Investment Tally & Perspective

Lincoln
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INVESTMENT REVIEW AND OUTLOOK

As we reflect on the past year, we note several significant events, including investment returns that exceeded most expectations. This issue provides a summary review of 2012, with a focus on the investment outlook in the year ahead.

The Economy

- Since the economic recovery began in 2009, growth (real GDP) has ranged from zero to four percent each quarter, with last year averaging two percent (estimate), too slow to lower the unemployment rate (7.8%).

- The political battles leading up to the elections continued post-election, with government functioning polarized, as evident in the year end "fiscal cliff" drama. With the debt ceiling and other budget deadlines directly ahead, political battles may rattle the financial markets.

- Even given government dysfunction, economic activity is likely to gather momentum as the year progresses, and possibly transition to a self-sustaining expansion by 2014.

- With fiscal uncertainty clearly impacting business and consumer confidence, and spending, the Fed continues to support economic growth by suppressing interest rates near zero and buying trillions of bonds, thereby, largely financing our trillion dollar budget deficits.

- Meanwhile, the price of gold has climbed for twelve straight years and, while recently trading in a narrow range, we expect significantly higher prices before the long bull market reverses course.

- For commodities in general, periodic price pressures arise when global demand exceeds supply, yet pricing pressures are often offset by technological changes which produce higher yields (Energy is an example, with newer drilling technology providing increased supplies).

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Special points of interest:

Ronald E. Albert, CFP
Brittany A. Moran, CFP
Nina Walsh
Karen Jones Ariosta

40 Westminster St.
Suite 202
Providence, RI 02903

Phone: (401) 454-3040
Fax: (401) 453-0678
Email: info@lccorp.com

Website:
www.lincolncapitalcorp.com

MAJOR INDUSTRIALIZED COUNTRIES

	2012 Est. GDP	Unemployment	Consumer Prices	Budget Balance	Interest Rate, %
Britain	-0.1%	7.8%	2.8%	-7.9%	1.82%
Canada	2.1%	7.2%	1.5%	-3.7%	1.87%
France	0.1%	10.7%	2.2%	**-4.5%**	2.08%
Germany	0.8%	6.9%	2.1%	**-0.2%**	1.45%
Italy	-2.2%	11.1%	3.2%	**-2.8%**	4.28%
Japan	1.7%	4.1%	-0.1%	-9.7%	0.79%
Spain	-1.4%	26.2%	2.5%	**-7.4%**	5.26%
Switzerland	0.9%	3.0%	-0.6%	mil	0.56%
United States	2.2%	7.7%	2.1%	-7.0%	1.84%

Note: Interest rates in bold are Euro currency rates.

Data from The Economist, January 5, 2013

EQUITY INDEX RETURNS—QUARTERLY AND ANNUALLY FOR 2012

	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	2012
S&P Index	12.66%	-2.84%	6.35%	-0.38%	16.00%
NASDAQ Composite	18.67%	-5.06%	6.50%	-2.65%	17.45%
Dow Jones Ind. Average	8.91%	-1.90%	5.02%	-1.74%	10.24%
Russell 2000	12.06%	-3.83%	5.25%	1.85%	16.35%
MSCI EAFE	10.86%	-7.13%	6.92%	6.57%	17.32%

Data from Morningstar

EQUITY INDEX RETURNS

Period Ending December 31, 2012				Average Annual Returns		
	2012	2011	2010	3 Year	5 Year	10 Year
S&P 500	16.00%	2.11%	15.06%	10.87%	1.66%	7.10%
NASDAQ Composite	17.45%	-0.83%	18.02%	11.19%	3.68%	- - %
Dow Jones Ind. Average	10.24%	8.38%	14.06%	10.87%	2.62%	7.32%
Russell 2000	16.35%	-4.18%	26.85%	12.25%	3.56%	9.72%
MSCI EAFE (Foreign Index)	17.32%	-12.14%	7.75%	3.56%	-3.69%	8.21%

