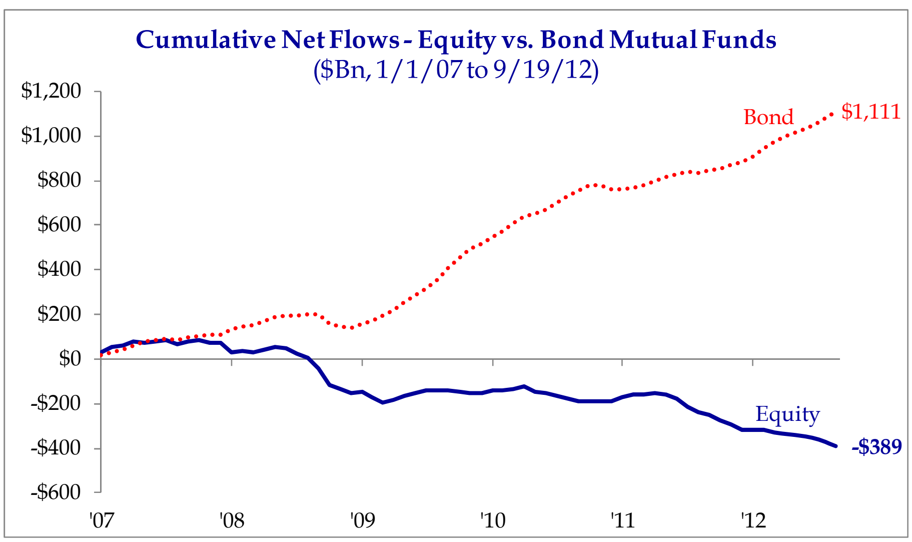
QUARTERLY REVIEW AND OUTLOOK

**"There's something happening here
What it is ain't exactly clear . . ."**

**For What It's Worth
Lyrics ~ by Buffalo Springfield**

It appears that economic confusion, both here and abroad, seems to be the norm in the last few years. Investors are getting tired of trying to make sense of the actions by our political and economic leaders in the U.S. and Europe. Interestingly, the Federal Reserve has continued to implement unique and un-tested financial programs in the hope of jump starting the economy. Last month the Federal Reserve extended its zero interest rate policy through 2015 (another 12 months) and initiated a monthly $40 billion program to purchase mortgage back securities for an indefinite period. In effect, these programs attempt to cap long-term interest rates and should continue to stimulate or reinvigorate the housing market.



Source: Strategas

While investors are well aware of the Fed's low interest rate policy, equity market risk concerns still dominate. As the above chart indicates, money is still flowing into bonds and out of equity mutual funds. In fact, money flows into high yield and emerging market debt have accelerated in the quest for higher yields.

As we have emphasized in our past quarterly letters, the Treasury bond market is in bubble territory. While interest rates remain at very low levels, the longer term trend could be painful for bond investors once rates begin to rise.

The situation in Europe is even more convoluted. The ECB (European Central Bank) has established a new program in which it can make unlimited direct purchases of the sovereign debt of the struggling peripheral nations (i.e. Greece, Spain, Italy). In this way, the ECB will try to serve as a "supportive buyer of last resort" for the debt markets and have a stabilizing effect on market interest rates in the region. Why does the European Union (principally Germany and France) still want to maintain the EU to the point of bailing out the countries even though Greece (for example) has little if any chance to repay its debt? This makes no sense. While the German and French commitment to the Euro and EU is intact, we believe this will end badly for everyone in the next few years.

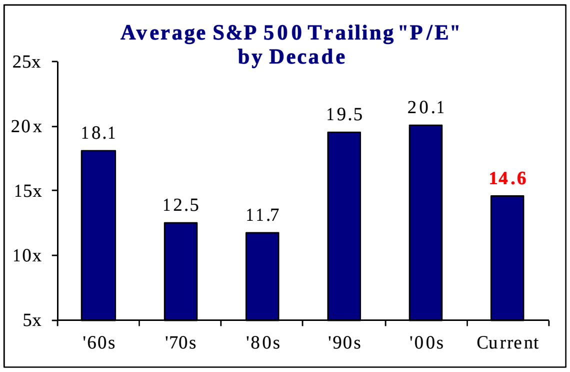
Simplistically, the effort of the U.S. and European leadership to slowly deflate the debt crisis while concurrently stimulating economic growth may be impossible to achieve without keeping economic growth at a near standstill. As a result, two scenarios may develop in 2013.

First, the U.S. could slip into a modest recession in the first half of 2013 if Congress takes certain actions to deal with the fiscal cliff and to reduce certain tax shields. This could set the stage for better economic growth in the second half of 2013 and beyond. Secondly, if they delay dealing with our fiscal problems, growth may continue to be relatively anemic for a long period of time.

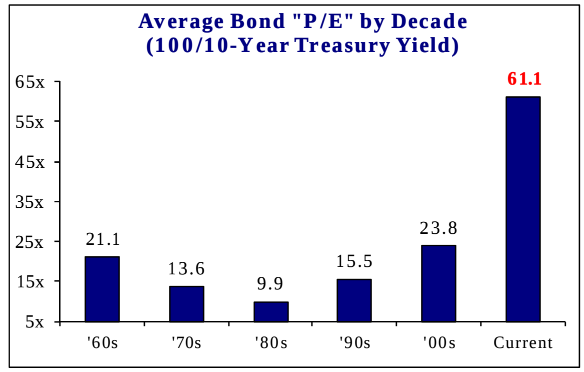
Even with this backdrop, we are seeing signs that the U.S. consumer is starting to accelerate spending. Housing is finally turning upwards, retail stores are busy and job recovery (while slow) is improving. Barring a major misstep by the government, 2013 should end in an accelerating trend of growth.

