QUARTERLY COMMENTARY
Fourth Quarter 2012

In 2012, governments and central bankers worldwide succeeded mightily in pushing stock markets higher despite slowing and, in some major areas, declining economic growth. So concerned with deteriorating fundamentals were governments in all but a few emerging countries that they overtly promoted rising stock prices. By directly purchasing bonds, many governments also pushed interest rates to all-time lows, providing bondholders with positive returns as well.

Nothing comes free, however. To prevent potentially severe recessions, central banks resorted to unprecedented policies which raised debt levels to heights that have typically led to history's greatest economic collapses. Even fellow central bankers have warned that these actions risk painful economic consequences that could last for a decade or more.

Especially following successful Federal Reserve stimulus efforts, the phrase "Don't fight the Fed" often becomes the rationale for abandoning all caution and going with the flow. And conceivably, that abandon could be the roadmap for success in 2013. But investors would be wise to evaluate the risks as well.

While the Fed succeeds more often than it fails, it has some glaring episodes of ineffectiveness on its resume. In the United States' most serious stock market collapses (1929-32, 2000-03, and 2007-09), the Fed aggressively attempted to bolster asset prices. Having finally run out of interest rate tools, the Fed and the European Central Bank have of necessity resorted to unparalleled levels of money printing. In 2013, stocks could continue to rise if investors retain their confidence in the central bank's ability to support markets. But today's debt levels also present unprecedented risks. Confidence could dissipate quickly, and markets could fall rapidly. That puts great question marks and uncertainty around investments in the year ahead.

Mission's longstanding equity selection process is built on valuation fundamentals. Since 1986, it has selected equities that have on an annualized basis outperformed the S&P 500 by about 700 basis points. In recent years, however, in which the Fed has dramatically altered free markets, our process has found very few equities meeting our traditional selection criteria. Consequently, we intensified our search for an additional approach that would retain Mission's carefully designed risk controls but would also be responsive to an environment dominated by central bank stimulus. In our third quarter commentary I referred to two new equity allocation processes that we were prepared to initiate. Back tested for more than three decades, each has outperformed the S&P 500, while suffering fewer and smaller losses than that index. We invited clients with interest in exploring these alternatives to contact us. Many did, and we have held several small group sessions to outline the processes and to respond to questions. Most have chosen to add one of the new alternatives to their investment program.

Tom Feeney provides frequent economic and investment commentary on our blog at www.missiontrust.com/blog.

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While these new approaches are not designed to replace our time-tested traditional process, they have the potential to supplement that process in a period of artificial central bank stimulus. We encourage all clients who want equities as part of their investment program to evaluate these processes. We will continue to schedule small group meetings to review details. Let us know if you would like to attend.

We continue to believe that while the Fed could still drive interest rates lower, thereby producing small profits in bond portfolios, there remains greater risk in the bond market than probable reward. Central bank money printing will eventually produce inflation, although its timing is subject to a number of uncertain variables. We have begun to build a position in gold as a hedge against eventual inflation. Because short-term gold prices are based more on investor emotions than fundamentals, we are not inclined to chase prices. We will continue, however, to build that position should prices decline.

We anticipate that great uncertainty and volatility will mark the year ahead. If central bankers win their historic bet on more stimulus, markets could continue to rise. If deteriorating fundamentals overwhelm central bank largesse, security prices could fall precipitously, as they have twice so far in this new century. Investors should remain flexible and avoid fixed allocations to either stocks or bonds.

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