

NOYES CAPITAL MANAGEMENT[®], LLC

Wealth Management for Changing Markets

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2012 Forecast - Global Deleveraging Continues

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Since the spring, the equity markets have been absolutely bombarded by bad news. Yet for all the crises in the world, the markets are ending the year on a resilient note. We believe that low inflation and strong corporate earnings have protected the markets from a serious decline and may continue to do so in 2012.

In the U.S. the S&P 500 is modestly lower for the year but the Dow Jones Industrial Average has gained 5% as investors have moved towards more conservative stocks. High quality U.S. bonds have declined almost 1% in yield while high-yield (junk) bonds remained unchanged. Financial and materials stocks have led the market decline. In foreign markets, Europe is down approximately 16%, emerging markets have declined 18% and foreign bonds have lost almost 6% in value as rates have increased. A typical balanced portfolio is likely to close the year near breakeven depending upon its weightings in the various global markets.

As we prepare to enter what may be another challenging investing environment, 2012 promises to be a year of transition. Politically the United States will be focused on the presidential election. Financially, Europe will come to terms with the potential breakup of the monetary union, and economically China will settle the debate over the risks of a soft or a hard landing.

However, one thing seems reasonably certain: the global economy is going to endure a significant deleveraging cycle as we move through 2012 – one that will affect most, if not all, parts of the developed world. It will be accomplished by some combination of default, write-downs, debt repayment, and increased savings rates. All of these measures promise to be very deflationary and we will have to invest with that prospect in mind.

Commodities Start the Year in Decline

During the fourth quarter, there has been a decline in the prices of base metals and agricultural products. This appears to be the result of a slump in global manufacturing, particularly in China and Europe. Commodity demand depends heavily on China's appetite for metals—it consumes half of the world's annual production of iron ore and more than one third of most base metals. China's economy appears to be slowing although it is unclear whether the central government can buffer the landing.

Secondly, European banks are reported to be the largest lender to major commodity firms dealing in physical materials as well as to hedge funds and the trading industry. Because European banks are being forced to increase capital due to losses on sovereign bonds, they must either sell more stock or reduce their loan portfolios. Many have chosen to reduce new loans and refuse to renew those coming due for commodity firms. The reduction in financing availability

for importing and exporting firms, as well as other types of commodity related transactions has begun to take a toll on the cash and futures markets. I believe the growing credit crunch for the commodity industry could become a new negative force in those markets during the first half of 2012.

Inflation – Not to be Feared in 2012

The outlook for all major components of inflation: labor costs, housing prices and commodity costs appear to be subdued for 2012. The global economic slowdown and financial deleveraging have helped reduce the cost of raw commodities. Overall labor costs remain stable except for areas requiring specialty skills and advanced degrees. While home purchase prices are still finding a bottom, residential rental prices are up due to increased demand. Overall, inflation prospects for 2012 are quite low – 0% to 2%.

Housing Update – Finding a Bottom

The housing market collapse has been unprecedented. One would have to go back to the Depression to find something comparable. Housing starts, that were running 2,000,000 a year, are now down to 500,000. That's a 75% decline in one of the biggest sectors of the U.S. economy. It has been said that, directly or indirectly, there are four million jobs that are connected to housing and we've wiped out three quarters of them.

Housing will eventually pick up. We can't continue to build only 500,000 new units annually and match population growth. There's got to be a saturation point coming where the housing market begins to pick up and provides a major boost to the entire economy. In addition, credit lending needs to loosen up in order to allow more people to get mortgages. Our best guess is that the housing market is starting to find a bottom and current prices present a buying opportunity for those with a long-term horizon and strong credit scores.

Tax Policy – Good in 2012, Terrifying in 2013

There are only minor tax changes likely to take place between 2011 and 2012 – enjoy what should be the lowest tax rates of your lifetime! However, in 2013 the tax world may come unglued. Now is the time to think through your long-term tax reducing strategies.

- The expiration of the Bush tax cuts will lead to an increase in marginal tax rates of 3% to 4.6% for the top three tax brackets.
- In 2013, the Medicare Payroll tax is slated to increase by 0.9% for higher-earning households by increasing the taxable portion of wages.
- Unearned net investment income will be taxed at an additional rate of 3.8% in 2013 for those earning over \$250,000 to help pay for health care reform.
- The estate tax bracket was increased to \$5 million in 2010 but will revert back to \$1 million in 2013 unless re-approved or modified.
- Many states are looking for new sources of revenue. Increased user fees and specialty fees are likely to increase.

Beware the Volatility Trap

Nobody enjoys stock market volatility. When it is combined with large market losses, it is doubly painful. Highly emotional events are more likely to be remembered, so it is not surprising that many investors believe that volatility is usually associated with market losses when in fact, it can often lead to higher returns. It is easy for investors to fall into the Volatility Trap by abandoning the stock market after a significant decline when near-term anxiety wins out over long-term benefit. However, the greater risk is being on the sidelines and missing out on higher future returns.

At Noyes Capital, we try to minimize the Volatility Trap by using two portfolio targets, (1) a neutral allocation—typically 60% stocks, used during normal market conditions; and (2) a “survivable” core portfolio—often 35% to 40% stocks, which would be held even in dire market circumstances. These targets are customized for each client as financial needs and risk tolerances vary. Resisting the impulse to decrease market exposure in the face of increased volatility is counterintuitive. But if you have built a cash buffer, it is easier to re-enter the market when you can “buy on sale”.

The Sustainable Portfolio Strategy for 2012

Our core “sustainable” portfolio is composed of high-quality large-cap U.S. equities with a bias towards income. Similarly we like value-focused international stocks with an emphasis on income as well as emerging markets issues. While we have been avoiding Europe, opportunities are starting to appear in the stocks of high-quality European companies. In addition, we continue to be underweighted in small-cap stocks and more speculative situations.

In terms of sector choices, technology and health care look attractive for long-term growth. While we are big fans of “resources in the ground” on a 10-year horizon, we believe patience will be rewarded for those who can wait until the spring or summer months to buy them. Gold, particularly coins, would be attractive on a dip in price.

On the bond side we are strong believers in investment-grade corporate bonds of intermediate maturity. We are hopeful that we can eke out another decent year in the bond market before rates go higher. We also allocate a modest portion to high-yield bond funds with shorter maturity portfolios.

We are currently maintaining 10% to 15% in cash reserves using highly-liquid short-term bond ETF's or T-Bills. We would be willing to put this back to work in the stock market if there were a significant decline or if economic conditions improved.

Conclusion

While we remain cautiously optimistic for 2012, we believe the dominant focus will be on capital preservation with an income orientation. We are maintaining a cash reserve to deploy in the market in the event of a meaningful sell-off. In view of the political, financial and economic

uncertainties around the world, 2012 should prove to be an interesting year!

Please call me if you have any questions at 973-267-8120.

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