussed in the Presidential election campaign, employment growth after the recession ended has been anemic by historical standards. The U.S. economy remains almost five million jobs short of pre-recession employment levels, even though the unemployment rate has fallen from 10.1% in late 2010 to 7.8% currently. Because of the slow jobs growth, the monthly change in non-farm payrolls and the unemployment rate are front-page news and impact the financial markets if either is better or worse than expected. While they may trend or move together over longer periods, the reality is the jobs numbers and unemployment rate are not all that important on a monthly basis since the numbers are usually revised later. These revisions, however, do not receive nearly the same level of attention among investors as when the initial numbers are announced. Even with the revisions, though, investors would truly be well-served not to over emphasize the short-term number because of all the noise involved in collecting the data.

The metric for non-farm payrolls and the metric on the unemployment rate come from two different surveys. The non-farm payroll number comes from employers reporting how many workers are on their payroll; the unemployment rate from a household survey collecting data on how many people in the family have jobs. The two surveys routinely diverge. In September, for example, the payroll survey reported an increase in jobs totaling 114,000, while the household survey reported that 873,000 more people were employed – the largest monthly increase since June 1983. The unemployment rate comes from the household survey so it dropped sharply that month. Since the two surveys involve sampling, it is important not to place too much confidence in a specific reported number. With approximately 130 million people employed in the U.S., an increase of 100,000 in the jobs report is miniscule relative to the total number of people employed. In fact, sampling errors mean that for a reported gain in jobs of 100,000, one would be 90% confident that the correct number was actually between 9,000 and 191,000. The unemployment survey of households is smaller than the jobs survey and also involves sampling error. For an unemployment rate of 7.8%, one would be 90% confident that the correct number was between 7.6% and 8.0%.

In addition to sampling error, the unemployment rate faces a more serious problem in that no one really knows exactly how many people are in the workforce. The government computes a labor participation rate which is the estimated civilian labor force relative to the estimated civilian population. The labor force includes everyone over 16 years of age working or seeking work. Seeking work includes anyone who in the last four weeks applied, interviewed or sent in a resume for a job. The civilian population includes those over 16 years of age, but does not include those in the military, institutionalized or wards of the state. In the 1900's through the 1990's, the labor participation rate grew as women entered the workforce in greater numbers. From 2000-2007, the rate averaged 65.8% but has fallen since then to a low of 63.6% in 2012. While no one has absolutely precise data on why this has happened, a recent report in the *Wall Street Journal* attributed a large part of the decline to soaring government benefits including food stamps, social security disability payments, Pell Grants, and extended unemployment benefits. Early retirement and stabilization in the number of women seeking work have also had an impact. The net result is 5-6 million people who are not counted as in the labor force but may be willing or able to work. If you add these people to the unemployed, the unemployment rate would be above 10%. (A broader measure of unemployment, the U-6 unemployment rate, includes those people who want to work but have gotten discouraged and quit looking plus those people who are working part-time for economic reasons, registered in at 14.4% for December.)

Since the 1970's, the Federal Reserve maintained a dual mandate of containing inflation and maximizing employment. In spite of all of the noise in the data, the Fed recently made a historical change in monetary policy by announcing that it will keep short-term interest rates close to zero until the unemployment rate falls below 6.5%. It is the first time that a major central bank has tied its interest rate policy directly to the state of the economy. The Fed said it would follow this policy as long as forecasted inflation does not exceed 2.5%. What we now have are financial decisions being made by investors and monetary policy being directed at the Fed tied to unemployment and inflation forecasts which are not precise and have large margins of error. The next time you read in the headlines or hear on the evening news about the jobs report or the unemployment rate, remember that it is not a precise number, and monthly changes are less meaningful than their impact on the markets. In the longer term, however, the accumulation of monthly data is an important indicator of the health of the economy. Without question, the growth in employment is lagging past economic recoveries after 3.5 years, but fortunately, the longer-term trend is showing some improvement. Hopefully this will continue to the point where the Fed will be able to begin eliminating financial repression caused by a zero interest rate policy. Employing more people would also increase income tax receipts plus place less demands on unemployment benefits, both helping to reduce the deficit as long as interest rate increases were not too significant. Social benefits aside, deficit reduction from employment growth would be welcome considering the U.S. government currently owes a ludicrous $16.4 trillion ($16,400,000,000,000) when considering all debt outstanding, not just that held by the public.

"No pecuniary consideration is more urgent than the regular redemption and discharge of the public debt; on none can delay be more injurious, or an economy of time more valuable. - ***George Washington***

January, 2013