capital markets review

HAMILTON CAPITAL MANAGEMENT
REGISTERED INVESTMENT ADVISER

Winter 2013

Economic Outlook

Economic Data, Fiscal Agreement Improve Outlook

Executive Summary

Against all odds, gloomy forecasts and many investors' expectations — including some of our readers' — a seemingly improved tone in economic news has lifted spirits, and risk assets like stocks, noticeably. But the real progress has arisen from the agreement in Washington to avoid the severest version of fiscal contraction – the dreaded "cliff".

Unfortunately, the tragi-comedy is far from over. This agreement only modestly reduced our budget deficit and the GOP members feel Obama over-played his gains from the election in the negotiations, with little "give" and much "take." As a result, Republicans are likely to use the debt limit negotiations in a couple of months to play hard ball. We may even see a government shut down. Although the process offers the media fertile ground for the frightful headlines it seeks, the likely outcome is one of additional steps in reducing our future deficits. And that would be good news for future growth in the economy, earnings and financial markets.

Frankly, although we've heard nothing but "fiscal cliff" for months, I'm not sure I understand what just happened. Is the agreement going to accelerate or slow to the economy?

In essence, it's a moderate brake, which is a good thing because inaction would have resulted in a wheel lock-up and arrested growth.

The most significant result, had Washington done nothing, would have been a sharp increase in income tax rates for nearly everyone, sharp across-the-board cuts in spending and a material slowing in economic growth leading to a recession in 2013 – all at a time when things remain fragile. That scenario would have had a silver lining – it would have reduced our government deficits much more rapidly, but likely at too high a price.

Most observers are able to exhale after holding their breath, even if only briefly.

Instead, Washington managed to reach a half-baked agreement that only takes us, say, 40% (with progress achieved in 2011) of the way we need to travel in the next 10 years to reduce federal government deficits, with little in the way

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The Interviewees

The content in this issue of *Capital Markets Review* was taken from an interview with Hamilton Capital Management Chairman & CEO Matt Hamilton, CIO Tony Caxide and Vice President & Portfolio Manager Eric Shisler shortly after the end of the fourth quarter of 2012.

Equity Portfolios

A Trying But Very Profitable Year

Executive Summary

Although few had a kind word to say about stocks during 2012, disciplined investors were rewarded with double-digit returns in many markets – compensation for perseverance. Many, however, succumbed to traditional views on reducing risk – such as buying high-quality bonds or exiting the stock market "until things calm down" – which invariably forfeited returns two to three times what we expect the market will average going forward over the long term.

"Fiscal cliffs," Greece, European recessions – all this bad news and the markets still did well?

"You can have cheap valuations or good news, but you can't have both at the same time." Someone more creative and eloquent than we are said it during 2012, but we've believed it for a long time. During this past year selected markets had some attractive fundamentals, such as record earnings and valuations at a discount to "fair value". These were ignored due to predictions of doom that despair investors and make many of them quick on the trigger, churning portfolios and often moving them into and out of the market at the worst times.

The wise voice above was drowned out by the breathless alarmists on TV and other media that you've heard us castigate before. We point fingers because, for selfish commercial reasons (we just can't look away from the negative headlines, which causes advertisers to flock), the media increasingly make investors behave like traders. Good for brokers, who depend on transaction volume for their profits, but bad for investors' blood pressure and long-term financial well-being.

Do you feel that the turn-of-the-year budget agreement is a watershed event for stocks?

We feel this agreement is an important step in both chipping away at the federal government budget deficit and in reducing uncertainty about our long-term level of debt. But we haven't expected watershed positive surprises from Washington since we learned the truth about Santa – a sad day on both counts.

On the positive side of the ledger, this agreement does eliminate a meaningful degree of uncertainty "forever". We now know what our income tax rates will be going forward, and 99% of taxpayers will see no change (not to be confused with the payroll tax that funds Social Security, which will revert to its 6.2% regular rate from the 4.2% temporary level). We now also have a permanent fix to the Alternative Minimum Tax (AMT), which had required several regular "patches". The estate tax issue is settled, as are capital gains. And we have reduced deficits by over $700 billion over the next 10 years. This clarity is nothing to sneeze at.

The remaining hurdle is that future deficits will still grow starting in a few years – which will drive debt too high as a share of the economy – and that the way to fix them will require that politicians meddle with the third rail of politics: spending cuts.

So what's coming, when will it hit and how bad will it be?

We will face much of this issue in the next couple of months. We anticipate a potential breach of the government debt ceiling as early as the February-March time frame, and the end of government spending authority at the end of March may well lead to a government shut down. Republicans will, directly or indirectly, use this threat as a crowbar to negotiate spending cuts from the administration. We assume the discussions could be brutal and headlines ugly. Hence we would bet on continued volatility near term rather than "fair winds and following seas".

