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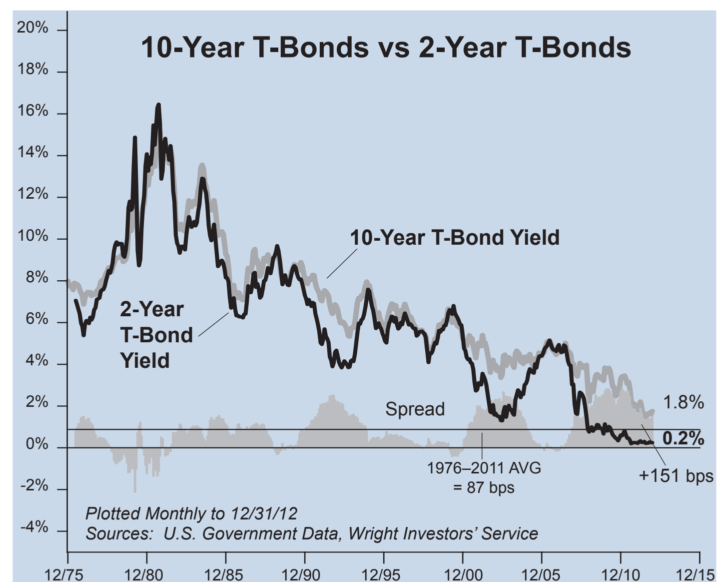
Quarterly Investment Report

January 2013

***SUMMARY:* The global bull market in stocks continued in 2012, although U.S. stock returns lagged their foreign counterparts in the fourth quarter. Bond returns were nominally positive in the quarter, but for all of 2012 bonds acquitted themselves fairly well – especially corporate bonds – considering where yields were to start the year. The U.S. economy picked up steam during the third and fourth quarters but growth remains subpar. The European financial crisis came off the boil during 2012, and Chinese economic growth appears to be starting to build again. The Fed has been largely successful in moving investors to risk assets, but its Quantitative Easing program is not without risk. While Washington managed to avoid the "fiscal cliff," fiscal concerns remain, in particular a replay – sometime in March – of the July 2011 debate on raising the government debt ceiling.**

Despite negative fourth-quarter returns, U.S. stocks managed to post quite respectable returns in 2012, although they lagged foreign stocks by virtue of the generally strong fourth-quarter markets outside the United States. All three major U.S. stock market indexes lost ground in the fourth quarter: the NASDAQ composite fell 2.7%; the Dow Jones Industrials declined 1.7%; and the S&P 500 was off 0.4%. For the year, NASDAQ was the best performer of the three with a 17.5% return, followed by the S&P 500 at 16% and the Dow at 10.2%. A big reason for NASDAQ's outsize performance, both to the downside in Q4 and on the upside for the year, was Apple Inc., which fell 20% in price in the fourth quarter but held on to a 33% increase for the full year. Smaller cap stocks beat large caps by a handy margin in the fourth quarter and more than held their own for the year. The Russell Midcap index returned a positive 2.9% in Q4 to bring its full-year return to 17.3%. (A number of small- and mid-cap stock indexes hit all-time highs during the opening week of 2013.)



Financial stocks were the best-performing sector in the S&P 500 both for the year and for Q4. Financials returned 5.3% for the quarter and more than 26% for the year. The sector was led by the beleaguered Bank of America, which jumped 32% in the fourth quarter on its way to more than doubling for the year, evidence of the past year's risk-on trade. Industrial stocks had the next-best performance for the quarter, +3%, while consumer discretionary stocks were second best for the year, +22%. Telecommunications (-7%) and info tech (-6.2%) were the worst performing sectors in Q4, while utilities were the only sector to post a full-year price decline, losing 3%.

Foreign stocks beat U.S. stocks by a comfortable margin in the fourth quarter, enough to produce a full-year advantage, the first since 2009. The MSCI Developed World ex U.S. Net Index had a return of 6% in Q4 and 16.4% for the full year. Foreign stocks were led by a rebound in Europe, where the Stoxx Europe 600 finished the year with a 14.3% increase, rebounding nearly 20% off its 2012 low on June 4. Germany's DAX index rose 5.5% in Q4 and 29% for the year. Emerging markets also outdistanced their U.S. counterparts, rising 5.6% for Q4 and 18.2% for the year. The Shanghai composite index participated in the rise, recording a 3.2% gain in 2012, its first