Data from Morningstar

INVESTMENT STRATEGY & OUTLOOK

January 10, 2013

The Economy

- In 2013, the most likely economic scenario is a slow first half, then a stronger second half
- With the elections over and fiscal resolutions (good or bad) underway, the high level of uncertainty is being reduced; this should result in more business investment and hiring
- Progress in Europe is greater than generally perceived, as is their commitment to the Euro
- The China slowdown appears to have passed with growth poised to accelerate
- Increased housing and auto activity have changed from drags to growth contributors
- The ugly fiscal cliff process was a prelude to major battles ahead, led by the debt ceiling

The Fed and Monetary Policy

- Central banks are more concerned with deflation than inflation near term
- The Fed's strategy to inflate stock and real estate values to spur spending is working; if events unfold as expected, then the Fed will retain an easy money policy into 2015
- After four years of manipulating interest rates to record low levels and buying massive amounts of bonds, the process of unwinding these actions brings many unknowns

Bonds and Interest Rates

- The 10-year Treasury yield has risen from the June low of 1.4% to the 1.9% level
- Mortgage rates remain near modern time record low levels
- The prices of income producing assets have been bid up to rich levels from investors desperately seeking income
- Longer term, while it is widely expected that interest rates will normalize (rise) over time, the "global savings glut" noted by Ben Bernanke in 2005 may keep interest rates suppressed

Equities

- Though popular stock indices ended 2012 with above average returns, over half of individual stock returns were below average, with a sizable amount posting negative returns
- The stock price rise was fueled from "money printing" as well as rising earnings
- We expect stock returns to exceed bond returns by a considerable amount in 2013, as investors increasingly transfer funds from low yielding bonds to stocks

Summary Outlook

- Though the democratic process can be frustrating and ugly, the global process of deleveraging and addressing un-funded liabilities is well underway
- The economy is expected to gather momentum with brighter prospects in the second half
- Solid growth companies are gradually being revalued higher, and offer potential returns that will likely exceed fixed alternatives by a considerable amount

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The Fed and Interest Rates

- The Fed's main strategy is to increase the asset prices of real estate, stocks, and bonds to hopefully prompt business and consumer spending. The primary risk with current Fed policy is the creation of asset bubbles, which inevitably lead to painful adjustments when they burst (a la tech and real estate).

- While history is replete with examples of Fed miscues, we can be confident that short term interest rates will remain near historically low levels during 2013 and, perhaps until 2014-15

- Interest rates on intermediate and long term bonds, also at historically low levels, are more difficult for the Fed to control; eventually, bond investors will demand higher rates to compensate for greater inflation risk, though the timing of a significant rate rise is probably later, rather than sooner.

- While central bank purchases of bonds are a definite factor in driving bond prices higher (and interest rates lower), two other significant factors are the enormous amount of capital seeking returns in a risk-averse manner, and the private sector continuing to reduce their debt levels and increase savings (deleveraging).

Dollar Outlook

- With the U.S. federal government running trillion dollar deficits in the past four years while the Fed "prints money", one would expect the value of the dollar to decline. Yet, given recessions in several developed countries and slower growth in most emerging markets, the U.S. trade-weighted dollar stayed within a wide range last year, as it remains a defensive currency that tends to do well in times of financial turmoil. Looking forward, the coming year could see a resumption of a declining dollar, as Europe and emerging market economies improve.

Stocks

Stocks ground their way higher in 2012, though the rise was not all encompassing. As examples: (1) the 2012 return for the Dow Industrial average was 10% compared to nearly 16% for the S&P 500 index (2) for the S&P 500, well over half of the 500 companies returned less than the overall average, and nearly one fifth had negative rates of return.

- In 2013, assuming the U.S. somehow addresses its fiscal imbalances and barring an external shock, stock prices should rise along with an improving economy and increasing profits. Though the broad market is up over 100% since the market low in March 2009, stock prices, in general, are not overpriced by several valuation metrics. European and emerging markets are also expected to provide positive returns (all with periodic declines that test investor resolve).

Outlook Summary

- The economy is moving closer to powering itself into a self- sustaining expansion. As it gathers momentum over the next one to two years, corporate profits will move higher and, hopefully, support rising stock prices and positive returns. Given the state of global economies and central bank actions, odds favor interest rates remaining low in 2013, though higher rates are likely in coming years. In sum, as we travel through stormy periods in the year ahead, the skies will gradually clear with stock returns poised to exceed fixed income alternatives by a considerable amount.