RITTMANN
Capital Management

Q3 2012 Commentary

Note to Clients:

I hope you are well and getting ready for what appears to be a very eventful end of the year. With the third quarter coming to a close, all eyes now officially turn to the presidential election.

Major stock indexes rallied in the third quarter of 2012, despite a weak economic recovery in the United States, a recession in Europe and decelerating growth elsewhere (notably in emerging economies China, India, and Brazil). There was very choppy trading throughout the quarter, especially the last five days. There was, and still exists a large gap between the market's outperformance and the gloomy state of our economy.

Headlines surrounding the Eurozone sovereign debt crisis remained an overhang on the markets. Mid-quarter, the European central bank finally acknowledged that the European debt crisis had reached critical levels and indicated that it was prepared to act to restore stability to the markets. This was very well received by the global markets. But there is still a long way to go fixing the "Euromess". Very high unemployment and lagging economic activity are still prevalent throughout the continent. Spain and Greece need immediate bailouts. We have been through these empty exercises of promises by the European officials only to be delayed and pushed out unresolved. Hopefully, we will see some agreement and movement toward the European Central Bank's pledge to do "whatever it takes" to save the euro.

The U.S. stock markets witnessed a nice rally off the June lows. But at the end of August, market participants were looking at the next Federal Reserve meeting in anticipation of future Quantitative Easing (QE) comments. Our domestic economy is still sagging and the lack of new jobs being created is still a major sore point. Job creation, or lack thereof, is the major reason why the Federal Reserve initialed a third round of QE. This measure is different than prior policy measures in that it is open ended and will be in force until the "forseeable future" (i.e., when the job market returns to acceptable levels of around 5.5% unemployment). Also, the Fed announced that in addition to maintaining low long-term interest rates, it promised to continue the "highly accommodative" policy even after the economy strengthens.

With an economy that is growing slowly, compounded by consequences of Congress's inability to act on our domestic debt and a looming tax situation, investors and companies are unwilling to invest. Uncertainty continues to hold us back. When businesses and households confront large-scale uncertainty, they tend to wait for more clarity to emerge before making major commitments to spend, invest and hire.

However, equities are cheaper than their historical averages. Even with declining earnings growth, companies have so much excess cash today and will continue to produce even if the economy isn't growing much. Historically, companies paid out over 50% of income and they still had enough capital to reinvest in the business. Whereas today the ratio is around 70% of earning being retained and added to their balance sheets. The result is that companies should be increasing dividends and increasing stock repurchase/buyback programs and might even be acquisitive, all of which are very positive for shareholders and for the market.

Energy and technology sectors were laggard performers in the quarter. During the quarter I attended several energy and technology conferences. As a result of visiting with several companies we own in our portfolios, I remain very bullish in my convictions for owning the companies. In the energy sector, the continual development of our domestic unconventional shale resource plays continue to produce great results and the companies are maturing into what I see as very good investment play for the long term. Also, in technology, our companies in the "Big Data" and "cloud computing" space are also growing and becoming integral plays in the next shift in enterprise computing. This most likely will not be a linear growth pattern for these stocks, as young companies do go through growing pains and product adoption phases. But the long term prospects are very favorable, and we should be rewarded by nice returns.

So six years after its collapse, economists believe the housing market has turned a corner. Housing activity has been improving since late last summer, with house prices on the rebound since early this year. We still think the housing story is a positive one and will continue to be one for many years to come, even if in part it's simply due to the currently still very depressed levels of activity.

There are times when the outcome of an election can truly have a profound impact upon the direction of a country, and this year appears to be one of those times. It is not just that the ideological divide between the two parties has rarely if ever been wider, but it is also because there is so much at stake on such critical issues ranging from tax policy and entitlement reform to energy security and healthcare transformation. Sorting through each of the key issues, the likely outcomes and their potential impact on the real economy and financial markets is a fairly daunting undertaking.