Angeles Wealth Management – Quarterly Review

REVIEW OF THE QUARTER

For the second quarter of 2012, world markets remained imprisoned by the ongoing saga of the European debt crisis. Concerns about the fiscal stability of the "PIIGS" (Portugal, Italy, Ireland, Greece and Spain) continued to cast a dark shadow over not only Europe, but over world markets, as the realities of a true interconnected global economy were readily apparent. We are all now well aware that an economic thunderstorm in one market can create a financial flood in another.

Perhaps most unsettling about the Euro problems, is not the current fiscal mess of many of its members, but the apparent lack of resolve on the part of these members to actually face the music…to make the changes necessary to fix the system. It may seem apparent to all of us on the outside that a single currency also requires a commitment to a single monetary and fiscal policy, however, for the moment, in Europe, "this dog won't hunt." The fundamental flaw was that when the Euro was adopted just over 10 years ago, the need for common monetary and fiscal policy was simply not properly addressed, because reaching consensus amongst these member nations was a fantasy. Europe is a collection of independent sovereign nations with different languages, cultures and perspectives on social policy and government. Citizens do not see themselves as "European." This is where the United States has a great advantage in solving our fiscal woes…we are all connected. Citizens of California actually care about the plight of citizens of Louisiana, for example. Further, our centralized federal government creates consistency in national economic policy that controls activity in all 50 states. Imagine if our citizens were not forced to comply with federal laws on taxation, policy, etc? We would then be the Eurozone.

During the quarter, the Spanish banking system displayed signs of material weakness pushing government borrowing costs to new heights, and now at the level at which Greece, Ireland and Portugal were forced to seek international bailouts. In mid-June, Greek voters elected Antonis Samaras, leader of the pro-bailout, conservative New Democracy party who has yet to form a coalition government for the country. On June 29th, euro-zone leaders agreed to let the permanent bailout fund directly inject capital into distressed financial institutions, driving capital markets sharply higher on the last day of the quarter.

This last minute rally did little to save the quarter. International Equities, as measured by the MSCI EAFE Index finished the quarter down 7.1%. The MSCI Emerging Markets Index also produced a negative return, declining 8.9%. In the US, the Fed announced the extension of its $400 billion Operation Twist program, pledging to swap $267 billion in short-term securities with longer-term debt through the end of 2012. The S&P 500 lost 2.8% over the trailing three months, a poor result in absolute terms, but quite heroic when compared to the dismal quarter elsewhere. The fixed income market and the US Dollar both rallied in a "flight to safety" and in reaction to Operation Twist. US Treasuries posted large gains in April and May, aiding in the Barclays Capital US Aggregate Bond Index's positive 2.1% return, and the Euro's 5.1% decline relative to the US Dollar. The economic downdraft also led to one of the biggest and broadest declines in commodity prices since the financial crisis. The Dow Jones/UBS Commodity Index finished the quarter down 4.5%. The decline in commodities prices was a reflection of an increasingly pessimistic outlook for worldwide economic recovery.

OUR OUTLOOK

We would love to use the classic market cliché of being "cautiously optimistic." However, "optimistic" is way too bold a word for us at this part of the cycle. Equity markets risks remain significant as so much of what happens next rests in the hands of politicians, both here and abroad. As you can imagine, this makes us extremely nervous, as political irrationality in Europe and partisan gridlock in the US have us hurtling towards global fiscal cliffs. If no real change comes until the point of crisis, the question is, when will politicians decide that the crisis is large enough to act?

For a little good news, US corporations have never been healthier, and US equity metrics are flashing a valuation "buy" signal. Since the financial crisis of 2008, they have transformed their balance sheets, slashing leverage, cutting expenses, raising cash and right-sizing operations. Return on equity is high, dividends are high, and price/earnings ratios are low. According to data from Bloomberg, the 2011 year-end P/E ratio of the S&P 500 was 13.8x, the lowest year-end number since 1988. The 2011 year-end S&P 500 dividend yield was 2.1%, the highest since 1995, with the understandable exception of year-end 2008. Additionally, 2011 year-end return on equity for the S&P 500 was a robust 26%, the highest in many years. As a frame of reference, the dividend yield on the MSCI Euro Index at year-end was 4.7%, but the return on equity was a paltry 15.0%. In short, US corporations have gotten "lean-and-mean" since the 2008 crisis. However, with the current problems in Europe and a lack of clarity from Washington on the business climate, they remain cautious and defensive.

OUR PORTFOLIO POSITIONING

Our asset weighting remains neutral as attractive equity valuations are offset by the risk of Euro implosion, slowing world growth and deleveraging activity. However, financial markets are a leading indicator, and turn upwards far in advance of noticeable economic improvement. Our strategy is to identify areas with better valuation and/or growth prospects with acceptable risk, such as convertible bonds, alternatives and distressed assets.

The rise in interest rates that will come with the eventual end of Federal Reserve interest rate manipulation makes investment in long-dated, high-credit quality fixed income unattractive. Extending duration to stretch for yield in this area will eventually result in the significant loss of market value. However, spreads on lower credit quality instruments are wide and attractive. Our strategy is to overweight credit/spread products such as high yield, emerging markets debt, etc.

THEMES

Invest in scarcity. Our search for yield in a low-yield world leads us to investment in convertibles, credit, MLPs, preferreds, REITS and high dividend stocks. Enhance yield via credit, not duration. Our search for growth in a low/no growth world leads us to emerging markets, North American energy and countries with accommodative monetary policies. Be properly positioned in the world de-leveraging process. The US is significantly ahead of Europe in this regard. Favor low-leverage, high-quality companies, and creditor countries.

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