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Quarterly Economic Update

4th Quarter 2011

Wow! 2011 was one of the most gut-wrenching years in recent stock market memory. Drama was everywhere—from a U.S. credit rating downgrade to turmoil in Europe to the tsunami in Japan—creating significant volatility! The Dow Jones Industrial Average ended the year with a total return (including dividends) of 5.5% and the total return for the S&P 500 (including dividends) was 2.1%. Just to highlight the market's sharp ups and downs, think of this: If you missed the three best percentage gain days last year, the 2.1% gain falls to a 10.7% loss. If you avoided the three worst percentage days last year, the 2.1% gain rises to 20.2% gain. That 2.1% total return masks the fact that the S&P 500 was up as much as 8.4% in late April and down nearly 13% for the year at its 2011 low in early October. (Source: BTN Research)

One of 2011's biggest surprises was the strength of the U.S. stock market. Although it was certainly a rough ride and a flat finish, the Standard and Poor's 500 Stock Index outpaced the stock benchmarks in Frankfurt, São Paulo, Tokyo, Shanghai and Hong Kong by 15 percentage points or more this year. (Source: WSJ, December 27, 2011, C1)

So, how did last year's predictions pan out? At the start of 2011, many investors were warned to avoid the bond market. Many advisors described the low yields of U.S. Treasuries as a "bond market bubble." But in fact, if you had bought a 30-year Treasury bond at the start of the year with a yield of 4.42% and sold it on December 31, 2011, when the yield had fallen to 2.89%, you would have earned a strong return! Compare that to flat stocks, double-digit declines in Europe and Japan, and even greater losses in emerging markets. But while it's virtually impossible to make accurate short-term predictions of investment returns, we can make reasonable long-term forecasts in the bond market. If an investor buys a 10-year U.S. Treasury bond and holds it to maturity, he will make exactly 2%, the current yield to maturity. However, if the inflation rate is only 2% (the informal target of the Federal Reserve) the investor will earn a zero rate of return after inflation. With a higher inflation rate, U.S. Treasuries will lose purchasing power. (Source: WSJ, January 5, 2012, A13)

Forecasts for long-term equity returns are more difficult, but they can be estimated under certain assumptions. If valuation metrics such as price-earnings ratios are constant, we can add the anticipated 2012 dividend yield for the stock market (2%) to the long-run growth rate of earnings and dividends (approximately 5% per year). Thus, with no change in valuation, many economists predict that U.S. stocks should produce returns of about 7%—five points higher than the yield on Treasuries. However, stocks also come with a much higher risk than high quality bonds and investors should be aware that no investment advisor or economist can accurately predict all of the changes that may occur in the market. (Source: WSJ, January 5, 2012, A13)

What will 2012 bring? We are in the fifth year of a financial crisis, and it would be wonderful to forecast a strong global recovery. Unfortunately, Europe is still trying to right itself, joblessness stays high in the U.S., and China's ability to escape the malaise in the West remains an open question. Markets are caught between Europe's worsening debt crisis and improving news on the U.S. economy.

Snapshot of the Economy

Let's look at some economic indicators:

Consumer Spending

Consumer borrowing leapt as holiday spending kicked in late last year, according to a new Federal Reserve report that hinted that the era of household debt reduction that has held the economy back for years might be entering a new, milder phase. "Consumer credit growth is a positive sign for the recovery in that it signals increasing demand and willingness to spend," said Paul Edelstein, an economist with IHS Global Insight. (Source: WSJ, January 10, 2012, A3) The Fed announced on Monday, January 9, 2012 that household borrowing on credit cards, car loans, student loans and other kinds of installment debt rose at a 9.9% seasonally adjusted annual rate in November, the fastest monthly increase since November 2001, when the economy was bouncing back from the terrorist attacks and Detroit car companies were rolling out 0% financing.

Corporate Profits

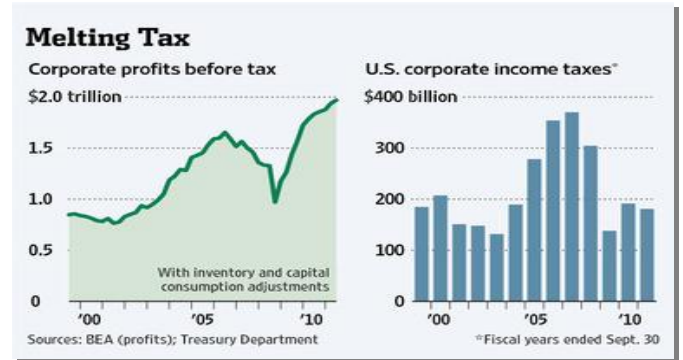
As illustrated by the chart on the left, U.S. corporate profits have rebounded significantly since the financial crisis a few years ago, regaining their pre-crisis peak in early 2010, according to the Bureau of Economic Analysis. The latest release just before Christmas showed corporate profits before tax rose to a record of \$1.97 trillion in the third quarter of 2011. (Source: WSJ, January 4, 2012, C14)

