THE BUTTONWOOD

On May 17, 1792, twenty-four merchants gathered under a buttonwood tree at 68 Wall Street. There they signed the Buttonwood Agreement, creating the first investment community, which later evolved into the New York Stock Exchange.

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FOURTH QUARTER 2012

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2012 is in the books as they say, and by almost any conservative measure it was a very good year for US based markets. In fact, as the chart below illustrates, the US markets have done quite well since the end of 2008. All of the data comes during a period (2008 – 2012) when the majority of US investors have been net sellers of stocks. This is somewhat surprising because interest rates are at 30 year lows and the Federal Reserve has suggested that rates will likely remain low. The Associated Press reported that "It's the first time ordinary folks have sold (stocks) during a sustained bull market

Index (Total Returns)	2012	2011	2010	2009	2008
DJIA	10.24%	8.38%	14.06%	22.68%	-31.93%
S & P 500	16.00%	2.11%	15.06%	26.46%	-36.99%
NASDAQ Composite	15.90%	-1.80%	16.91%	43.89%	-40.54%
S&P Muni Bond Index	7.41%	10.64%	2.45%	14.63%	-5.09%
DJ Corporate Bond Index	10.80%	8.51%	8.85%	17.55%	1.80%

since relevant records were first kept during World War II". In fact, the data indicates that investors were net sellers as early as April 2007. The Wall Street Journal reported that "investors globally have poured nearly $700 billion into bond funds, while pulling nearly $300 billion out of stock funds" during the last three years.

We took a look back to the last time stocks corrected as severely as they did in 2008 (the Great Recession) to try and determine if the average investor has ever been a net seller before a significant secular (long term) stock market correction as well as a net seller after the correction. The Investment Company Institute reports that there have been nine recessions since World War II that were followed by recoveries lasting at least three years. We are in a similar environment currently. During this time frame there was only one instance when investors were sellers before and after a recession. This was the severe correction in 1973 – 1974 when the Dow Jones dropped by more than 44%. What is interesting is that the correction in 1973 – 1974 was brought on by a confluence of circumstances. Arguably the two most significant were inflation and the Arab oil embargo. To this day both still have a significant influence on our lives.

Inflation is a major economic variable in the investment equation. The table on the next page shows the inflation rate rising from 6.2% in January of 1970 to over 12% by December of 1974. Remember that the rise in the inflation rate was gradual as witnessed by the fact the average rate was as low as 3.2% in 1972. How significant was this increase in inflation? Some of our older readers (like me!) might remember WIN buttons – ***Whip Inflation Now***. This increase was a very significant shock to the economic model of the day and would remain so until well into the 1980's.

The Arab oil embargo demonstrates how international politics and war can have a devastating impact on markets. In 1973 Egypt and Syria, with the support of other Arab nations, launched a surprise attack on Israel which was vastly outnumbered. The United States choose to support Israel and was summarily punished by OPEC in the form of an oil embargo. The result was a price of $25 for a barrel of oil when most business models used a price of $4 per barrel.

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The seeds of both of these events were sown over time. Once they reared their ugly heads, the impact was a shock to our economy and the stock market. Hence the 44% correction in stock prices from 1973 to 1974.

Table of Historical Inflation Rates by Month and Year

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Ave
1970	6.2	6.1	5.8	6.1	6.0	6.0	6.0	5.4	5.7	5.6	5.6	5.6	5.7
1971	5.3	5.0	4.7	4.2	4.4	4.6	4.4	4.6	4.1	3.8	3.3	3.3	4.4
1972	3.3	3.5	3.5	3.5	3.2	2.7	2.9	2.9	3.2	3.4	3.7	3.4	3.2
1973	3.6	3.9	4.6	5.1	5.5	6.0	5.7	7.4	7.4	7.8	8.3	8.7	6.2
1974	9.4	10.0	10.4	10.1	10.7	10.9	11.5	10.9	11.9	12.1	12.2	12.3	11.0

To a degree, our recent history shows some similarities. The events of 9/11, while far more horrific and shocking than an oil embargo, have led to one of the longest wars in our nation's history. The ensuing wars have placed a strain on our budget and have led to domestic discord (though not to the extent of the Vietnam War).

The real estate and banking debacle also evolved over time and placed as great a strain on our economy and banking system as we have witnessed since the 1920's and 1930's. While the deleveraging process appears to be in its end stages, it is a certainty that banking policy and our daily lives will be impacted going forward. These two situations combined to place a strain on our financial markets and economy that resulted in a stock market correction similar to that of 1973 - 1974. What is interesting from our perspective is the similar behavior of the average investor in the period immediately following each time period – net sellers of stocks during the early phases of economic recovery.

So where are we now and where are we headed? It's our opinion that we went off the fiscal cliff in 2008. Think about it – Lehmann Brothers belly up, Merrill Lynch rescued by Bank of America, Fannie Mae, Freddie Mac and AIG rescued by Washington as was GM and Chrysler. And the beat goes on!

The odds greatly favor good quality, income producing stocks doing very well over the long term. Bonds are undoubtedly over valued and don't offer much upside for money coming into the markets at this point. That will change as interest rates eventually rise, but that is very likely to be a long process. Stocks, on the other hand, while not exceedingly cheap, do appear to be reasonably priced. The S&P 500 trades at a price earnings ratio of about 14 which is below the 10 year average of 16. The dividend yield on the S&P is 2.25% which is higher than some bonds. As has happened so many times in the past, the average investor selling stocks has been bullish for the market. The push to buy bonds has caused significant overvaluation in all fixed income markets. We'll get very nervous when the "mad rush" to buy stocks begins again, and it will at some point.

A word of caution is in order. While signs indicate a continued future recovery, short-term fluctuations are less predictable. Certainly the stock market could, in fact, go through a severe correction again in the near term. The world is full of uncertainties at present, and there are no guarantees in the world of investing.

However, we have endured and overcome major challenges before, including two world wars. We have also seen periods of enormous inflation, three watershed stock market corrections (1929, 1973, 2008) and a prime rate of 21.5% (12/19/80). Despite these trials we continue to improve our standard of living, and we believe in the power of free enterprise to continue to grow our economy.

In closing, we wish you a very happy and prosperous 2013, we welcome your thoughts and comments and, as always, encourage you to "get rich slow".