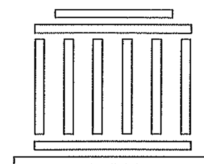
Investment Tally & Perspective



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

40 Westminster Street
Suite 202
Providence, RI 02903
Phone #: (401) 454-3040
Fax #: (401) 453-0678
Toll Free #: (855) 768-3040
Email: info@lccorp.com

Better Days Ahead – Investment Doldrums are Poised for Change

INFLECTION POINT - defined in Wikipedia as the point in a curve at which it changes direction. This applies to global economies and financial markets, which have changed greatly in recent years, and now appear on track to reach significant "inflection points" in coming months, as explained below.

As background, the economic recovery from the financial crisis and recession of 2008 to 2009 is now over three years of age, yet its strength, consistency and breadth are weak when compared to past recoveries. While part of the feebleness is explained by demographic changes (aging populations in developed countries), the main factor behind slow growth is the painful process of deleveraging. Simply stated, a good amount of past activity was financed by borrowed funds, and when the main source of credit – housing – declined in value, then the world became aware of the huge amount of excessive debt and liabilities (pensions, healthcare).

Using debt allowed borrowers to "consume now and pay later" which juiced prior economic activity at the expense of the future. Now, as the overdue bills are being paid or restructured, the end result is reduced spending by consumers, businesses and governments around the globe. So despite the lowest interest rates in modern times and trillions of deficit spending, economic activity remains tepid, with much of Europe in recession, and slower growth in the U.S. and emerging countries, such as China.

Anticipating Important Inflection Points

While we lack a crystal ball and approach forecasting with great humility, we anticipate several significant changes, as noted below.

The Economy – The Fed and most economists expect slow growth in the second half of 2012 and in coming years. Our view allows for faster growth as the level of uncertainties are reduced - Europe's problems will evolve from "crisis" to "chronic"; the U.S. elections may resolve some huge uncertainties, mainly in the tax, healthcare and regulatory policy areas.

Interest Rates – Fed statements support expectations for low interest rates for two or more years. While we generally live by the adage "Don't fight the Fed", their unprecedented actions may well produce unintended consequences which cause interest rates to rise sooner than expected.

MAJOR INDUSTRIALIZED COUNTRIES

	2012 Est. GDP	Unemployment	Estim. 2012 CPI	Budget Balance	Government Bond Rates
Britain	0.1%	8.2%	2.7%	**-7.8%**	1.81%
Canada	2.1%	7.3%	2.1%	-3.3%	1.71%
France	0.2%	10.1%	2.2%	**-4.4%**	2.55%
Germany	0.8%	6.8%	2.1%	**-1.2%**	1.46%
Italy	-2.0%	10.1%	3.2%	**-2.6%**	5.77%
Japan	2.3%	4.4%	0.2%	-8.1%	0.82%
Spain	-1.6%	24.6%	1.8%	**-6.5%**	6.27%
Switzerland	1.2%	3.2%	-0.4%	0.3%	0.65%
United States	2.1%	8.2%	2.1%	-7.6%	1.63%

Note: Interest rates in bold are Euro currency rates.

Data from The Economist, July 7th, 2012

EQUITY INDEX RETURNS

Period Ending June 30, 2012	2012			Average Annual Returns			
	1 Q 12	2 Q 12	YTD	1 Year	3 Year	5 Year	10 Year
S&P 500	12.66%	-2.84%	9.46%	5.38%	16.31%	0.16%	5.31%
NASDAQ Composite	18.67%	-5.06%	12.66%	5.82%	16.98%	2.43%	7.22%
Dow Jones Ind. Average	8.91%	-1.90%	6.84%	6.63%	18.23%	1.99%	6.05%
Russell 2000	12.06%	-3.83%	7.77%	-3.50%	16.28%	-0.86%	5.62%
MSCI EAFE (Foreign Index)	10.86%	-7.13%	2.96%	-13.83%	5.96%	-6.10%	5.14%

Data from Interactive Data Corp.

INVESTMENT STRATEGY & OUTLOOK

July 12, 2012

The Economy

- The U.S. economy continues to expand at a sub-par rate with high unemployment
- Job growth has slowed as businesses remain cautious amid a world of uncertainty
- Budget deficits and excessive debt are growth suppressants around the globe
- The U.S. "fiscal cliff" may well cause a recession if not resolved or revised
- Economic indicators point to modest growth in the second half
- Much of Europe is in recession with continuation into 2013 likely
- Underfunded pension and healthcare obligations are major problems

The Fed and Monetary Policy

- We expect a substantial policy response to ongoing economic woes in Europe
- The Fed will probably launch another bond buying program (QE3) targeting mortgages
- If the Fed announces further actions (QE3), it will push-out rate guidance to mid-2015
- Highly simulative monetary policies are setting the stage for future inflation

Bonds and Interest Rates

- Economic sluggishness has brought historically low interest rates including:
  - 10-year Treasury yield of 1.5%
  - 2 year German bonds at zero percent
  - negative interest rates in Denmark and Sweden
- Rates may decline further, then rise when quantitative easing becomes more likely
- Investment grade corporate bonds provide attractive returns when compared to Treasuries

Equities

- Expect a lot of noise with little movement, and lower prices in coming weeks
- When the correction ends, perhaps by or in September, U.S. large cap stocks will do well
- Stock market positives include bearish positioning, low expected returns from bonds, a healthy corporate sector, stabilizing US real estate, easy money policies
- Negatives include U.S. & E.U. budget cuts, GDP recession risk, slowing China, disappointing earnings, and tremendous uncertainties

Summary Outlook

- The global process of right-sizing budgets and excessive liabilities is well underway
- While it is painful and takes time, we are no longer in denial, as we face the tough issues
- The end result will be stronger balance sheets for consumers, businesses and governments
- In a world of zero interest rates, solid growth companies will become the asset of choice
- Following more near term weakness, stocks will likely move higher with significant potential in coming years

Energy and Commodities - Current fears of recession and slow growth have depressed most commodity prices. As time passes, we expect continued growth in China, India and other emerging markets to cause periodic price spikes and higher prices. The price of gold approached $1,900 last September and then corrected to $1,500. We expect the next major move to be upward with target prices of $2,000 to $2,200 in the next year or so.

The Dollar – Long considered a safe port in stormy seas and the best of a bad lot, long term budget and trade imbalances will eventually pressure the dollar lower.

Stocks – Similar to the past two years, stocks have been in a corrective trading range in recent months. Further weakness is likely in the next few weeks, as the market forms an important bottom. The outlines of a bottom are within sight and, with stock valuations providing attractive risk/reward relationships, we are selectively and gradually moving portfolios from a defensive to neutral structure. Current and expected weakness is providing investors with buying opportunities that may provide exceptional returns in the next one to three years.

VALUE LINE SELECTION & OPINION

Tracking the Economy