Employment

The U.S. job market is showing signs of a sustained recovery. The latest labor-market report out on Friday, January 6, 2012, gave cause for continued optimism. U.S. employers added 200,000 jobs in December, and the unemployment rate dropped down to 8.5%, its lowest level since early 2009. While increased hiring and a falling unemployment rate are good signs, even if the unemployment rate returns to a healthy level—an outcome most experts don't predict in the near future—the labor market would still be far from healed. The length and depth of the crisis will have a lasting effect on both individuals and the economy as a whole. (Source: WSJ, January 9, 2012, A2)

The Cost of Government

There are many different reforms we need to make and one of these is to radically reduce the cost of Government. 100 years ago the total cost of Government at all levels in the U.S.—local, State and Federal—was only 8% of our GDP. In 2010 it was 40%! Government is spending trillions of dollars in unprecedented deficit spending—money that could better be used by individuals or entrepreneurs. Government debt is growing at such a rapid rate that the Congressional Budget Office projects that in the next 70 years public money spent on interest annually will grow to almost 41.4% of GDP, from 1.4% of GDP in 2010. Today, interest on our debt represents about a third of the cost of Social Security; in only 20 years, it is estimated to exceed the cost of that program. We will need to focus on cutting costs in the various government programs in order to make a significant positive impact. (Source: WSJ, November 16, 2011, A17)



Housing

Home prices are estimated to fall about 2% through the spring of 2012, and are anticipated to recover lost ground by year end, according to many economists. Three million foreclosures in the pipeline are holding down prices. Sales of new and existing homes were approximately 5.3 million units in 2011 and are estimated to increase slightly up to 5.5 million units in 2012. (Source: Kiplinger's Retirement Report, January 2012)

Europe

European stock prices declined significantly during the debt crisis, with most indexes posting losses well into the double digits. Italy, where bond yields soared to record levels, saw its stock market lose 25% for the year 2011. Many emerging stock indexes also suffered sharp declines.

At times, U.S. markets have been held captive by headlines of Europe's economic problems. In December, Standard and Poor's placed 15 European Union countries on negative credit watch, suggesting at least a 50% chance that such economic stalwarts as Germany and

France will lose their prized AAA ratings. (Source: Dow Theory Forecast, December 12, 2011) However, the European debt crisis has actually been beneficial for the United States in that it has boosted the safe-haven premium of Treasury bonds and reduced the debt-service burden for the U.S. Unfortunately, the current plight of Euro-zone debtors provides a blueprint for the way a debt crisis could develop in our country, if we're not careful, which could result in increased volatility with our own Treasury bonds.

Periods with sharp market declines and considerable pessimism often create bargains, so it comes as no surprise that many advisors have recommended purchasing companies in these regions at discounted prices. However, a number of other specialists argue that the opportunities in Europe are not that compelling. Since no one knows for sure, this is a perfect example to remind us of the three rules of investing:

- 1. Diversify**
- 2. Diversify**
- 3. Diversify!**

Many economists predict that Europe appears to be heading into a recession. A recession in Europe would weigh on U.S. exports and corporate growth, endangering hopes for a sustainable recovery (U.S. exports to Europe account for 20% of U.S. sales abroad). The region's economy will continue to shrink into early 2012, according to many economists, and it is estimated to grow little during the year. (Source: Kiplinger's Retirement Report, January 2012, pg10)

International Politics

Keep in mind that the world's leadership will be reshuffled in 2012. The United States, France and Russia will all hold presidential elections, and the top leaders in China will also change after a Communist party congress that will probably take place in October. Political leaders will likely be playing to a domestic audience, possibly weakening international cooperation. This could make it more difficult to cope with a deteriorating global economic climate and to tackle big international issues.

Inflation

Let's bring up the subject of inflation. Sure, there is little to worry about now. The slow economy will most likely keep a lid on demand through 2012, and ample supplies of resources, from workers to raw materials, will most likely mean little pressure on wages and prices for at least the next year or so. However, watch out after that.

There are a number of major ingredients to this possibility:

- The Government's crushing debt load (67% of the U.S. annual GDP)
- Washington's inability to control it (and the two parties show no signs of making the painful compromises needed to rein in debt)
- The faltering economy (and the Federal Reserve's reluctance to raise interest rates for fear of throwing the country into another recession).

