

QUARTERLY REPORT

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TOPSY-TURVY

Dear Clients:

It's been a topsy-turvy six months for world equity markets as "solutions" for Greek debt, undercapitalization of the German and French Banks and, ultimately, the sustainability of the euro are bandied to and fro by the politicians in the European Union. US equity markets have been driven by "macro" events rather than by fundamentals. The third quarter saw the political farce of our Congress threatening to shutdown government and cease paying federal obligations. As unhealthy as the US budget deficit may be, the ability of the US government to meet its financial obligations is unquestioned. The relentless beat of negative news is making investors trade on fear rather

than on facts. The US economy continues to grow, albeit at a modest rate, while corporations remain profitable. We expect an eventual policy prescription for Europe's ailments and a rebound in stock prices by the end of the year. Fixed income portfolios, primarily consisting of US Treasuries and high-quality municipal debt, have performed strongly this year, as global investors have flocked to the relative "safe-haven" of US debt. This is deliciously ironic considering the superfluous credit downgrade of US Treasury debt in the third quarter!

Cordially,

Kathy Wimmer, CFA, CIC
President

GREECE IS THE WORD

Yes. Greece is the word; a proxy for all the financial problems that have beset the European Union (EU). Greece is the alpha, but not the omega of economic malaise in Europe. Everyday markets around the world gyrate up and down, the direction is dependent upon news reports that Europe has developed a credible plan to bail out Greece and forestall default contagion throughout the southern periphery of Europe, especially in Spain and Italy. In order for Greece to move forward economically, the country's sovereign debt must be written down by at least 50%. This is especially problematic for Europe's banks, primarily German and French, which hold the majority of Greek debt.



So, not only do Portugal, Ireland Italy Greece and Spain (the PIIGS) need financial support to refinance their maturing debt maturities, but the German and French banks need to be recapitalized with new equity in order to weather the credit write-offs that are necessary to stabilize Greece.

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KEY FACTS FOR 2011

- *Annual gift exclusion*
\$13,000
- *Estate, gift and generation-skipping tax exemption*
\$5 million
- *Highest marginal estate tax rate* 35%
- *IRA contribution limits*
\$5,000, plus another \$1,000 for those over fifty
- *SIMPLE IRA and 401(k) contribution limits*
\$11,500, plus another \$2,500 for those over fifty
- *401(k) contribution limits*
\$16,500, plus another \$5,500 for those over fifty
- *SEP IRA contribution limits*
25% of compensation, max of \$49,000
- *Top Federal tax rate is 35% on income over \$379,150*

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GREECE IS THE WORD (CONTINUED FROM PAGE 1)

Economists and policy makers have discussed the fear of “contagion” from a Greek debt default and the necessity to create a “ring fence” around Greece. In simple terms, this means Germany and the northern European countries must ante up billions of dollars to aid the refinancing of maturing debt in the periphery countries. This is especially galling to the fiscally disciplined Germans who are not amused at the prospect of bailing out their profligate EU members. Moreover, the European Central Bank (ECB) will need to lower interest rates in order to lessen the burden on overstretched debtors in the EU at the risk of stoking inflation. This is a harrowing outlook for the Germans who have a profound revulsion to inflation, stemming from the hyper-inflation nightmare of the Weimar Republic.

The IMF estimates that European banks will have to raise \$200 billion Euros to recapitalize their balance sheets after taking a 50% “haircut” on Greek sovereign debt. As Greece can not possibly meet its current

obligations, a default is inevitable. However, European policymakers are perpetrating a charade as they demand creditors take “voluntary” write-downs and substitute new indebtedness with longer maturities to restructure Greek indebtedness. The “voluntary” nature of the write-downs allows Greece to avoid a technical or “involuntary” default, which would otherwise trigger the crystallization of credit default swaps (CDS) and put further stress on Europe’s under capitalized banks. We noted in our recent letter to clients that American money market funds have stopped investing in European bank debt as a precaution against a Greek payment default.

It is apparent that Europe must provide a credible policy response to deal with Greece’s inevitable default and the under capitalization of its banks. It is important that the Europeans address both the lack of liquidity and, more importantly, the solvency of major European banks. Just as Americans were disgusted with the Congressional TARP program that recapitalized US

banking institutions, the Europeans must now hold their noses and shore up the solvency of their financial institutions. This means that bank shareholders will face dilution as new capital must be raised to ensure the viability of the banking sector. As for Greece, if the euro zone (a seventeen member monetary union) were to expel the Greeks, it is likely that the whole euro construct would fold. It seems most likely that we will see a further bailout of the Greek state, which will only provide further moral hazard to spendthrift countries in the EU. We have seen Germany and France cobble together a reasonable plan that would increase the European Financial Stability Facility (EFSF) to \$1.4 trillion, which should be adequate to backstop the needs of Italy and Spain; however, the proposed solution lacks credibility, as it is sorely lacking in details.



THIRD QUARTER 2011

Stock prices performed poorly in the third quarter, as reflected by a drop of 14% in the broad-based Standard & Poor’s 500 Index. The Dow 30 Index of blue-chip stocks fell 12% during the quarter. Of course, we should not pass up a bit of Schadenfreude, as the German and French stock markets lost about 25% of their value during the quarter. We attribute the poor equity performance in the US markets to hedge funds liquidating their leveraged holdings, primarily in US financial stocks like Bank of America, CIT Group and Citibank, to meet client redemptions: September is the month when investors are allowed to elect to redeem their hedge fund investments.

Additionally, European banks have lost a major source of funding as money market fund managers refuse to hold short-term European bank notes; this disappearance of short-term funding has forced the banks to sell off their equity holdings in order to maintain liquidity.