Global Investment Returns
In U.S. Dollars

	Q4 2012		YEAR 2012	
	Stocks	Agg. Bonds	Stocks	Agg. Bonds
U.S.	**-0.4%**	**0.2%**	**15.3%**	**4.2%**
Canada	0.7%	-1.2%	9.1%	4.6%
Mexico	5.7%	1.0%	29.1%	16.8%
Japan	**5.8%**	**-10.1%**	**8.2%**	**-9.5%**
Pacific ex Japan	6.1%	#N/A	24.6%	#N/A
Australia	6.8%	0.4%	22.1%	8.7%
China	12.9%	2.0%	22.7%	12.3%
Hong Kong	5.7%	2.0%	28.3%	10.9%
Europe	**7.0%**	**4.4%**	**19.1%**	**12.3%**
France	10.8%	4.6%	21.3%	13.2%
Germany	8.5%	3.3%	30.9%	7.3%
Italy	9.3%	7.5%	12.5%	22.5%
Netherlands	9.4%	3.7%	20.6%	9.3%
Spain	9.6%	8.2%	3.0%	9.6%
Switzerland	8.0%	3.1%	20.4%	8.3%
U.K.	4.2%	1.3%	15.3%	10.6%
World	**2.5%**	**-0.5%**	**15.8%**	**4.3%**
World ex U.S.	5.9%	-1.0%	16.4%	4.1%

Sources: MSCI Stock & Barclays Capital Bond Indexes.

annual increase since 2009, mainly due to a nearly 16% jump in December.

Bonds managed slightly positive returns in the fourth quarter but trailed stocks for the year, mainly due to weak returns in the Treasury and Agency sectors. The Barclays U.S. Aggregate bond index returned 0.2% in the fourth quarter and 4.2% for the year; there was a wide variance in performance within the fixed-income asset class, with higher-risk assets such as corporate and high-yield bonds performing much better than governments. Treasurys returned -0.1% in the fourth quarter and just +2% for the year. In the risk-on world that was 2012, high-yield bonds returned 3.3% for Q4 and nearly 16% for the year (essentially matching the performance of the S&P 500). Long-term bonds of financial companies returned 3.6% for the quarter and a category-topping 23.5% for the year.

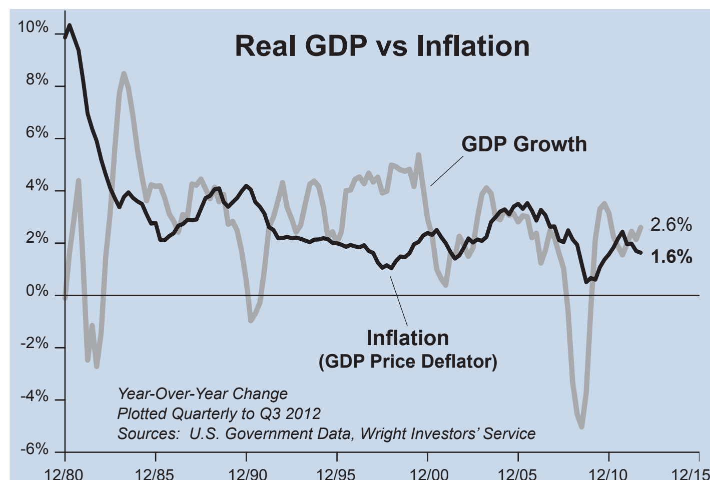
Commodities generally fared poorly in Q4 and underperformed stocks for the year. Crude oil futures fell 0.4% in Q4 and 7% for the year. Precious metals were also weaker, although they had positive returns for the year. Gold fell 5.4% in the quarter but returned 7% for the year; silver dropped nearly 13% in the fourth quarter but finished 2012 up 8%. Copper futures prices were up 7% in 2012.

Economic reports for the third and fourth quarters improved on the first half's relatively weak showing, but the U.S. economy remained in "muddle-through" mode. The Commerce Department's final revision for U.S. GDP growth in the third quarter came in at an annual rate of 3.1%, up sharply from its initial 2% reading; it was also the strongest quarter since Q4 2011 (4.1%). Consumer spending and confidence appeared to lose momentum near year's end, perhaps as a result of all the talk about the fiscal cliff and what it might portend for 2013. Personal spending rose 0.4% in November, making up for October's Hurricane Sandy-impacted 0.1% drop, and personal incomes jumped 0.6%, the biggest rise in nine months. After some initial Black Friday optimism, holiday sales appear to have been somewhat weaker than expected: retail sales grew only 0.7% in the October 28-December 24 shopping season, as compared with 2% in 2011, making the recent season the slowest since 2008, according to MasterCard. Meanwhile, the Conference Board's consumer confidence index fell short of forecasts for December, falling to 65.1 from a revised 71.5 in November. The University of Michigan's consumer sentiment index also declined in late December, falling to 72.9, nearly 10 points below November's reading.