That said, we also feel that almost any probable outcome — including that of failure, which would result in large automatic spending cuts or "sequester" — will result in lower spending (along with possibly new revenues) and lower deficits. That is both what the economy requires long-term and financial markets seek, and that could be good for future returns of some equity sectors, depending on valuations. Hence we will carefully monitor both economic causal factors and political developments impacting policy and valuations. It's what we do every day.

Want To Learn More?

If you'd like to take a deeper dive into Hamilton Capital's proprietary research or better understand our top-down, forward-looking investment process, join our investment management team for one of our upcoming client briefings:

February 14 - Lunch
Scioto Country Club

February 15 - Lunch
Scioto Country Club

March 14 - Lunch
The Columbus Club

March 15 - Lunch
The Columbus Club

April 18 - Lunch
The Refectory

April 19 - Lunch
Scioto Country Club

Space is limited, so contact Laura Hamilton at lah@hamiltoncapital.com or (614) 545-4013 to RSVP.

In Agreement

"Cautious optimism is probably the right attitude. Central banks may be keeping their feet to the monetary accelerator but the brakes are being applied in the form of fiscal policy."

— Buttonwood/Hope Springs Eternal, *The Economist*, January 5, 2013

"Europe's political risk has diminished but hasn't disappeared."

— Jonathan Buck, Europe On Sale, *Barron's*, December 24, 2012

Fixed Income Portfolios

Risk Was Rewarded In 2012

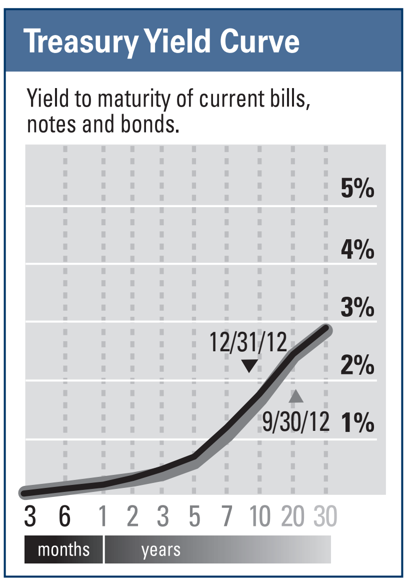
Executive Summary

Lower quality was the principal driver of bond returns this past year, as risk-taking rewarded investors. Although the economy may not feel better to some, the stronger performance by higher-risk bonds appears to forecast at least a mild recovery. And even moderate economic strength may lead to higher market rates, a pattern which may have started after the lows hit this past summer. For now, though, the bond market remains subject to volatility as the debate continues to unfold in Washington.

We've heard for some time that the bond market is a balloon waiting to pop. Any evidence of that during 2012?

To borrow from a famous Mark Twain quote, the announcement of the bond market's death continues to be greatly exaggerated. At a time when many are predicting a correction in the bond market, it's interesting to note that the out-performance in the market comes from the riskier assets. Risk in bond terms can be measured from two angles: issuer credit quality, where lower-rated bonds are riskier than higher-rated issues, and bond maturity, where bonds with longer maturities are riskier (more sensitive to moves in interest rates) than shorter-term bonds.

In 2012, high-yield bonds (also called junk bonds or below-investment-grade bonds) outperformed investment-grade bonds materially, which in turn outperformed the safest U.S. Treasury bonds. In terms of maturity, long-term bonds outperformed intermediate-term and short-term bonds only modestly. Investors holding cash and short-term, high-quality bonds experienced the worst relative performance this past year.



It doesn't feel like the economy is to the point where we can ignore risk and just stretch for yield.

It's not, but what the market apparently determined over the past year is that the economy isn't so weak that investors should completely ignore taking on some risk. In essence, riskier assets started the year mispriced relative to their underlying value and the market corrected some of that mispricing.

Was Hamilton Capital able to take advantage of this?

Given our view of global stimulus, a moderately recovering U.S. economy and attractive relative valuations in the sector, we over-weighted high-yield bonds in our fixed-income and balanced strategies. In fact, we saw such an attractive return-risk balance in the high-yield space that we owned the asset class in our equity-oriented strategies, too, for much of the year. We felt high-yield bonds provided return opportunities competitive with equities while also offering the opportunity to mitigate equity-type volatility. Now, however, the appreciation experienced over 2012 has the sector more fairly valued, so we recently reduced the allocation in our equity strategies in anticipation of greater returns from specific equity markets. The over-allocation in high-yield bonds remains intact in our bond and balanced strategies, however.

What about the other angle you mentioned – maturity or long-term bonds versus short-term bonds?

