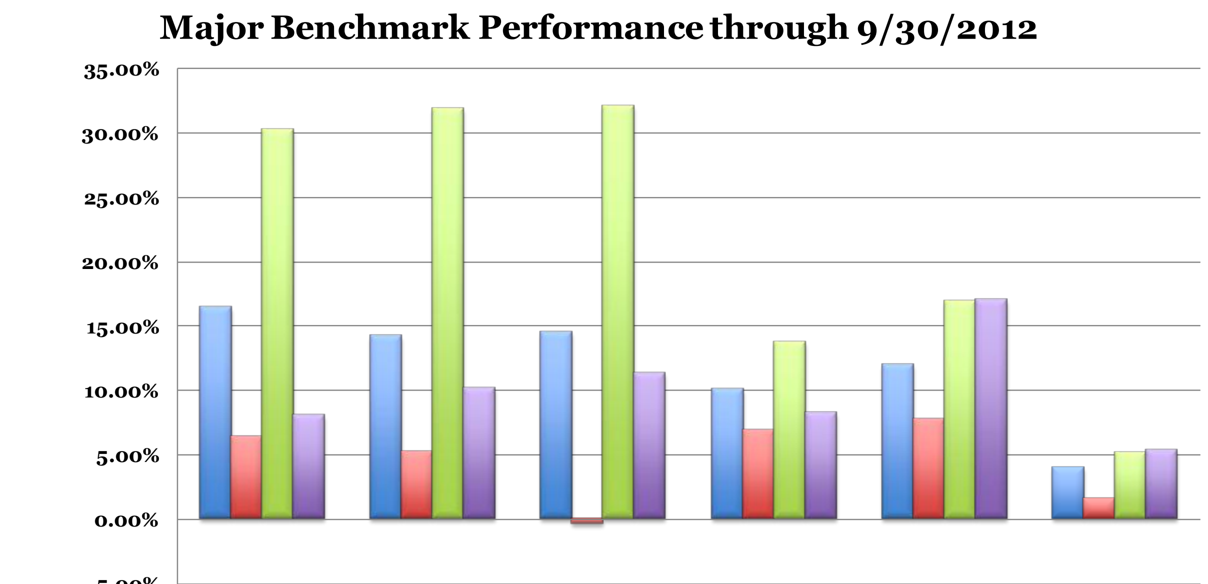
Market Summary and Outlook - 3rd Quarter 2012

This was a very good quarter for stock markets. After a quiet August, investors expected a rough September in Europe. The opposite occurred, helped greatly by the US Federal Reserve's stimulus announcement, as well as the European Central Bank's announcement that it would do whatever it takes to hold the euro together.



	S&P 500	US Small Cap	US REITs	Foreign Developed	Emerging Markets	US High Quality Bonds
YTD	16.44%	14.23%	14.47%	10.08%	11.98%	3.99%
3rd Qtr 2012	6.35%	5.25%	-0.38%	6.92%	7.74%	1.58%
12 Month	30.20%	31.91%	32.06%	13.75%	16.93%	5.16%
10 Year (ann.)	8.01%	10.17%	11.28%	8.20%	17.00%	5.32%

Source: DFA

The US will be focused for the short term on the upcoming presidential elections and potential changes to US tax policy in January 2013. We remain concerned that the lame duck Congress will wait until the last minute to address the potential changes to tax and spending policies. We are also concerned about the possibility of lower corporate earnings in the 4th quarter.

Below is a look at the main developments:

United States

After a series of weak unemployment reports since the spring, the Federal Reserve in September announced its 3rd major round of bond buying. It plans to purchase $40B per month of mortgaged-backed bonds until the employment trends are more positive. The intent of this stimulus is to lower mortgage rates even further to help turn around the housing sector. The Fed also announced that it is committed to keeping interest rates at very low levels until the middle of 2015. This time frame is consistent with forecasts of how much longer it could take before unemployment rates drop to more acceptable levels.

As of the October 5 employment report, the unemployment rate is now 7.8% (down from 8.1%), about where it was when President Obama took office almost four years ago. The market reaction to the report was tepid, in part due to the belief that the lower rate reflects many people having given up on their job search.