One of the most closely watched economic indicators, the civilian unemployment rate, ended 2012 at 7.8%, the lowest level since December 2008 and down a full percentage point from 8.7% a year earlier. But that's still far above the 6.5% rate the Federal Reserve wants to see before it will consider unwinding its low interest rate policies.

Business indicators showed an economy on the rebound as 2012 drew to a close. Industrial production jumped 1.1% in November, the biggest increase in two years, as the economy made up some of the losses from Sandy. Durable goods orders rose 0.7% in November, after increases of 1.1% in October and 9% in September, adding up to the strongest three-month growth since Q1 2010; ex the volatile transportation sector orders, growth has exceeded 1.5% for three months running, the best showing of the year. Construction spending for the September-November period rose at an 8% annual rate, led by housing activity, which jumped at a 27% rate. Auto industry sales continued strong, finishing the fourth quarter at an average annual rate of 15.0 million, the highest rate since the February-April 2008 period. *The Wall Street Journal* said the average age of the U.S. motor vehicle fleet is now a record 11 years, suggesting a good deal of pent-up demand as we move into 2013.

The housing market continued to gain strength, both in terms of sales and building activity, as well as higher home prices. The National Association of Realtors' pending home sales index rose 1.7% in November to 106.4, its highest level since April 2010 and up nearly 10% compared to the year-earlier period. The index has now increased 19 consecutive months on a year-over-year basis. Existing home sales reached an annual rate of five million in November, the first time sales have topped that level without a government stimulus incen-



Comparative Bond Returns
Total Investment Return for a Ten-Year Treasury Bond*

If Bond Yields at End of Period Are:	1.0%	1.25%	1.5%	1.75%	2.0%	2.25%	2.5%
Next 12 Months – Annual Rate of Total Return:	8.2%	6.0%	3.9%	1.8%	-0.3%	-2.3%	-4.2%
Next 2 Years – Annual Rate of Total Return:	4.6%	3.6%	2.7%	1.8%	0.9%	0%	-0.9%
Next 3 Years – Annual Rate of Total Return:	3.4%	2.8%	2.3%	1.8%	1.2%	0.7%	0.2%

*: Estimated returns for a hypothetical 10-year 1.76% Treasury bond due September 2022 under various interest rate scenarios at 12/31/12. Source: *WIS*

tive since mid-2007. The inventory of unsold homes fell to less than a five months' supply in November, the lowest backlog since 2005. Building permits, one of the Conference Board's 10 leading economic indicators, rose nearly 4% to an annual rate of 899,000 in November, the highest level since July 2008. In terms of home prices, the widely-watched S&P/Case-Shiller 20-city home price index showed a year-over-year increase of 4.3% in October, its biggest YOY rise since May 2010. The rise in home prices over the past several months is starting to have a positive effect on household net worth. According to the Fed's third quarter flow of funds report, household net worth rose by $1.7 trillion, or 3%, to $65 trillion at the end of September, with real estate accounting for more than 20% of the increase.

For the most part, inflation continued to be a non-issue in 2012, remaining well below the Fed's 2% target, as oil prices retreated. Consumer prices actually fell 0.3% in November, the first decline since May, as energy prices fell more than 4%. The core inflation rate, excluding food and energy, rose a modest 0.1% for the month, just below the 0.2% increase analysts were expecting. Producer prices dropped 0.8% in the latest month, and the PCE price deflator fell 0.2%, in line with forecasts, while the core rate was flat.

Investment Outlook

Now that the fiscal cliff has been averted following the New Year's resolution, the next order of business in Washington is the matter of raising the government debt ceiling, which may prove to be a more problematic obstacle for the economy and markets. Treasury Secretary Geithner said the government reached its statutory debt limit on December 31; Treasury may be able to buy another two months of headroom to avoid a default by taking "extraordinary measures." According to President Obama, the failure of Congress to increase the debt limit would be "catastrophic" to the world economy, likely resulting in another downgrade of U.S. Treasury debt. But, fresh off their less-than-stellar performance at the fiscal cliff, Republicans can be expected to dig in their heels and require significant spending cuts before they acquiesce to Obama Administration plans. While we think Congress can be expected to raise the debt limit before it comes to default, the issue creates another layer of uncertainty that investors need to consider over the next couple months.