The stock market however, has moved higher due in large part from the Fed policy of quantitative easing. Given our cautious outlook, we remain focused on staying invested but defensive. While conventional wisdom suggests that we should seek out growth, we believe that elevated yields in stocks with good dividend growth potential, strong free cash flow and category dominance are too attractive to ignore.

Before we discuss some of our investments, it is worthwhile to look at market valuations in general.



Source: Strategas



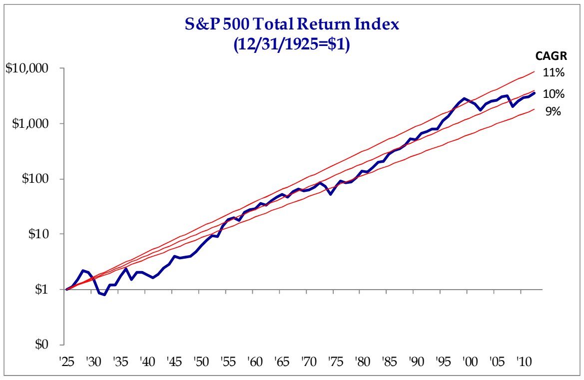
Source: Strategas

As the above charts indicate, equity valuations are not extended even if corporate profits disappoint modestly in 2013. With risk free interest rates (as measured by the 10-year treasury) at historically low levels, the equity market can sustain current valuation levels. Alternatively, the average Treasury bond valuation is significantly higher relative to the last 50 years. This underscores our concern regarding a bond bubble. Should an economic recovery occur in the next two years, we would expect a secular drift upwards in interest rates. This would make 10 year treasuries unattractive until a more normalized rate is achieved.

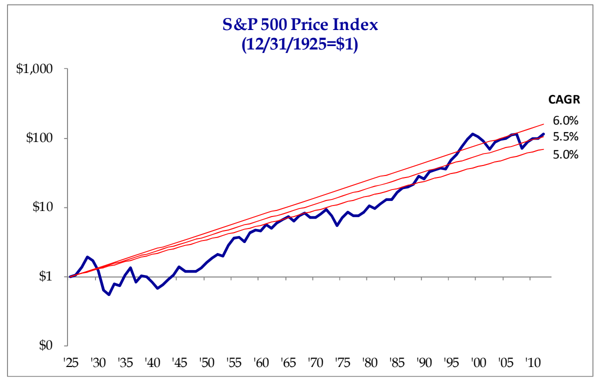
With this in mind, our asset allocation strategy is to augment client portfolios with equities offering bond-like yields in order to offset any decline in income from reinvesting in bonds with lower coupons. Additionally, we have added select corporate bonds to capture attractive yields. Finally, we continue to remain focused on purchasing callable “kicker” bond structures with shorter maturities and higher coupons which, if not called, offer a higher total return (“the kick”) in this relatively low interest rate environment.

For equities, strong cash flow generating companies with above-average dividend yields and a record of dividend growth, are particularly attractive in the current market environment. Indeed, we feel that at this point in the global economic recovery, these equities offer extremely attractive potential investment returns. During normal market periods, dividends play a very important role in total return. We see the current market environment uniquely more positive on a yield basis.

The following charts clarify the importance of total return:



Source: Strategas, Ibbotson, S&P



Source: Strategas, Ibbotson, S&P

The chart on the left is the total return (stock price appreciation plus dividends) for the S&P 500 since 1925. The average annual return has been around 10%. The chart on the right is just stock price appreciation excluding dividends. As the data reveals, the average return is about 5.5% since 1925. Thus, almost half of the total return in the S&P 500 has come from dividends. When we consider that the yield on high-quality growth stocks is unusually high currently, we believe that this is a unique time to take advantage of this trend.

When we have an opportunity to marry our desire to own attractive yielding equities with our discipline of strong free cash flow, category dominance and long term growth potential (among other factors), we move quickly. Such is the case with our newest purchase of Kraft Foods Group. Kraft was just split into two companies; the residual Kraft which we now own, contains such well-known brands as Maxwell House coffee, Kool-Aid, Velveeta and Kraft cheeses, Philadelphia Cream Cheese and Oscar Meyer meats. Management is focused on cash flow, return on invested capital and driving profit margins considerably higher in the next few years. They are also dedicated to paying out the vast majority of free cash flow in dividends and expect to generate 5% dividend growth in the future. With a beginning dividend of $2.00 per share, the equity is yielding about 4%.

Additionally, we continue to seek out securities with exceptional growth potential. eBay is a good example of an attractive GARP (growth at a reasonable price) security. The company is on the leading edge of mobile commerce. Its prodigious free cash flow is being redeployed into new business programs. One program, offering same day delivery, is just now being rolled out into new test markets.

Overall, we try to focus on the long term for each debt or equity position we own. We believe that the U.S. economy will ultimately recover. This will create significant further opportunities to invest. However, until the Presidential election is decided and we see real progress on our national debt and deficit issues, we continue to remain in a defensive posture.

As always, please feel free to contact us to discuss any issues on your portfolio.

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