Golden Capital Management

Commentary – December 31, 2011

Market Review

The U.S. equity markets finished the year with a strong quarter. The Russell 1000® returned 11.8% in the fourth quarter, bringing its 2011 return into positive territory at 1.5%. The Russell 2000® returned 15.5% in the quarter, but this did not make up for losses earlier in the year as it finished 2011 down -4.2%. The markets experienced the reversal of several trends from earlier in the year; specifically, smaller capitalization stocks outperformed their larger peers, while higher beta stocks outperformed lower beta stocks during the fourth quarter.

During the third quarter, equity markets were overwhelmed with a sense of negativity that led to significant declines. However, in October, U.S. economic data began to show signs of stabilization, and the markets rallied from the previous quarter's declines. Some indices for manufacturing and servicing activity showed slight improvements while others continued to disappoint; employment reports continued to show net job additions, though the unemployment rate was unchanged; new home sales provided some encouragement; and the initial third quarter GDP estimate came in at 2.5% (it was later revised to 2.0%). Through most of November, a pessimistic tone once again pervaded the markets, and fears took hold that the European sovereign debt crisis could escalate and drag down the U.S. recovery. Despite the negative mood, economic data continued to show signs of stabilization, including a rise in consumer confidence and a decline in the unemployment rate to 8.6%. The markets dipped in mid-December, but finished slightly higher than they began.

Over the course of the quarter the European sovereign debt crisis was a persistent overhang on U.S. equity markets. Toward the end of October, an important summit was held in Brussels to discuss the crisis, and an agreement was reached that included plans for recapitalizing European banks, boosting the Euro zone rescue fund, and sharing losses on Greek debt. The proposal seemed to be met with enthusiasm until Greece's Prime Minister Papandreou called for a referendum vote to approve or reject the terms of the deal and the markets reeled in response. Soon thereafter, Papandreou stepped down as Prime Minister and cancelled the referendum, but the damage to confidence caused by the idea that Greece might actually leave the monetary union was not so easily erased. At the end of November, the U.S. Federal Reserve and five other central banks opened unlimited swap lines and reduced the swap rate by 50 basis points to increase liquidity in the European banking market. Shortly thereafter, the European Central Bank announced a new repurchase program that will allow banks to exchange a variety of assets as collateral for low-rate, 3-year loans. The introduction of these liquidity mechanisms to prevent a sovereign debt crisis from becoming a crisis of the European banking system brought some year-end comfort to markets in the U.S.

Market Outlook

As we enter 2012, there is a sense of déjà vu when it comes to the investment environment. The macroeconomic backdrop continues to be characterized by U.S. consumers that are de-leveraging; fiscal authorities in the U.S. and other developed economies that have reached their capacity for fiscal stimulus; a healthy corporate sector that lacks the confidence to aggressively expand and hire new employees; and equity valuations that seem reasonable but are mired in uncertainty.

It seems likely that the most pressing issue facing investors in 2012 will continue to be the European sovereign debt crisis. It appears that Europe is entering a recession and the fiscal authorities do not have the capacity or the public support for fiscal stimulus, bank bailouts, or fiscal transfers from stronger countries to weaker ones. As a result, Europe will likely be a drag on the global economy and will present a significant risk of financial contagion due to its very weak and over-leveraged financial sector. However, we believe the monetary authorities may have significantly reduced the tail risk of a disorderly and cascading failure in the financial system with the recent implementation of two liquidity mechanisms: the unlimited, lower-cost, bi-lateral swap lines established between the major central banks, and the three-year repurchase operation offered by the European Central Bank. In essence, these steps amount to a quantitative easing program that may be enough to backstop the European banking system and prevent a repeat of the 2008 financial crisis.

In the U.S., we believe that the domestic economy has stabilized and should be able to grow modestly. While consumers are likely to continue facing headwinds, we think the modest improvement in the labor market should continue, contributing to a positive feedback loop of improving income, improving consumer confidence, improving consumer spending, improving corporate profits and more jobs. Additionally, the U.S. housing market seems to have stabilized, and we think the Federal Reserve and the Obama administration are likely to take additional steps to boost the housing market in 2012. However, the biggest boost to the economy may come as businesses pick up capital investing, which has been depressed for some time. The real capital stock of the U.S. is at the same level as it stood in 2008, and capital expenditures are only running at approximately 80% of cash flow according the Federal Reserve's flow-of-funds data. On the negative side, the potential for a stronger dollar due to its "safe-haven" status may lead to a difficult environment for U.S. exports.

We are cautiously optimistic toward the equity markets based on the outlook for corporate profits and valuations that we perceive to be reasonable. As for corporate profits, sales should be supported by a growing economy, and input costs should be contained by slack in the labor market and commodities prices held back by a strong dollar. Although profit margins are near historical highs, we believe these conditions, coupled with additional productivity growth, will allow high margins to persist for the medium term. As for valuations, on balance, the U.S. equity markets appear fairly valued. While there are some measures that point to slight overvaluation (e.g. certain cyclically adjusted price-to-earnings multiples) and other measures that point to slight undervaluation (e.g. equity risk premium as measured by the corporate earnings yield minus the real yield on AAA-rated corporate bonds), most of the measures indicate historically average valuations (e.g. trailing and forward-looking price-to-earnings ratios, Tobin's Q ratio, and the Shiller price-to-earnings ratio).

In conclusion, the risk of another global financial crisis is still higher than normal, and that risk could lead to a continuation of the heightened level of volatility we have experienced recently in the financial markets. However, we believe that long term investors will be rewarded for disciplined stock-picking that seeks out quality, reasonably valued companies.