There are two more important elements that we can count on in 2013: the first is that the world economy is likely to remain weak; the second is that central banks will continue to provide stimulus and liquidity as necessary. The latest economic projections from the Fed, taken at face value, point to a 1.5%-ish rate of GDP growth in the fourth quarter of 2012, half the growth rate in Q3 but probably enough to keep the economy from stalling in 2013. The Fed's "central tendency" projection for 2013 GDP growth has been reduced to 2.3%-3.0%, slightly lower than its previous projection of 2.5%-3%. In contrast, the Organization for Economic Cooperation and Development (OECD) projects U.S. GDP growth at a more modest 2% for 2013.

To keep the economy from stalling further, the Fed unveiled its latest iteration of Quantitative Easing on December 12, under which it began buying $45 billion a month of Treasury securities in January 2013. Unlike Operation Twist, which it replaces, QE4 will expand the size of the Fed's balance sheet (in effect printing money) rather than the sterilized swapping of short-term Treasurys for an equal amount of long-term bonds. QE4 will take place in addition to the already-existing QE3, in which the Fed is buying $40 billion of mortgage-backed securities a month, for a total of $85 billion of bond purchases a month. (The minutes of the Fed's December policy meeting suggest that there is no consensus as to how long these bond purchases will continue, but we expect the Fed to continue them for most of 2013, and quite possibly into 2014 as well.) The Fed also said it would link its low interest rate policy to unemployment and inflation thresholds rather than to a specific calendar date; short-term rates will likely remain near 0% "at least as long" as unemployment remains above 6.5% – which the Fed doesn't expect to happen until sometime in 2015 – and inflation expectations remain under 2.5%.

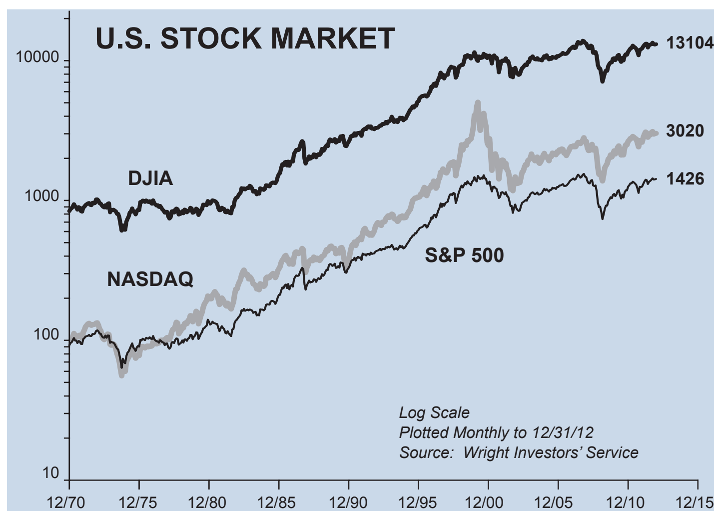
Historical and Prospective Returns from Equities and Bonds

Annual Rates of Return S&P 500 (12/31/12)	1950-2012	1950s	1960s	1970s	1980s	1990s	2000s	2008	2009	2010	2011	2012	Projection Next 5 Yrs
Dividend Income	3.7%	5.1%	3.3%	4.3%	4.5%	2.5%	1.7%	1.5%	3.0%	2.3%	2.1%	2.2%	2.2%
+ Earnings Growth	6.0%	3.9%	5.5%	9.9%	4.4%	7.7%	2.0%	-23.2%	-8.6%	37.7%	14.0%	5.0%	6.3%
+ Change in P/E Ratio	1.4%	10.4%	-1.0%	-8.3%	8.6%	8.0%	-4.7%	-15.3%	32.1%	-24.9%	-14.0%	8.8%	-1.0%
= Total Return	11.1%	19.4%	7.8%	5.9%	17.5%	18.2%	-1.0%	-37.0%	26.5%	15.1%	2.1%	16.0%	7.5%
– Agg. Bond Return	6.2%	1.0%	3.0%	6.6%	12.3%	7.7%	6.3%	5.2%	5.9%	6.5%	7.8%	4.2%	2.5%
= Equity Risk Premium	4.9%	18.4%	4.8%	-0.7%	5.2%	10.5%	-7.3%	-42.2%	20.6%	8.6%	-5.7%	11.8%	5.0%

Source: Wright Investors' Service.

