CENTURION ASSET MANAGEMENT

## MARKET LETTER October 2012

Although the performance of the equity and fixed income markets has been favorable this year, much of the focus is on the economic environment. It appears that most investors believe the U.S. economy is not growing at a strong enough pace, and all desire improvements prior to fully committing capital.

### Economic Notes

If we understand the size of our economy, we can appreciate what it takes to accelerate the pace of growth. Below (table 1) is a list of the largest global economies as measured by Gross Domestic Product in 2011. The U.S. is off of its highest GDP output achieved in 2008, but its mega economy is still almost twice that of China, and equal to the size of Japan, Germany, France, and Brazil combined (numbers 3, 4, 5, & 6).

**table 1**[1]

| Rank | Country | GDP (millions in US $) |
|---|---|---|
| 1 | United States | $ 15,075,675 |
| 2 | China | $ 7,298,147 |
| 3 | Japan | $ 5,866,540 |
| 4 | Germany | $ 3,607,364 |
| 5 | France | $ 2,778,085 |
| 6 | Brazil | $ 2,492,907 |
| 7 | United Kingdom | $ 2,431,310 |
| 8 | Italy | $ 2,198,732 |
| 9 | Russia | $ 1,850,401 |
| 10 | India | $ 1,826,811 |

However, the U.S.'s ability to compete on the global stage has fallen for the fourth year in a row as measured by an annual survey from the World Economic Forum in early September.[2] The survey ranks each country's competitiveness according to factors such as the state of its infrastructure and its ability to foster innovation. Derived from a gathering of global business and political leaders in Davos Switzerland each January, this survey acts as an economic barometer for the world.

**table 2**[3]

| The Global Competitiveness Index 2012-2013 rankings | | | | | |
|---|---|---|---|---|---|
| Top 10 | GCI 2012 | | GCI 2011 | | |
| | Rank | Score | Rank | 2011/12 change | |
| Switzerland | 1 | 5.72 | 1 | ➡ | 0 |
| Singapore | 2 | 5.67 | 2 | ➡ | 0 |
| Finland | 3 | 5.55 | 4 | ⬆ | 1 |
| Sweden | 4 | 5.53 | 3 | ⬇ | -1 |
| Netherlands | 5 | 5.50 | 7 | ⬆ | 2 |
| Germany | 6 | 5.48 | 6 | ➡ | 0 |
| United States | 7 | 5.47 | 5 | ⬇ | -2 |
| United Kingdom | 8 | 5.45 | 10 | ⬆ | 2 |
| Hong Kong | 9 | 5.41 | 11 | ⬆ | 2 |
| Japan | 10 | 5.40 | 9 | ⬇ | -1 |

As noted in table 2, the U.S. has slipped from its 5th place ranking a year ago, to 7th. The world's largest economy is said to be struggling from mistrust of the government and concerns over its fiscal health, which was also revealed by the survey. Political deadlock over reducing the unsustainable federal government budget deficit prompted Standard & Poor's to downgrade the country's credit rating by one notch to AA+ from AAA in August 2011.

Further, a mix of U.S. tax hikes and spending cuts – referred to as the "fiscal cliff" – may occur in January unless lawmakers reach a compromise for avoiding them.

Among emerging market economies, China was ranked highest at 26, thanks to favorable macroeconomic conditions. This was significantly higher than Brazil, India, and Russia which came in at 52, 56, and 66, respectively. While China, as the world's second largest economy, has a leg-up in economic strength among emerging economies – China's sovereign debt rating of AA- is significantly better than others – it lags developed market economies in the maturity of their financial markets and technological readiness.

### Fiscal Cliff

The U.S. government will face a conundrum during the fourth quarter this year as lawmakers have a choice: they can either let current policy go into effect at the beginning of 2012 – which features a number of tax increases and spending cuts that are expected to weigh heavily on growth and possibly drive the economy back into a recession – or cancel some or all of the scheduled tax increases and spending cuts, which would add to the deficit and increase the odds that the United States could face a crisis similar to that which is occurring in Europe. This situation has been referred to as the "Fiscal Cliff".

There could be a dramatic effect on the economy under either scenario. The Congressional Budget Office (CBO) estimates higher taxes and spending cuts would reduce the deficit by an estimated $560 billion, and those changes will drop US GDP by four (yes four) percentage points in 2013, resulting in negative economic growth (i.e. a recession). They further estimate unemployment to rise by a full percentage point.

Most feel it is more reasonable to assume that Congress will punt and not end up at the extremes, and instead bump taxes and cut some spending, but it is extremely difficult to identify at this time *which* rates will move and what spending cuts may take place. In either case, our plan is to assume a solution that is based upon modest improvements to unemployment, continued low interest rates, and tepid corporate earnings.

**Investment performance**

As we can see from the Year-to-Date investment performance of U.S. equity categories listed in table 3, thus far investor returns have been robust. At the beginning of the year, after a very strong last four months of 2011, many investors said they would be pleased with a return on stocks of 8%. As you can see in table 3, investors have been rewarded with returns of over 13% after only three quarters. If the fourth quarter does not turn into a disaster we will likely hold that return and far exceed our expectations.

Below are tables representing the Year-to-Date (YTD) percentage growth of each U.S. Large, Medium, and Small Cap stock category across Value, Blend, and Growth styles, as well as the returns for five bond categories.

**table 3**[4]

| YTD 2012 Market Barometer | Value | Blend | Growth |
|---|---|---|---|
| Large | 13.62 | 16.52 | 21.26 |
| Mid | 12.62 | 13.31 | 14.54 |
| Small | 13.83 | 12.88 | 14.41 |

| YTD 2012 Bond Indexes | |
|---|---|
| U.S. Government | 2.06% |
| Corporate | 9.21% |
| Mortgage | 3.30% |
| Short-Term | 1.58% |
| TIPS | 6.29% |

The same can be said of bonds or fixed-income securities, where the past several years have been quite good, and that is holding true in 2012. This year the U.S. Aggregate Bond Index is up nearly 4%, and higher risk bonds have returned in the 7% range. These returns are on a great pace but investors should be skeptical of these levels persisting without pause. In fact, bonds have lagged equity returns, a sign of the abatement of equity market fear.

**Summary Viewpoint**

In the face of economic uncertainty in 2012 the markets rallied strongly in the third quarter amid signs that the European Central Bank (ECB) would respond more assertively to the continent's debt crisis and the Federal Reserve would embark on another round of quantitative easing. The antidote could be a slow-down in U.S. corporate earnings that may cause volatility to come back into the markets during the last three months of 2012. This, in our view, will bring opportunity for rebalancing among investor portfolios, regardless of their appetite for long-term growth in a mostly equity based allocation, or for a relatively conservative fixed income oriented investment profile. We still prefer equities to fixed income securities, and maintain an overweight to Large Caps at present.

Another piece of our equity investment thesis heading into 2013 is the distance in returns between the haves and the have-nots will become much wider. Corporate earnings will come in soft for many companies, but others may post in-line or better than expected earnings. The last several quarters have seen a rising tide lifting most stocks, and at times dropping them, in unison – we refer to this as correlation. Thus, we feel the correlation among stocks will begin to weaken and investors will have to be very specific when building an allocation with stocks and sectors if they want to outperform their benchmarks.

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[1] International Monetary Fund: "Report for Selected Countries and Subjects.", World Economic Outlook Database, October 2012

[2] Business Week: September 5, 2012; by Pan Pyles; Bloomberg L.P.

[3] World Economic Forum, Switzerland: "The Global Competitiveness Report 2012-2013."

[4] Morningstar, Inc. Retrieved on October 25, 2012.

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