MURRAY
INVESTMENT MANAGEMENT

4th Quarter 2012 Update

Economic Review

The U.S. economy continued to grow at a modest pace during the 4th quarter and showed some signs of potential acceleration with the housing sector as one of the bright spots. 3rd quarter GDP was revised up to 3.1% with the expectation for similar growth during the 4th quarter. The U.S. unemployment rate remained at 7.8 % at the end of year, and job growth averaged 153,000 per month with the second half improving after a mid-year slowdown.

The U.S. Federal Reserve announced further monetary easing during December and tied its interest rate intentions to the unemployment rate for the first time noting that it will not raise rates until the unemployment rate is below 6.5%. This stance will likely keep interest rates low through 2013.

The fiscal cliff debate was the most significant issue during the quarter and was partially resolved in early January as Congress agreed to raise taxes on upper income Americans while keeping in place the Bush tax cuts for most taxpayers. The 2% payroll tax cut, however, expired for everyone. The increased tax rates on couples making over $450,000 include higher dividend, capital gains and estate taxes as well as reduced deductions for couples making over $300,000

While additional tax revenue is needed to balance the budget, spending is by far the more significant issue related to the deficit. In that regard, the fiscal cliff resolution was disappointing as it failed to address entitlement spending.

Equity Market Performance

	3 Months	YTD
S&P 500	-0.38%	16.00%
MSCI EAFE (International index net return)	6.57%	17.32%

The S&P 500 was slightly down during the 4th quarter but posted very strong results for the full year 2012 (up 16%). All 10 S&P 500 sectors had positive performance during the year with the Financial and Consumer Discretionary sectors showing the strongest results while the Utility and Energy sectors were the weaker performers. With the strength in the Financial space, the value style of investing generally outperformed growth investing during the year.

After lagging domestic markets for most of the year, the broad International markets rallied during the 4th quarter and posted very strong 2012 performance (MSCI EAFE up 17.32%). European markets were among some of the better International performers during the year as investors were relieved to see some progress on the European debt situation.

Bond Market Performance

	3 Months	YTD
BarCap US Aggregate Bond (Broad Bond Market)	0.22%	4.22%
BarCap Municipal	0.67%	6.78%
BarCap US Treasury Long	-0.77%	3.56%
BarCap US Corporate	1.06%	9.82%
BarCap US Corporate High Yield	3.29%	15.81%

The 10 year U.S. treasury rate fell slightly during the year to close at 1.78%, and the broad bond market posted solid results with particular strength in the High Yield Corporate space.

Economic Outlook

The U.S. economy is expected to grow modestly (1%-3%) during 2013 but is showing signs of improvement and could surprise to the upside. The housing sector is one of the bright spots, which should contribute to an improving jobs market and potentially increase consumer spending. In addition, with the resolution of the tax side of the fiscal cliff, businesses and consumers have more clarity on that front, and pent-up demand could lead to increased spending, capital investment and job creation.

On the other hand, the fiscal cliff negotiations called for the end of the 2% payroll tax holiday and increased taxes on upper income Americans. These changes will have a direct impact on the economy in the short term and will drain money directly out of consumers' pockets.

The fiscal cliff deal that was agreed upon in early January only delayed by 2 months the automatic spending cuts that were to go into effect on January 1. This highlights the biggest long term economic issue for the U.S. which is getting our spending under control through entitlement reform.

If reduced spending is the result of part 2 of the fiscal cliff negotiations, we could see a very favorable economic environment. While the cuts in spending will serve as somewhat of a drag on economic growth, the cuts will likely be pushed out and phased in over time. Currently, the cuts will be viewed favorably, and we could see much better economic growth given the confidence that will be generated from our nation being on a much more sustainable, long term financial path.

Source: standardandpoors.com, bls.gov, Morningstar, bea.gov, cnbc.com, wsj.com, msci.com, federalreserve.gov and treasury.gov
The performance data shown represents past performance, which is not a guarantee of future results.
Return data is as of 12/31/2012. Except as noted, index returns are Total Returns.

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Market Outlook

Given the impending fiscal cliff negotiations and the debt ceiling debate, equity markets will likely be volatile during the first quarter as lawmakers debate the debt ceiling and entitlement spending. Hopefully, we can get a bill passed that reduces entitlements and puts the U.S. on sound financial footing for the long term which could be very favorable for equity markets.

Even with the expected volatility, equity markets could produce solid results again in 2013 given reasonable valuations and the potential for solid corporate earnings growth. With the S&P 500 closing the year at 1426 and expected 2012 estimated earnings of $108, the current P/E (price to earnings) ratio is 13.2, which is reasonable from a historical perspective. Further earnings growth and potential multiple expansion could drive the market higher in 2013.

In the fixed income space, it's important that investors consider the massive bull market that has played out over the last 30 years and the current low level of interest rates. In light of this, it's reasonable to assume that fixed income returns will be modest in the next several years with the potential for losses. With rates so low, modest interest rate moves up could lead to total return losses for bonds. It is a lot easier for bonds yielding 4% or 5% to produce a positive return when rates rise compared to bonds with much lower yields. In other words, the margin for error is low, and this is not even factoring in inflation, which could make the real return on fixed income even more challenging.

As such, the relative unattractiveness of the fixed income space could serve as a tailwind for equity markets. Many could conclude that the additional risk associated with owning equities is worth the additional return potential and move money from bonds to equities. This coupled with an improving economic environment could lead to a favorable equity market in 2013.

Murray Investment Management

If you would like help with establishing an investment plan or would like to schedule a portfolio review, please give us a call. Also, please pass along our name to anyone that may be in need of investment advice.

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