Outside the U.S., the economies of Europe and Asia are still not out of the woods, but signs of gathering economic momentum in the latter part of 2012 provide some basis for optimism in 2013. In Europe, which is likely to remain in recession for at least the first half of 2013, the crisis atmosphere has been ratcheted down; Europe is no longer experiencing weekly shocks as was the case in 2011 and the first half of 2012. This is most evident in the reduced yields on sovereign bonds of the euro zone's most troubled economies. In July, the European Central Bank's Mario Draghi said the ECB would do "whatever it takes" to preserve the euro, including buying government debt. While the ECB has yet to actually put that policy into action, it has had the effect of sharply reducing yields on sovereign bonds: more than 230 basis points in the case of the 10-year notes of Spain and Italy, over 10 percentage points for Portugal and 16 points for Greece. It has also resulted in a stronger euro, which has climbed 10% in value since late July.

In Asia, the Chinese economy has also started to turn higher, and the new Japanese government is promising "bold monetary easing" and stimulus spending to boost the country's moribund economy. HSBC's flash manufacturing PMI for China rose for a second straight month in December to a 14-month high of 50.9. The bank said the increase "confirmed that China's ongoing growth recovery is gaining momentum." Chinese industrial output rose 10.1% year over year in November, up from 9.6% in October and the strongest increase since March. Japan's Nikkei 225 rose more than 20% in 2012 (closer to 10% in dollar terms because of the weak yen), including an 18% run-up since the middle of November. It should also be noted that tensions between the two Asian giants have cooled in recent months.



The U.S. Economy 2011–2014

		% Change In			End of Period Rates	
		Real GDP*	PCE Core Deflator*	Profits from Operations#	90-Day T-Bills	10-Year T-Bonds
2011	Q1	0.1%	1.3%	19%	0.1%	3.5%
	Q2	2.5%	2.3%	12%	0.0%	3.2%
	Q3	1.3%	1.9%	18%	0.0%	1.9%
	Q4	4.1%	1.3%	9%	0.0%	1.9%
2012	Q1	2.0%	2.2%	9%	0.1%	2.2%
	Q2	1.3%	1.7%	7%	0.1%	1.6%
	Q3	3.1%	1.1%	1%	0.1%	1.6%
	Q4 e	1.4%	1.6%	2%	0.0%	1.8%
2013	Q1 e	1.0%	1.5%	-4%	0.1%	1.7%
	Q2 e	1.7%	1.6%	-1%	0.2%	1.9%
	Q3 e	2.0%	1.6%	2%	0.2%	2.0%
	Q4 e	2.5%	1.7%	6%	0.2%	2.2%
2014	Q1 e	2.7%	1.8%	11%	0.3%	2.4%
	Q2 e	2.8%	1.7%	8%	0.4%	2.6%
	Q3 e	2.9%	1.7%	7%	0.5%	2.8%
	Q4 e	3.0%	1.8%	8%	0.5%	3.0%

e: WIS estimate @ 12/31/12; *: Annual rates; #: Year-over-year chg. in S&P 500 e.p.s. Sources: U.S. Government data, Wright Investors' Service.

Longer-Term Outlook

While the effectiveness of the Fed's various QE programs is open to debate, there's little question that the Fed has been successful in moving investors out of the safe haven of Treasury securities and into riskier assets like corporate bonds and stocks. Generally speaking, during 2012 stocks outperformed bonds; mid- and small-cap stocks outperformed big-cap issues; foreign stocks outperformed domestic stocks; emerging markets outperformed developed markets; and corporate and high-yield bonds outperformed Treasurys. Whether or not these trends continue in 2013 is difficult to say, but we expect Federal Reserve monetary policies to encourage risk-on trades. There are also fundamental reasons that make the case for equities, starting with the fact that stocks are priced far more attractively than government bonds. The current 2.2% dividend rate on the S&P 500 represents a 150 basis-point premium over the yield on five-year Treasury notes and 50 bps over 10-year Treasurys, the biggest differentials since the 1950s. Respondents to the CFA Institute's 2013 global market sentiment survey expect stocks to be the best performing asset class in 2013, with the U.S. the best place to invest.

January 7, 2013

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