High-grade fixed income investors enjoyed the quarter as the US Treasury ten-year note fell to a yield of 1.92% at the end of the quarter, compared to 3.18% at the end of the second quarter. The total return for the ten-year Treasury was approximately 12% during the third quarter.

Gold finally lost a bit of luster falling off its all-time high, but still managed to make a gain for the quarter, ending at \$1,620.00 per troy ounce, up from \$1,505.50 at the end of the second quarter. Gold is not a productive resource; however, it now trades like a reserve currency, as investors grow

THIRD QUARTER 2011 (CONTINUED FROM PAGE 2)

wary of central banks' willingness to combat inflation. Oil prices have declined 17% over the third quarter, which is beneficial to consumers and transportation sensitive industries. Oil remains a volatile commodity, so we are not convinced that lower prices will remain steady. Moreover, we believe that China slowed down its stockpiling of commodities over the

quarter, which also led to the decline in copper prices by 26%!

Preliminary US GDP numbers were surprisingly strong at 2.5% for the third quarter. Personal spending rose 2.4% in the quarter as consumption rebounded to the consternation of "perma-bears". Business investment in computers and equipment was especially strong, rising 17.4% in the

third quarter. Employment grew by 103,000 jobs during the month of September, which is the right direction after August showed no new jobs being added to the employment rolls. Talk of a "double-dip," or second recession, should be further discounted after the economic growth seen in the third quarter.

THE ROAD AHEAD

The recent whip-sawing of equity prices will most likely continue as "macro" events, such as a sovereign debt default by Greece, drive investors nutty not knowing the ultimate effects. As we stated earlier, "Greece is the word"; and, the word is a proxy for the health of the peripheral members of the European Union. Europe has the resources to manage an orderly Greek default and withdrawal from the Euro. It is unlikely however that Europe has the resources to manage a Spanish or Italian default should they occur. It is hard to imagine the euro continuing as a monetary union when there is not a fiscal union that demands fiscal responsibility by each of the member states. Further, it is unlikely that the fiscally disciplined Germans will stomach the costs to bailout the profligate Greeks. One can hope for an orderly default by the Greeks and a managed withdrawal from the euro. Hope, however, is not a strategy and we therefore refrain from exposure to European banks with sovereign debt exposure for the foreseeable future.

The Federal Open Market Committee (FOMC) of the Federal Reserve released its latest statement saying "The Committee continues to expect a moderate pace of economic growth over upcoming quarters" after "economic growth strengthened somewhat in the third quarter".

As reported earlier, during the third quarter we watched GDP growth accelerate to a 2.5% annual clip, up from 1.3% in the second quarter, and the 0.9 percent rate of growth for the first half of 2011.

According to Standard & Poor's' Lookout Report, "with 67% of companies reporting as of October 20th, eight of ten sectors reported earnings that exceeded expectations".

This is the ninth consecutive quarter of positive growth for the US economy. Consumers increased consumption belying the continued weak consumer confidence surveys.

The balance of the year looks to be moderately promising for equities as October realized the sharpest one month gain in the past two years. We believe corporate earnings will remain strong, underscoring the fundamental health of corporations. According to Standard & Poor's' Lookout Report, "with 67% of companies reporting as of October 20th, eight of ten sectors reported earnings that exceeded expectations." Earnings rose 14.7 percent at S&P 500 companies in the third quarter, according to the data

compiled by Bloomberg through the end of October. This is the eighth consecutive quarter of double-digit earnings growth for US corporations.

The economic growth in China has moderated this year, but continues to grow at an enviable 9.5% pace per year, down from 10.1% last year. The IMF is predicting a further drop in Chinese GDP growth next year to 9% per annum. The moderation of Chinese economic growth is being engineered by central planners trying to slow down the breakneck growth of housing and high inflation in China. Although pessimists worry about a "hard landing" for China, the Chinese authorities have fiscal and monetary tools to manage the continued growth of the economy. China will continue to account for approximately one third of the world's economic growth.





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We strive to optimize our clients' financial well being by coordinating investment decisions with other professionals in the fields of taxation and estate planning.

SUMMARY

In a nutshell, European governments, economies and banks are mired in a Euro-Debt Swamp, with Germany the only dry, stable patch of ground. It is probable that some European economies will sink into recession, as governments write-down debts, reduce spending and the Euro-banks increase capital and reduce lending. And it may take years for European countries to extract themselves from this Euro-bog.

The US economy continues to grow at a moderate pace. US corporate earnings have been growing at double-

digit rates for the past two years, as the benefits of cost-cutting and increased operating efficiencies accrue. Many US companies are sitting on historic cash reserves, estimated at \$1.5 trillion (Examples include Apple's \$81 billion and Microsoft's \$40 billion cash piles).

Volatility will persist in the US stock markets, as institutional and individual investors are making decisions based on "macro elements", geopolitical instabilities, and news hype, rather than specific company fundamentals. This market has been a very difficult environment for a number of short-

term traders, a fact evidenced by the abysmal performance of many hedge funds in 2011. And given the extreme daily and weekly moves in the market, on any given day there could be a significant divergence between the fundamental value of a company and its stock price, as investors and the markets negatively overreact to the exogenous macro factors. At Wimmer Associates, we continue to diligently monitor the markets and stand ready to opportunistically add attractively valued securities to our clients' portfolios.



Disclosure: "Be careful about reading health books, you may die of a misprint." Mark Twain Keep that in mind as you read these articles. We obtain data from sources we believe are reliable but they should not be relied upon for making life-changing decisions.