And voila—you have a recipe for inflation. Many skeptics say that inflation comes from too much money chasing too few goods. Clearly that is not the case in today's economy. Unfortunately, an overheated economy isn't the only cause for inflation. (Source: Kiplinger Washington Letter, October 2011) It is magnified by the enormous quantities of debt involved—\$5 trillion in maturing Treasuries must be rolled over each year. Expectations of inflation push up interest rates on long-term Treasuries as investors demand higher returns to compensate for erosion in their investment's value. Prices of other investments are usually bid up so holders of Treasuries seek alternatives (stocks, etc.) that may appreciate in value. And then, many goods and services—and the labor to produce them—often start to cost more. Consumers may spend more and save less today, fearing a rise in prices tomorrow. With demand, prices rise. (Source: WSJ, December 15, 2011, C4)

Interest Rates

In response to the sluggish economy, the Federal Reserve announced last summer that it would keep short-term interest rates near zero through mid-2013, and maybe even longer.

Many investors are ignoring better-than-expected U.S. economic data, pushing Treasury yields down to near record lows – a level normally associated with severe recessions. For example, on Wednesday, December 13, 2011, the demand for a 30-year Treasury bond was so strong that investors were willing to accept a record low yield of 2.925% at the auction. A day earlier, the government unloaded some \$21 billion in 10-year notes at a low of 2.02%, the second-lowest yield ever at a 10-year note auction. There are various reasons investors are willing to accept such low yields, such as Europe’s simmering debt crisis. Fear is driving many investors to their favored safe haven of Treasury bonds, causing bond prices to rise and yields to fall. The biggest bond gains in almost a decade have pushed the 30-year returns on long-term Treasuries above those of stocks—the first time that has happened since before the civil war. (Source: Investment News, November 7, 2011, pg27)

Based on this data, is it a good time to abandon stocks? In our opinion, no way. An ownership stake in dynamic multinational companies, both American and foreign, is still the bedrock of a well-crafted long-term investment strategy. And what are the alternatives? There are no risk-free assets except cash, but cash earns essentially nothing and is eroded by inflation. Gold and other commodities were great over the past decade, but they’re prone to wild price swings. Bonds were the star of the past decade, as falling interest rates pushed prices ever higher. But today’s yields are historically low, and when nervous investors start demanding higher rates on government debt, bond prices will most likely drop. Real estate can offer relatively higher yields, but also volatility and additional risks. One option that provides value for a long-term investor are depressed single-family homes and condos, but that requires the hassles of renovation and landlord duties. (Source: Kiplinger’s Personal Finance, December 2011, pg19) It is important to understand that these investments may not be appropriate for all investors as individual situations vary nor is this information intended to be a substitute for personal advice.

Even if the U.S. economic picture isn’t pretty, the picture is worse overseas. The debt storm in Europe appears to be getting worse and there is more speculation that the Euro could possibly disappear. Bond markets in Europe are also expected to slump further, according to many economists. Even once-unquestioned German debt, considered the safest European port in the storm, looks more vulnerable to the crisis when an auction of German bonds was met by weak investor demand at the end of 2011. (Source: Barron’s, November 28, 2011, pg M8)

However, it is not just Europe whose sovereign debt suffers. “Tension is even reaching the JGB market (Japanese Government Bonds) with fears of a downgrade,” says Société Générale’s Sebastien Galy. (Source: Barron’s, November 28, 2011, page M8) In a world in which even debt traditionally considered safe—such as Japan’s and Germany’s—comes under increasing scrutiny, few safe harbors still remain. A number of analysts say that the U.S. appears to be the last man standing in the global crisis of confidence. However, many investors remain skeptical about the health of the U.S. economy. While it is growing now, some investors worry it could falter during the year.

One of the major risks of long-term Treasuries is that bond prices can swing wildly even if interest rates move up or down by only one or two percentage points, especially when yields are this low. Many long-term investors are grappling with a similar problem: how to preserve the purchasing power of their capital and still wring some positive returns out of an economic environment that seems determined to rob savers and risk-averse investors of fair treatment. Today, avoiding risk, at least in the usual sense of the word, all but guarantees loss. Unfortunately, we are in an environment where super low interest rates force many investors to embrace some kind of risk, which in turn raises the question of which risks are worth taking. (Source: Morningstar Advisor, October/November 2011, pg 34 #17)

One solution for certain investors is dividend-producing stocks. However, many investors forget that even with the best high-yielding stocks in today’s environment, a year’s worth of dividends could be lost in minutes given the volatility to which all stock prices are prone. Please remember that the payment of dividends is not guaranteed. Companies can reduce or eliminate the payment of dividends at any given time.