In essence, most bond maturities performed similarly, with longer maturities showing only a modest edge in 2012. Our research has led us to be cautious on long-term, high-quality bonds, although for different reasons than others. While the market has been repeatedly on the page of inflation risk, our work suggests that inflation pressures are quite balanced. The most recent Producer Price data, for instance, shows inflation running only in the range of 1-1.5 % in recent months — a touch on the low side since it could raise renewed concerns about deflation.

Rather, our shorter-than-benchmark position on maturities is driven by our view that even at current low levels of inflation, long maturities offer little value and even modest levels of growth could cause the market to correct, sending yields higher with or without higher inflation. We've seen just such a scenario unfold in recent weeks.

These are unprecedented times in terms of the stimulus and low interest rates from central banks around the world. As that stimulus spurs economic recovery, we expect interest rates will move higher — maybe not dramatically, but higher rather than lower. With rates so low, even a minor increase will reduce the price of a bond. And a key characteristic of this inverse relationship is that it intensifies the further out an investor goes on the maturity scale. We currently see investors increasingly confident about the economy and high-yield bonds, leading us to believe the risk to rates is on the upside.

How has the "fiscal cliff" debate impacted the bond market?

It creates another layer of uncertainty. For example, taxing interest on municipal bonds at the federal level has been discussed as a potential source of revenue for the federal government. This could have a significant impact on the market for both existing issues and new issues. The finances of municipalities, from the state level to counties, school districts and all the way down to the smallest village, could be impacted. So, although we've cleared the "fiscal cliff" hurdle, further negotiations around lifting the debt ceiling, the issue of sequestration (automatic spending cuts) and government spending authority (which expires at the end of March) should keep the bond market volatile in the immediate future.

Economic Outlook

(Continued)

of spending cuts. At least the direction is good and we avoided an economic "collision" of sorts. Hence most observers are able to exhale after holding their breath, even if only briefly.

So, we're not done with this issue yet?

Were this the end of the story, investors would likely be much more negative about future economic performance, as we remain on an unsustainable path for government debt levels. However, we feel that markets will look at the modest step taken in the context of what is likely to happen next. In a couple of months we will again reach our federal debt limit and spending authority will expire shortly thereafter. Without Congressional action, federal spending will grind to a halt and the possibility of a U.S. default, downgrades and even a government shutdown after late March will again fill the airwaves. Republican members of Congress now feel manhandled by a President who, in their view, over-leveraged a strong hand from his election win rather than "governing" in a presidential way. And they feel they will have much more negotiating power to wring spending and deficit cuts as part of the debt-limit and spending authority discussions.

This does not sound good. Are we just finishing one skirmish to start another?

We couldn't blame you for being cynical about Washington's ways. Yes, it's reasonable to conclude that the dark clouds and heavy winds of additional antagonism are squarely in the forecast, and just over the horizon.

But context is important here, too. What they will be arguing about, and the most probable result, is almost certainly what markets seek – some additional, necessary progress on spending restraint and deficit reduction over the next 5 to 10 years, or the "60%" that was not addressed in this recent legislative agreement and previous actions. The balance of power is likely to be more even in this next round and we feel that most scenarios paint a picture of some progress on this score. That would further reduce uncertainty and lead to a somewhat better environment for consumer spending and business investment.

But it will likely be ugly as the headlines, and all those TV shows, will again forecast gloom, since we keep "buying" those predictions by watching. Without the Mayan calendar, they will find some other way of forecasting the end of the world as we know it.

So would such an agreement stimulate the economy or not?

Well, it's important to consider a couple of issues. Firstly, any new agreement will likely generate a fiscal stance that will provide less stimulus, acting in a contractionary way. But the removal of fear and uncertainty that unsustainable deficits and government debt trigger could be quite helpful to the economy, particularly if they are gradual in implementation and the opportunity is used to implement good economic policy.

Secondly, we live in a global economy. Our future path will also be impacted by growth in Europe, the UK, emerging markets, Japan and elsewhere. But there, too, steps are being taken to reduce uncertainty and gradually improve balance sheets and the growth environment.

What are some of the elements of "good economic policy" that you would like to see?

There are several, and we only anticipate moderate steps in some. But, for instance, we would like to see simplicity in the tax code and reduced involvement by government in how capital is allocated. A broader, flatter tax approach would be a positive. And, greater acknowledgment that we cannot afford some spending, even if it otherwise seems humane.

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THE HCM ADVANTAGE

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Unfortunately, most investors can't maintain an internal team of that caliber. But if having an external investment team of that sophistication is something you could gain from, then we're here to serve.

We function in a fiduciary capacity as an external Chief Investment Officer for our clients. Our structure is similar to the investment departments of large, sophisticated institutional investors, and our team has extensive global investment experience. In fact, several of our team members have received national recognition for their abilities and accomplishments.

Each day, we diligently apply our disciplined investment process to the design and continuous, forward-looking supervision of your portfolio. Our goal: To build a complete investment solution for you.

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