TFC Market Update
November 27, 2012

Careening Toward the Fiscal Cliff?

Close readers of these occasional communications know their purpose is not political punditry. For analysis of the latest inside-the-DC-Beltway developments and gossip, your favorite columnist will be far more informative and entertaining. With the longer view in mind, our concern is to update the fundamental and strategic scorecard for investors. Managing other people's money tends to clear the mind and force an attempt to see through the constant media fog.

In the U.S., voters have had their say. The president was re-elected by the smallest percentage point gap ever in the popular vote. Post-election, investors rendered their verdict with an immediate 5% decline in the price of U.S. equities, but U.S. stock markets still remain 30% above their October 2011 levels. In China, the Communist Party's every 10 year leadership transition is still underway. Together, these two countries represent roughly 35% of the world's economic output and nearly 55% of global stock market capitalization value. Both countries also are slowly recovering from wrenching economic readjustments; and each in its own way represents an essential lynchpin if the world's economic malaise is to be overcome. Future Chinese official GDP growth reports will, it seems, reflect more of a "soft-hard landing" rather than the potentially recessionary numbers pessimists had predicted.

Domestically, U.S. personal balance sheet and banking system deleveraging continues. And based on our improving energy self-sufficiency and the re-pricing of labor costs outside the U.S., the competitiveness of our manufacturing sector rebuilds apace. Remaining still in the U.S. is for fiscal policy to catch up with the remedial examples set by our state governments (exceptions being California and Illinois), corporations, and individuals.

China, on the other hand, faces the intimidating task of shifting its economic model from one driven by exports and trade to a consumer-oriented structure, plus the daunting requirement to create roughly twenty million new jobs annually. For the new leadership, this needs to be accomplished in an era when annual U.S. carbon emissions have declined to less than 15% of the global total, while China's has risen to 34%; not to ignore for one moment its yawning wealth distribution gap, nor the pervasive official corruption undermining the governing class's mandate.

Ripples Across Wall Street (Coming to Grips with the Fiction of Federal Reserve Board Independence)

In the absence of any politically-derived fiscal policy in the U.S. and Europe, central banks (i.e., in the U.S. the Federal Reserve Board, or Fed, and across the Atlantic the European Central Bank, or ECB) have been forced to intervene to keep their respective economies and financial systems functioning. In reality, central bank monetary policy (certainly in the U.S.) has

now merged with, or become a substitute for, fiscal policy. Our Federal Reserve Bank (in the person of Chairman Bernanke) has become yet another branch of the Federal Government. The idea of the Fed's independence is a myth, and its focus (due currently to the fiscal policy void) of necessity has become decidedly short-term. The Fed's monetary tools (e.g., QEs 1, 2 and 3, "Operation Twist," etc.) are losing their effectiveness. The resulting flood of Fed-created liquidity has not found its way into the real economy yet, but rather onto banking system balance sheets and into the bond markets. The resulting economic, fiscal policy, and investment market cross-currents are conflicting, but through all the noise one gains the impression that in the U.S., and the emerging world (if not yet in the Euro-sector) most economies are proceeding with the necessary remedial actions. Awaiting greater fiscal clarity, the U.S. may be poised for improving numbers, perhaps surprisingly better than expected. If this assessment proves accurate, it will occur against a background of reasonable equity market valuations, but possibly vulnerable bond market conditions.

Bracing for Changes in the Tax Code (THE Key U.S. Economic Variable for 2013)

Maneuvering to protect themselves from the prospect of higher taxes on dividends and interest next year, Walmart, Steve Wynn (Las Vegas casino magnate) and other corporate entities have declared special year-end dividends. As 2012 closes out, more such pre-emptory early special dividend declarations will no doubt occur. Federal tax policy (or the absence of any such policy clarity), it could be argued, is the single most important drag on U.S. economic activity presently. This is certainly the case for most businesses engaged today in long-term strategic planning and hiring policy determinations. By the end of this week, you will receive a report from TFC's Vice President Scott Swartz detailing our thinking on how investors should view the probabilities and possible outcomes for future federal income and estate tax policy.

One temptation to resist is the urge to realize capital gains in 2012 just to avoid the scheduled rate increase next year. Wall Street is (will be) cranking up the pressure to sell now to bypass the certain increase in long-term capital gains rates set for 2013. For brokers, average yearly trading volume in U.S. stocks is down 30% year-to-date from 2011, so the pretext exists. Selling and reinvesting to reset tax basis at higher levels sounds tactically savvy, but remember subsequent reinvestment for most taxable investors would start with 80 cents on the dollar, or less. The immediate tax hit leaves one with less money upon which to earn future gains. For long-term investors, in most cases it makes sense to defer capital gains even if rates do go up.

Nonetheless, purely for investment reasons, some further portfolio rebalancing for client accounts is in prospect before year-end. U.S. stock valuations have moved ahead of developing and emerging market comparables. Given this shift, some fine-tuning with a re-weighting toward international/emerging markets seems warranted.

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Preliminary Mutual Fund Year-End Distribution Intentions

Our admittedly non-scientific sampling of many of our portfolio fund managers indicates that due to the anticipated run-out of the Bush tax rate schedule, few additional year-end *special* fund capital gains and income dividends will be forthcoming. Although we can be certain fiscal tax policy issues have been discussed actively throughout each portfolio manager's investment process, the decision on the whole seems to have been made not to make tax-motivated sales of any one fund's holdings which would force the realization of non-recurring gains and fund shareholder distributions before the end of 2012.

As always, we welcome your comments and questions.

Sincerely,

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Chairman and CEO

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