Maintaining a diversified portfolio is crucial when looking at an overall portfolio and planning a long-term investment plan. Although inflation can hurt bond prices, the income bonds provide a lower volatility relative to stocks, which depending upon the individual situation, can make them a mainstay for most portfolios.

Gold

Gold is sending investors a mixed message. The metal gained 10% in 2011, marking its 11th consecutive annual gain, its longest winning streak in at least 9 decades. Yet after closing at a record \$1,900 per ounce on September 5th, it plunged, finishing the year at \$1,564 an ounce, down 18% from its high. This last-quarter drop coincided with easing fears of a global banking system and financial market meltdown. But now, with inflation looming on the horizon, gold once again has the potential to rise, according to many economists. (Source: Bloomberg Businessweek, January 9-15, 2012, pg 47)

Volatility

For many investors, 2011 will be remembered as a year of white-knuckle volatility. This year, the S&P 500 experienced one-day swings in value greater than 2% on almost 15% of trading days, compared to less than 9% of trading days in 2010. The volatility of stocks was higher than in any other 5-year period since the Great Depression. (Source: Personal Finance, December 28, 2011)

According to an analysis performed by the New York Times in October, the market is more volatile today than at any time since 1962. During such volatility and uncertainty, making predictions about the economy and markets can be a difficult goal. (Source: Research Magazine, January 2012, pg 44)

Amidst the worried debate over whether the United States will tumble into a recession, most economists agree on one thing: volatility is here to stay. Even if the leaders in Europe solve the debt crisis swiftly and the U.S. also comes to an agreement on how to handle our country's own debt woes, many advisors expect the markets will continue to gyrate unpredictably. Why? Most economists believe the answer is simple—high correlation!

Correlation is simply a measure of how closely the prices of two stocks or indexes follow one another. If the stock is 100% correlated with another company's shares, the two securities rise or fall in perfect lockstep. When investors grow worried about the macroeconomic picture, they often sell off their holdings as a group—energy stocks are sold alongside industrials, retailers, commodities and other sectors. When the news brightens, in many cases all the stocks tend to rise as a herd. Rising correlations have been one of the most powerful trends underway in global markets over the past 18 months. Unfortunately, the high degree of correlation is not limited only to U.S. stocks. Stock markets around the world now seem joined at the hip—a bad day in the Asian market often rolls over to losses in Europe and further declines in the U.S. (Source: Kiplinger's Personal Finance, February 2012, pg41)

There are two primary causes of the increase of correlation among assets:

1. Globalization. Sophisticated investors today buy and sell in all the world's markets and react to instantaneous communications that everyone receives at more or less the same time.
2. Broad economic shocks. Since the 2008 financial crisis, we have been experiencing broad economic shocks that overwhelm company- and industry-specific developments.

Traders have a description for the sort of market activity that we've seen in the past year: "risk-on and risk-off days." On risk-on days, many traders feel optimistic about economic prospects and buy risky assets, such as stocks and commodities, and avoid Treasury bonds and Japanese Yen, which are the two asset classes that have reliably bucked a falling stock market lately. The opposite happens on risk-off days.

With so much volatility in stocks, many investors have increasingly favored the relative security of bonds. During the recent market upheaval, many investors felt euphoric one day, fearful the next. Those emotional ups and downs can be just as hazardous to your portfolio as the market swings that caused them. In 2009 and 2010, for example, many investors who were spooked by the financial crisis pulled out of stocks and invested the proceeds in bonds, missing out on a nice rebound in the stock market.

Using history as their guide, and weighing current stock valuations and low interest rates, many economists believe that stocks currently have a much better chance than bonds to beat inflation and achieve a higher rate of return in the long run. They have many valid reasons:

- Stock prices don't appear inflated. At the end of 2011, the Standard and Poor's 500 stock index traded at just under 13-times estimated 2012 earnings. (In March 1999, the S&P 500 traded at 33.5-times earnings.)
- The current dividend yield for the S&P 500 is higher than the interest rate on the 10-year Treasury note.
- Consumer confidence has soared in less than 4 months.
- The S&P 500 companies just had the best earnings last quarter ever reported.
- Company officers and directors invested even more of their own money buying their own stocks than they did at the bottom in March 2009.

