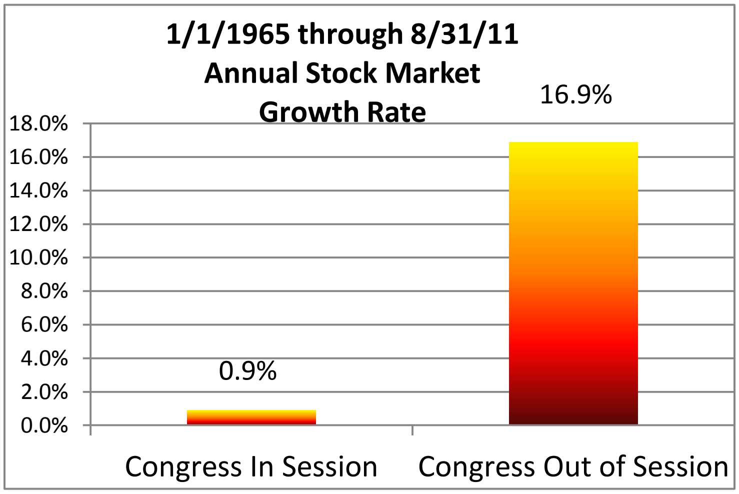
July 2012
Market Commentary

The last few newsletters have highlighted reasons for investor confidence in the longer-term future of stocks and other risk oriented assets in the U.S., yet the immediate future still presents the economy and investors with a gauntlet of hurdles and challenges.

Probably the biggest news of the month was the Supreme Court's confirmation of Obamacare. Although the Court ruled against the law's claim that the individual mandate to buy insurance could be required through Congress's power to regulate commerce, the reclassification of the mandate as a tax effectively upheld the law. The impact on stocks is likely to remain muted. While the law's confirmation is widely expected to adversely impact the economy through greater inefficiency and higher taxes (I'm only commenting on economics in this newsletter), the changes will take place over years, and will be difficult to predict. For now, at least we have greater clarity on the law's future.

This recent legal ruling highlights the uncertainty of many other laws, policies and politics. Within the next six months, the U.S. faces a massive, near-term fiscal cliff including

1. required debt ceiling increase,
2. expiring Bush tax cuts,
3. ending payroll tax cuts,
4. expiring accelerated depreciation,
5. 2013 sequestration mandating across the board budget cuts,
6. a required alternative min tax fix, and
7. Obamacare enactment.



All these events occur automatically if not changed by law. Various partially enacted legislation, whether it be Dodd-Frank, department of labor changes, the incredible slew of environmental protection agency mandates, etc, also ensure ongoing ambiguity. No matter who wins the presidential race, uncertainty will drag on the economy and likely unsettle investors as Congress struggles with toxic subjects during a lame duck session.

The chart above highlights investor dislike of uncertainty, and the percentage gain while Congress is out of session has climbed nearly a full percentage point during the last few years. When Congress is changing the rules of the game, investors consistently remain very cautious throughout administrations changes in congressional control. It could be argued that the next several months present even higher than normal uncertainty given the items mentioned above.

For investors, however, it's important to note that congress will be in session less than half the time during the rest of the year. More importantly, congress tends to accomplish much less during lame-duck sessions which has contributed to fairly strong stock market returns during election years. Moreover, the private sector has an incredible war chest of over $3 trillion that should help it weather ongoing uncertainty. Profits remain high, capital is cheap, and low inflation persists.

Possibly more to the point for investors, the current uncertainty in so many areas has kept **valuations** at conservative levels. While valuations of stocks and most other risk oriented assets no longer dwell at the distressed levels of a few years ago, prices for most assets still linger well below historical norms.

Europe will stay in the news as they struggle to sort through a twisted mess they've been creating for years. We will hear about more crisis and defaults, but Europe should continue to resolve them. Lost in the news over the past year seems to be Europe's steady development of a system to deal with the crisis involving a messy combination of the European Central Bank (ECB) and Germany writing checks because they have no other choice. Highly publicized problems will be accompanied by posturing, bluffing and frequently, insults. The ECB will become more visible and active, and eventually the ECB or Germany will write a check. The crises will be overcome, and collapse will be avoided. Wash, rinse, repeat. The structural problems plaguing European economies will remain and their economies are likely to grow increasingly uncompetitive, but they won't collapse. The U.S. should remain the clear developed economy leader while Europe limps behind.

A potential hard landing for China's economy also presents challenges to the global economy. China borrowed much to build buildings, roads, etc. that they can't finish and can't fill. Residential property prices are the highest in the world and affordability is the lowest. They have excess inventory of copper, housing, and infrastructure that was built in the wrong places. Growth could decline to only 6 percent from the forecast of 10 percent which would be below expected trend. While 6 percent remains high, projections by the rest of the world have assumed higher numbers and a large difference presents potential challenges. Unemployment could rise outside China, commodities could build up, and inventories may increase.

Yet with China, much of the concern is likely overstated. Problems are virtually never as bad as forecast, largely because we don't understand their economy very well. It simply works different than ours. Out of the 35 largest economies listed on the Shanghai stock exchange, 34 are state owned. Their growth rate also covers a large percentage of their problems, and 6 percent is likely high enough to continue the trend. China's inflation adjusted GDP is also at the point that most countries' inflation adjusted GDP growth slows to about 6-7 percent. China will likely make the transition successfully even if we don't understand exactly how it will happen.

In the midst of the current chaos, there's good news in other areas too. As long as problems rage in Europe, the U.S. dollar should be fine. The dollar still accounts for 62% or world reserves, and most economists predict that the dollar will strengthen in the mid and long-term. A currency is reflective of an economy, and the U.S. shines in comparison to every other developed nation. In the last year, the dollar has appreciated about 13% versus the euro.

Over the past 30 years, wars, conflict, terrorism have all declined dramatically. We're experiencing the lowest level of violence in history. In 1979, 35 countries struggled with hyperinflation. After Zimbabwe dollarized their economy earlier this year, no country faces hyperinflation today. The U.S. is experiencing an energy renaissance that will contribute immeasurably to our economy in future decades.

Over the last half of 2012, investors will almost certainly be pummeled by threats of possible catastrophes from Europe, China, Washington, and, as yet, unnamed villains. Markets may or may not react, but I believe that current valuations make a sharp sell-off unlikely. Regardless, the next several months will probably be tumultuous, but the longer term opportunity likely remains. For investors with a longer term view, stocks and risk-based assets should present an excellent opportunity.

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