International

While there have been many false starts in Europe to prevent the disintegration of the European Union, in this quarter the continent made real progress and the markets reacted very positively. The European Central Bank pledged in September an Outright Monetary Transaction program that will allow the bank to buy an unlimited amount of sovereign debt from countries that accept a bailout and are in compliance with the terms of the bailout. Also in the quarter, the German high court approved this stimulus, significant in that Germany (the most influential of the Eurozone countries) in the past claimed any sovereign interference was unconstitutional.

These developments are positive, but more is needed for stability of the EU. Most importantly, individual countries must adhere to the terms of the bailout. As we discussed in our last newsletter, there are deep cultural differences that will be very difficult to overcome, even with increased ECB willingness to help.

Presidential election: how will it affect the market?

Historically, the stock market (as measured by the Standard & Poor's 500 Stock Index) has improved more often than it has declined *immediately* following a national election. However, based on the number of presidential elections since 1926, statisticians would caution that there are not enough "data points" (presidential elections) to make a meaningful conclusion.

In any event, the consensus is that the positive market impact following an election seems to be less about the candidate or the winning party. Instead, the positive market impact is more likely based on an assumption that the election-based uncertainty has been removed.

One interesting exception was in 2008 when Obama was elected president and the S&P declined 37% during that calendar year. Depending on political affiliation, one could conclude the decline reflected the election outcome. However, the 2008 market decline more likely was due to the high level of uncertainly in the economy. Several major companies had gone under (AIG, Lehman Brothers, et al.), the US stock market had declined almost 17% in October alone, and investors continued to worry about other companies failing. The market did not hit bottom until March 2009.

The US economy continues to show signs of slow improvement as compared with 2008. By contrast, European economies continue to struggle, and international markets are potentially a drag on our economy.

Despite international concerns, the greatest threat to the US economy, short-term and long-term, is the uncertainty how we will address our tax and national debt problems. At this point, there is no resolution regarding tax policy or debt reductions, which must be resolved by year end (this is discussed further in the next section).

Regardless of the election outcome and any short-term market impact, in the long-term we anticipate that the market will continue to be volatile and investment risk will increase unless agreement can be reached about our revenue (taxes) and expenses (debt).

US Tax Policy and Spending

If Congress does nothing before January 1, 2013, there will be two very significant changes to US tax policy. The possibility of these changes happening simultaneously is being referred to as the "fiscal cliff".

1) The Bush tax cuts will expire, which will result in increased marginal tax rates, capital gains rates, and tax treatment of dividend income at ordinary rates instead of capital gains. This should result in increased revenue to the US government which will cut our deficit. However, there is widespread concern increased taxes will push an already weak US economy back into recession.
2) Deep cuts to defense and other federal spending will go into effect on January 1, 2013. These automatic cuts are the result of Congress' inability to agree on a combination of deficit-reducing cuts and revenue sources (taxes) during last year's budget stalemate that resulted in the downgrade from Standard and Poor's.

Politicians are acutely aware of the adverse effect all these changes would have on the US economy and stock market. However, it is impossible to know for certain whether our divided Congress will act in a meaningful way before January 1. Therefore, even after the election outcome is known, we may still be dealing with the uncertainty of changes to taxes and spending.

We plan to send another newsletter dedicated to year-end tax planning strategies and more detail on the "fiscal cliff".

Hedge fund advertising rule

We want to bring to your attention the recent relaxation of SEC regulations related to hedge fund advertising. The definition of accredited investor still applies (investors with a net worth of at least $1 million, or income of more than $200,000), but it is now very possible hedge funds will be able to advertise to the general public, for example in financial magazines.

We are concerned there are many people who meet the definition of an accredited investor but who do not understand the risks, high fees, illiquidity, and general lack of transparency of these investments. Further, the hedge funds that are worth investing in are not targeting individual investors – institutional investors have already shown enough demand to meet capacity.

As always, we hope if there is an investment you are considering, you will bring it to our attention. We will help you determine what the fees are, whether it makes sense in the context of your financial plan, and whether it is too good to be true.

Conclusion

We just experienced a good quarter in the midst of tremendous uncertainty. For reasons stated above, we expect the uncertainty in the markets to persist. Instead of trying to predict how the market will react to events, we continue to recommend staying diversified and maintaining a long term perspective.

We thank you for your confidence in us and encourage you to stay in touch with either of us.

Janet & Barry

Sources: Morningstar, Economist, Wall Street Journal, DFA