(Source: WSJ, January 9, 2012, R1)

China

China's economy has grown on average by around 10% per year for the last 30 years, and is predicted to surpass the United States as the world's largest economy within the next 2 decades. This impressive growth has not gone unnoticed by investors. However, China is facing many challenges—currency valuations, a real estate bubble, etc.—that have many investors wondering if China's long streak of growth is coming to an end. With growth slowing and inflation becoming less of a problem, China's Communist Party leadership indicated mid-December it was ready to stimulate its economy, underlining a challenge facing not just Beijing but other emerging markets as well. Although many economists are skeptical about China's ability to sustain its current levels of growth, most agree this is only a matter of a few years before China's 1.3 billion or so people produce more than the 310 million living in the U.S. (Source: WSJ, December 10, 2011, A9)

Compliance – New Rules and Regulations

If you tried to write a parody of the uncertainty and confusion triggered by Federal rule-making, it would be hard to top the latest proposal from Washington's financial regulators. Let's introduce the new Volcker Rule, which takes 298 pages to make a simple idea that limits a bank's ability to make bets with their own capital, rather than making simple, clear rules for banks to follow. How can banks comply with 298 pages and 381 footnotes? This is a perfect example of a good idea that became too complex, too detailed, too much government involvement. It is estimated that the Volcker Rule could cost the biggest banks \$2 billion or more in annual revenue, according to analyst estimates. Some opponents have made the argument that the cure is worse than the disease. (Source: WSJ, October 12, 2011, C1)

Still another disappointment during the quarter was the Super Committee's inability to reach an agreement on various spending cuts and scheduled tax-break expirations. The Super Committee's failure to agree on a deficit-reduction package means that starting in 2013, the combination of \$1.2 trillion in spending cuts and various scheduled tax-break expirations will take effect. (Source: Bloomberg Businessweek, November 28, 2011, pg10)

Although many Americans are frustrated with the inefficiency of our Government, I believe it is only a matter of time until some of these issues will be resolved. As Winston Churchill said, "Americans can always be trusted to do the right thing, once all other possibilities have been exhausted." Despite my disappointment with the Super Committee's setback, I still remain confident that we will yet again prove Churchill right.

Yours truly,

Gregory A. Kemp, CPA, PFS

P.S. This year should prove to be an interesting one, especially with all the scheduled tax rate changes for 2013. I look forward to keeping you updated.

Note: The views stated in this letter are not necessarily the opinion of Vantage Advisors, LLC and should not be construed, directly or indirectly, as an offer to buy or sell any securities mentioned herein. Investors should be aware that there are risks inherent in all investments, such as fluctuations in investment principal. With any investment vehicle, past performance is not a guarantee of future results. Material discussed herewith is meant for general illustration and/or informational purposes only, please note that individual situations can vary. Therefore, the information should be relied upon when coordinated with individual professional advice.

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Indexes cannot be invested in directly, are unmanaged and do not incur management fees, costs or expenses. No investment strategy, such as asset allocation, can guarantee a profit or protect against loss in periods of declining values. International investing involves special risks not present with U.S. investments due to factors such as increased volatility, currency fluctuation, and differences in auditing and other financial standards. These risks can be accentuated in emerging markets.

There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment.

This optimism about the future does not minimize the fact that we have gone through one of the worst economic periods in market history. Remember that equity markets are volatile and an investor may lose money and there is no guarantee that securities will appreciate. This material contains forward looking statements and projections. There are no guarantees that these results will be achieved.

The price of commodities is subject to substantial price fluctuations of short periods of time and may be affected by unpredictable international monetary and political policies. The market for commodities is widely unregulated and concentrated investing may lead to higher price volatility.

In general, the bond market is volatile, bond prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. The investor should note that investments in lower-rated debt securities (commonly referred to as junk bonds) involve additional risks because of the lower credit quality of the securities in the portfolio. The investor should be aware of the possible higher level of volatility, and increased risk of default.

The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.

Sources: Wall Street Journal (10/12/11, 10/24/11, 11/16/11, 12/10-11/11, 12/15/11, 12/27/11, 12/1/11, 1/3/12, 1/4/12, 1/5/12, 1/9/12, 1/10/12), Barron's (11/28/11), Investment News (11/7/11), Kiplinger's (12/2011, 1/2012, 2/2012), Money Adviser (1/2012), Research Magazine (1/2012), By The Numbers (1/3/12), Dow Theory Forecast (12/12/11), Bloomberg Businessweek (11/28-12/4/11, 1/9-15/12), Personal Finance (12/28/11)

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We would be honored if you would:

- ✓ Add a name to our mailing list;
- ✓ Bring someone to a workshop; or,
- ✓ Have them come in for a complimentary initial meeting

If so, please call Heather at Vantage Advisors, LLC (435.628.6336)
and we would be happy to assist you.

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