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January 4, 2013

2013 – The Low Interest Rate Trend Continues…
By Scott P. Noyes, CFA® CFP®

The year 2012 was a good one for financial assets. The Dow Jones Industrial Index was up 7.3%, the S&P 500 index rose 13.4% on a price basis and 15.9% with dividends included. The U.S. bond index gained 4.2% while commodities lost 1.3%. Broad foreign equity indexes performed particularly well in the last quarter, delivering an 18.1% increase for the year. Overall, it was a very good year considering the media was saturated with impending doom and gloom in Europe, China and the United States.

I believe that the battle between deflation and inflation will continue into 2013. In spite of coordinated global central bank rate reductions, the overall price level for real wages and real assets remains subdued. Central bank stimulus has manifested itself in higher prices for financial assets such as stocks and bonds. There are meaningful signs that housing values are starting to increase and may resume the historical pattern of growing with the rate of inflation (2-2.5%). However, the printing of money has not yet been transmitted to higher wage rates, particularly for less educated workers. Based upon continued central bank monetary stimulus, we believe 2013 will see reasonable gains for financial assets, particularly equities.

The "Fiscal Cliff" was averted but spending cut decisions were postponed as Congress chose to divide the negotiations into two pieces. While a new tax policy was approved late on New Year's Day, the budget cuts are likely to be negotiated around the time of the debt limit approval in March. This could coincide with a possible rating downgrade for the U.S. from Moody's and Fitch credit rating services. The difficult work will begin in late February or early March when the Republicans will use the debt ceiling negotiations to impose spending cuts on the government.

The recent tax increases are valued at $600 billion over ten years and have been designed to primarily affect individuals earning over $400,000 and couples over $450,000. State tax deductions, personal exemptions and credits would start to phase out on incomes as low as $250,000/$300,000. Surprisingly, even dividend and capital gain tax increases from 15% to 20% will only apply to those earning over $400,000/$450,000. Estate taxes would increase from 35% to 40% for those with inheritances over $5 million. All of these tax changes have been made permanent so as to eliminate future debate. All in all, this package does not affect most Americans, should be viewed positively and will help improve both business and consumer sentiment.

The perception is that tax increases are done for the year and spending cuts are to come. Tax revenues are now locked in at approximately 18.5% of GDP, far below current level of government spending, 23% of GDP. The difference being the fiscal deficit. Both parties in Congress are likely to be on a mission to cut expenses and improve the delivery of government services for the foreseeable future. This will likely require cuts in defense spending, social services, Medicare and social security. One additional catalyst for spending cuts may be the risk of a U.S. credit rating downgrade from one or more rating services. Overall, the government will remain a non-contributory factor to economic growth for a very long time.

Major trends for 2013

Interest rates are likely to remain low in 2013. Income investors now know they can count on a continued policy of little or no yield from their CDs or investment-grade debt securities well into 2013. Currently, the yield on a one-year CD is about 0.35% and ten-year corporate bonds yield 2.5%. With CPI inflation at 2.2%, owning bonds is a guaranteed way to lose purchasing power. If the Federal Reserve gets the inflation it wants, long-term interest rates should go higher, resulting in bond price declines. I believe that U.S. interest rates are in the very late stages of a long-term rally, or even a bubble reminiscent of the housing market in 2006. When interest rates turn higher, the financial damage will be swift and substantial. I believe it makes sense to migrate investments from bonds into equities and real estate during 2013.

The U.S. is not likely to enter a recession anytime soon. While the U.S. economy is growing slowly at 1% - 2%, it appears to have sufficient support from consumers, housing and business to maintain a positive growth rate. There are additional positives as well. The year-end tax bill should help the economy as it adds certainty to a low-rate forward tax structure. Repairs from the hurricane are likely to boost construction and auto spending in the northeast. Due to the natural gas boom, energy prices in the U.S. should remain low for the next few years. Finally, the U.S. stock market rally has created a wealth effect and improved consumer sentiment. I am hopeful that the economy will stay on track for the year, in spite of future Washington turmoil.

The housing recovery has achieved lift-off. Home sales are recovering now based on fundamental demand and favorable affordability conditions. The November pending home sales index increased to the highest level since 2010. However, full-scale expansion requires banks to loosen the tough lending standards put in place after the 2008 crisis.

Low and permanent tax rates improve business certainty. The psychological effect of making the Bush tax rates permanent, eliminating the Alternative Minimum Tax (AMT) for many in the middle class, retaining low capital gain and dividend tax rates and fixing the estate tax should have a profound effect on business certainty. At a minimum, a major excuse has been eliminated.

The Eurozone is likely to muddle through another year. The German elections for Chancellor occur in August making it more likely that the German government will want to promote growth and keep the euro intact. Processes have been put in place to provide conditional support in exchange for improved fiscal discipline from borrowing countries. Although there is continued market volatility risk, the risk of permanent capital loss has been substantially reduced. In addition, Mario Draghi, the head of the European Central Bank (ECB), has committed to helping Spain and Italy solve their funding problems through central bank bond purchases. Nevertheless, longer-term issues in the banking system need to be resolved and the move toward a fiscal union still needs to be completed.

Emerging Markets are improving. China has just completed a major political transition and the new leaders are working to realize their stated economic plans. They intend to get the economy moving in several new directions, including a push toward higher margin products and a more service-based economy. Wages will be allowed to grow in order to promote internal consumption. These plans are seen as key strategies to improve the overall prospects for the economy. China is likely to grow at 5%–6% per year. The rest of Asia is likely to follow China’s lead.

Latin America also appears to be bottoming. Economies have turned from fighting inflation to promoting

growth. Brazil, Mexico, Columbia and Peru have corrected inflationary pressures and appear to be on track for further growth. Latin America should benefit from further growth in China.

Our Investment Outlook

I remain cautious on bonds and optimistic about equities in 2013. As the markets move from denial to acceptance of an improving economy, business investment should improve on a global basis. As investors gain confidence, we should see investments move from low return CD's and bonds into global equity and real estate markets. Global central banks will continue to provide a sea of liquidity, further promoting asset appreciation. As we are now approaching what is seasonally a better time for the stock market, we believe the upward trend will likely continue. Outside of a major war or major political shock, I maintain a positive outlook for 2013.

Income investing still makes good sense. With bond rates so low, equity income investments such as energy MLP's, pipeline MLP's, utilities, infrastructure funds and real estate REIT investments continue to make sense. In many cases, investors can earn 4% to 7% from these investments.

Low cost exchange traded index funds (ETF's) are becoming an increasingly important component of our portfolios. We have found that they outperform many mutual funds, have lower costs and are more tax-efficient. You will find more of these in your portfolio in 2013.

In an age of instant information, the nature of financial markets is to be more volatile. Today an investor must be willing to take some volatility risk to achieve a potential return. Individual investors should have one major advantage over Wall Street traders: the ability to stick to a long-term strategy. One of our goals is to be more patient in 2013.

Our investment portfolios remain focused on large-cap U.S. stocks and a broad international exposure. In particular we like emerging markets in Asia and Latin America. In fixed income we have been moving away from high-yield investments and long-term bonds and favor both U.S. mortgage and shorter-maturity investments.

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

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