



# CAPITAL MANAGEMENT, LLC

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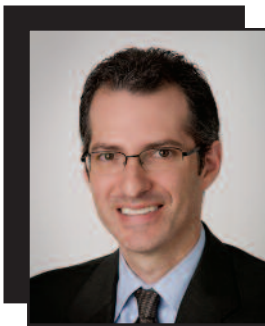
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By Steven M. Sheldon, CFA

## About SMS Capital Management

SMS provides investment management services to individual investors desiring to preserve and build long-term wealth. As a fee-based firm, SMS has an independent, objective and sound approach to portfolio management. The firm is a Registered Investment Adviser.



## About the Author

Steven Sheldon has more than 15 years of professional experience analyzing and managing investments. Prior to founding SMS, Mr. Sheldon worked as a senior member of a corporate principal investments group. Mr. Sheldon has an MBA from Tulane University and a BBA from The University of Texas. In addition, he is a CFA charterholder and a member of both the CFA Institute and the Houston Society of Financial Analysts (HSFA). He is also a Past-President of the MBA Council of Houston.

## 2012 Market Commentary

As we head into 2012, we leave behind an exceptionally volatile, erratic year that rewarded conservatism over risk-taking. It was a year in which strong, double-digit corporate profit growth was trumped by negative sentiment surrounding problematic global macro factors. As a result, the S&P 500 finished the year roughly flat (a rare occurrence). Developed international and emerging market equities fared much worse with those indexes down 11% and 18%, respectively (through 12/24). Despite many analysts forecasting a bear market for bonds, U.S. treasuries, municipals and corporate bonds were the big winners for 2011. U.S. interest rates fell due to investors seeking safety. This, in turn, pushed up bond prices.

At the beginning of last year, the market outlook and investor sentiment was quite strong. Most market forecasters expected the stock market to rise by double-digits and for interest rates to move higher as a result of the economic rebound. In fact, in my market commentary for 2011 I suggested, "...about the worst thing that can be said about the stock market outlook for next year is that, with few exceptions, everyone is bullish." As it turned out, that skepticism was well warranted as the consensus view turned out to be too optimistic. The obstacles standing in the way of a solid economic recovery weighed heavily on investors' minds, pulling down the prices of most "risk" assets in the process.

Now, however, it's possible the opposite may be the case. **With so much negative sentiment, and expectations rising for a global recession in 2012, any scenario that beats that dire forecast will likely be rewarded by the market.** It might be a similar situation to what the municipal bond market faced in 2011. At the beginning of the year, sentiment was so poor and bond prices fell significantly due to fears of widespread municipal defaults. I suggested that the sell-off presented a compelling opportunity to buy. As the year progressed and massive defaults didn't materialize, bond prices rose as investors picked up attractive bonds at bargain prices. In fact, municipal bonds had a stellar year, beating out most fixed income categories.

Of course, there is the real possibility that the U.S. and global economy does slip into another recession. There is no question that the threats facing the global economy are large and will continue to draw market-moving, headlines as these issues play out. A material slowdown in China's growth, the potential for a Euro zone implosion, more sovereign debt downgrades or possible defaults, geopolitical uncertainty in the Middle East and North Korea, and continuing U.S. political gridlock are on the top of investors' list of concerns. Throw on top of that the uncertainty of the U.S. presidential election and you have the makings of another potentially volatile year.



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With the S&P trading at a p/e of 12x trailing earnings (a significant discount to the 15x historical average), a decent argument can be that a slowdown in corporate profits along with other uncertainties are already baked into the market. **Should more positive U.S. economic data materialize in the months ahead, the S&P could rally to over 1,400 (13x next year's earnings) in 2012, representing at least a 15% total return from current levels. However, a new recession or financial crisis brought on by a Euro break-up or other market shock could drag the S&P 500 down 15% or more from current levels.**

Investors should continue to maintain equity holdings at target levels with a good portion of equity exposure in large cap, dividend paying stocks. In addition, investors should roll income from their bond holdings into cash rather than reinvest. The cash can be used to buy equities in the event of a more significant correction stocks. Or, if interest rates rise upon improving economic data, investors will have the opportunity to add to high quality bond holdings at more attractive levels.

## Can Anything Go Right?

With so much fear, doom, and gloom, can the economy continue to improve and actually avoid a recession in 2012?

You wouldn't know it by looking at the stock market's performance in 2011, but recent economic data in the U.S. has, for the most part, been improving. As shown in the chart below, first time claims for unemployment insurance, which may be a harbinger of a stronger job market in 2012, are now down to levels not seen since April 2008.

Other indicators that support the case that the U.S. economy is still in recovery mode include improving consumer confidence as well as the Institute of Supply Management (ISM) manufacturing and service sector surveys which both continue to show moderate expansion. In addition, recent data on the housing market has been somewhat encouraging. The housing sector is of particular importance since it has been a major drag on the economy the last few years. In fact, the November housing starts show residential building activity is back to levels seen in April 2010 when first-time home buyer credits were temporarily supporting residential real estate prices. Recent strength in residential construction has been largely attributed to development of multi-family dwellings as former home owners continue to turn to renting. Single family dwellings have also shown signs of stabilization.

Lastly, election years generally produce good stock market returns because incumbents, determined to stay in office, will do everything in their power to keep the economic wheels on the track. The same holds true for the Fed Chairman who is appointed by the President every four years. President Obama would likely reappoint Mr. Bernanke to his office for a third term in early 2014 while recent rhetoric from the Republican candidates has not been very supportive.



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Mr. Bernanke's aggressive monetary policies and pledge to keep interest rates at record lows at least into 2013 might finally be having a positive impact on consumer demand. Record low mortgage rates and affordable car loans have been a positive for consumers. This would be a big plus to the Obama administration if it means more jobs and a lower unemployment rate come next November.

## **Portfolio Positioning**

Investors should continue to maintain their equity exposure at target levels with increasing exposure to large cap value, dividend paying stocks. Given the drubbing that banks and financial services firms took in 2011, that sector now has a more appealing risk/return profile. Financial services makes up roughly 20% of the large cap value index as compared to only 3% of large cap growth. Moreover, large cap growth has handily beaten the large cap value index over the past five years. If the economy does improve in 2012, banks' stocks and other financial services firms could lead the market higher and start closing that performance gap.

International funds, which dragged down portfolio performance in 2011, are a bit more of a wild card in 2012 given the highly uncertain outlook for Europe. However, investors should maintain current exposure, but wait to add until more signs of stability emerge.

U.S. treasury bonds which along with municipal bonds (which I recommended buying this time last year) were the stars of fixed income investing in 2011 may not continue their streak in 2012. While it is possible that interest rates for long term U.S. treasury bonds do drop lower in years to come, they might take a detour next year as the economy finally shows some signs of life. Investors should hold what they have but wait for a better entry point to add high quality corporate bonds and treasuries. In the meantime, some exposure to secured bank loans and high yield bonds offers investors a good risk/return profile.

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