QUARTERLY COMMENTARY Q2

Newsletter 07-09-12

Twist Again, Near The Cliff, Like We Did Last Summer!

It is always a challenge to come up with a title to the quarterly letter. This quarter it was much easier as there are two discussion topics in the news that help to sum up the economic environment in the United States. First was the decision by the Fed to do a scaled back version of its program from last summer which was called *the Twist*. With apologies to Chubby Checker and his 1960 chart topping song of the same name - the song that inspired the Twist dance craze - is the source of that part of the title. The second inspiration comes from the recognition that between now and early January 2013 there will be several serious events that are expected to shape our economy for years to come. It appears that the politicians who have some control of events seem willing to have the economy jump off a cliff rather than come up with a compromise. Both have appeared in newspaper headlines so we claim no particular originality. We will also touch on some of the other events that have been in the news as the quarter drew to a close and in the week that followed.

On June 20, the Federal Reserve issued a press release concerning the decisions reached at the June meeting of the FOMC. That release restated the mandate of the Fed to “foster maximum employment and price stability.”[i] In that regard the Fed expects economic growth to remain moderate and unemployment to decline slowly. Inflation will be below the level that is judged to be consistent with its mandate. The conclusion is that additional stimulus is needed and therefore they will continue a program begun last summer where by short term treasuries are sold and long term notes are purchased with the proceeds. The Fed’s hope is that it will put downward pressure on long term rates, which in turn will aid economic growth and reduce unemployment. This is the second ‘twist’ operation and follows two quantitative easings in 2002 and 2010. We suspect that the current effort will have little impact.

The discussion of an upcoming cliff is likely to have more impact. The major events later this year and early next are the election in November, the expiration of the Bush tax cuts, and the mandatory cuts in expenditures and/or the increase in taxes that were agreed to last summer as a result of the debt ceiling debate. Current voter sentiment polls suggest that the federal election is too close to call. If the Republicans sweep both houses of Congress and the Presidency, the signal will be for a more business friendly federal government. Anything less may be more of what has gone on for the last few years –gridlock. The lame duck Congress will have the option to pass legislation on taxes and begin the debate on healthcare. The Bush tax cuts expire on December 31. Depending on the composition of the House and Senate as determined by the election, the outgoing legislative branches may decide to let the new Congress grapple with taxes. The new Congress will have to decide on how to handle the mandatory cuts in spending, most of which have substantial constituencies. It may be an uncomfortable start to the New Year.

The debate on tax issues means that it is not possible to do any long term tax planning. Continuation of the Bush tax cuts would keep rates on dividends and capital gains at the current level. If not continued, then capital gains tax rates will go back to 20% and dividends would be taxed as regular income.[ii] Estate taxes would also go back to higher levels. It must be noted that there is a surcharge to be imposed on investment income starting in 2013 which comes about through the Affordable Healthcare Act. This includes dividends, interest, capital gains, and rents. If the Act is repealed, then the tax also goes away.

This is a complex issue for taxpayers, and you should keep in touch with your tax expert as to what the appropriate tax strategy may be for you. Some of the issues that you may wish to consider for this year are to take capital gains in 2012. You may also wish to make charitable contributions this year as it is possible those charitable contributions may not be worth as much in 2013. So far we have heard nothing that would affect the tax treatment of energy Master Limited Partnerships (MLPs). There has been considerable talk that the tax code needs to be revised in order to simplify it. Whether this will be done in the next session of Congress is anyone’s guess.

The foregoing issues have captured much of the attention of investors, but there are several others that bear mentioning. First, the debt crisis in Europe reached a fevered pitch in June. The election of a Socialist to the presidency of France changed the dynamics of European crisis management enabling a bailout of Spain to be structured. Greece continues to limp along and Italy is not in great shape either. Various agreements have ‘kicked the can down the road’ but the details are yet to be finalized.

The US economy has been slowing as the year progresses. Unemployment remains stubbornly high. The change in nonfarm payrolls released on July 6 indicated an increase of 84,000 for June, and the increase in payrolls for the private sector was 84,000.[iii] This rate of improvement is too slow. Industrial production has slowed. On the other hand, housing is gradually turning the corner. New housing starts are up and new and existing home sales are improving. Energy prices are down, which may help the consumer stretch his pay check. Lower costs of raw materials will also help corporate profitability.

The major stock market indexes had negative results for the quarter ending June 30. The S&P 500 was down 3.29%, the Dow Industrials down 2.51%, the NASDAQ Composite down 5.06%. The Alerian MLP Index was down 3.70%. While the second quarter was uncomfortable, the year to date performance was much better. The S&P 500 was up 8.31%, Dow up 5.42%, the NASDAQ up 12.66%.

Only the Alerian was down for the first half of the year (3.22%). In view of the litany of issues, both political and economic, this market performance fairly reflects the conditions on the ground.[iv]

We believe that the next six months or so will continue to test the patience of equity investors. The lessons of 2008-2009 suggest that uncertainty demands investing in financially strong companies: ones that have solid balance sheets, have shown that they know how to manage expenses, and have great products and services. Companies that have been able to consistently increase dividends over a long period of time have demonstrated the ability to provide value to shareholders. Companies that have this record in place meet our investment discipline. We also believe that a proper national goal for the United States is to strive for energy independence. New technology has unlocked the potential for significant amounts of oil and natural gas. The MLPs have the necessary tools to move, process, and store the energy that is so readily available and are the second part of our investment discipline.

Dividend Assets Capital welcomes three summer interns: Ashleigh, Gates, and Lance. We have been enriched by their new visions, and wish them well as they venture into their senior years and beyond.

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There are no guarantees that dividend paying stocks will continue to pay dividends. In addition, dividend paying stocks may not experience the same capital appreciation potential as non-dividend paying stocks. The past performance of the strategy is not an indicator of future performance; and investment results may vary.

An investment in a Master Limited Partnership (MLP) unit involves risks that differ from a similar investment in equity securities including ownership controls associated with the limited partnership structure, high debt to equity ratios, and certain tax risks.

Investments in international markets present special risks including currency fluctuation, the potential for diplomatic and political instability, regulatory and liquidity risk, foreign taxation and differences in auditing and other financial standards. Risks of foreign investing are generally intensified for investments in emerging markets.

The S&P500 Index is a widely recognized unmanaged index of equity prices and is representative of a broader market and range of securities than is found in individual client portfolios. The Alerian MLP Index (NYSE: AMZ) is a widely recognized, unmanaged index that includes a composite of the 50 most prominent energy (MLPs). The Index returns do not reflect the deduction of expenses, fees, and taxes and assumes reinvestment of all distributions. Individuals cannot invest directly in the Index; however, an individual can invest in exchange traded funds or other investment vehicles that attempt to track the performance of a benchmark index. Dow Jones U.S. Index is a broad-based but investable measure of the U.S. stock market, intended for use as the basis of investment products. The index aims to consistently represent the top 95% of U.S. companies based on float-adjusted market capitalization, excluding the very smallest and least-liquid stocks. This index assumes the reinvestment of dividends and the percentage changes in the benchmark represent the annual percentage change of the index for the period reported. NASDAQ Composite Index is a stock market index of all of the common stocks and similar securities (e.g. ADRs, tracking stocks, limited partnership interests) listed on the NASDAQ stock market, meaning that it has over 3,000 components. Since both U.S. and non-U.S. companies are listed on the NASDAQ stock market, the index is not an exclusively U.S. index.

[i] Federal Reserve Press Release
[ii] *The Wall Street Journal*
[iii] Bloomberg
[iv] Bloomberg