RITTMANN

Capital Management

Q4 2012 Commentary

Note to Clients:

We got lucky in 2012. The financial markets held up. The economy, while slow, didn't tank. Inflation remained benign. And the world held together.

The year ended with a bang. While most Americans were welcoming in 2013, Congress and the White House were stitching together a long-awaited "fiscal cliff" agreement. But the damage was already done. The budget talks to avert the tax increases and spending cuts that were ominously termed the "fiscal cliff" dominated the financial headlines, and the market seemed to serve as a barometer for the progress, or lack thereof, of the negotiations.

The "fiscal cliff" is a term used to describe the result of the Budget Control Act of 2011, scheduled to go into effect on January 1, 2013. The impact was to dramatically raise taxes on all Americans and to dramatically cut spending programs. The resulting effects and loss of jobs (due to funding losses) would have put the U.S. economy into a recession almost immediately. So there was great urgency to reach an agreement and prevent the U.S. from "falling over the cliff".

Confidence among corporate leaders plummeted in the last quarter of 2012, since reaching a fairly high level in the first part of 2011, and the data shows that purchases of equipment, software and other goods have been very slow lately. As a result, U.S. companies scaled back investment plans at the fastest pace since the recession, which may signal more trouble for the economic recovery. Over half of the nation's biggest publicly traded corporate spenders announced plans to curtail capital expenditures this year and next. Corporate executives said they are slowing or delaying big projects to protect profits amid slowing demand and rising uncertainty. They feared that failure to resolve the "fiscal cliff" would tip the economy back into recession by sapping customer spending, damaging investor confidence, and eroding corporate profits.

Panic about the "fiscal cliff" also threatened to lead Congress into the same short term thinking that may compromise our future. Investments in education, scientific research and infrastructure (which account for a small portion of the federal spending but make the economy more productive in the long run) are at risk.

Shares of companies in technology, energy and telecom led the market lower. For technology, the underperformance was due to that fact that many technology companies earn over 50% of their revenue overseas, and overseas, especially Europe, has been very weak. The broad lack of revenue growth has been particularly distressing for investors, underscoring a drop in spending and corporate activity abroad. Revenue growth is a key sign of strength in a global economy. Companies are already very lean and can't rely on internal cost cutting to keep earnings growth going, as they have been doing for the last three years.

Energy stocks were weak in 2012 on concerns over global growth, and the perceived notion of lower global energy consumption. However, energy stocks should fare well going forward as it appears the U.S. will become a net exporter of petroleum products in the not so distant future. Our domestic oil and natural gas exploration and production is surging and the companies involved and that we own are very well positioned. The surge in production is also a catalyst for our economic growth and job creation.

Against this backdrop, housing is rebounding. Corporate earnings have been consistently positive. Corporations are sitting on piles of cash, and we are in a favorable low interest rate environment. Europe has avoided a financial meltdown, and domestic job creation is firming. A renaissance in our domestic energy production is also fueling economic growth.

The U.S. housing market, which plunged the economy into recession five years ago and has been a persistent drag on the economy, is now a key economic driver at a time when other sectors are slowing. Every housing statistic has turned positive, and housing will make a contribution to the economy in 2013. Home prices are rising, banks are posting record mortgage profits, and consumers are renovating, upgrading, and decorating their homes. This surely can be attributed to the Federal Reserve created low interest rate environment.

Emerging Markets economies, which were a source of strength when the downturn began, lagged during 2012. China's growth slowed as it saw its export markets shrink due to global economic weakness. Brazil, whose great potential remains untapped, tried and is still trying to make an economy work that incorporates rapid growth with domestic social programs, not an easy undertaking. India has internal infrastructure problems that are making growth difficult to achieve as well. While these emerging market economies will still grow and be attractive, they are not what they used to be.

Lost in all the focus on the "fiscal cliff" is the fact that the private sector continues to show signs of improvement. Manufacturing is signaling strength, the service sector is improving and the housing and domestic energy boom is helping to create modest economic expansion. The housing recovery includes positive wealth creating effects for the U.S. consumer. Rising home values translate to further consumer spending, healthier bank balance sheets and stronger demand for the industries connected to the housing market. Stronger bank balance sheets will hopefully translate into more lending, which would be an overall positive for the markets.

The U. S. job market finished 2012 with the same low growth rate as it has had for the past two years. The 7.8% unemployment rate is holding steady, however, there are risks with the looming battle in Washington over the debt ceiling, tax reform, and entitlement spending.

While keeping in mind the “headwinds” (Washington policy stalemate, unemployment) and “tailwinds” (housing recovery and the domestic energy renaissance) of the current environment, we are still very positive and confident that the stocks we own will do well in 2013. The Fed’s loose monetary policy should continue to stimulate demand for goods and services and stimulate companies’ desire to invest and hire!

We look forward to what 2013 has to bring us.