SAN ANTONIO CAPITAL & TRUST QUARTERLY INVESTMENT INSIGHTS

Investing Side by Side

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Wishing everyone a prosperous 2012!

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Deja Vu

Many of the "The Street's" most respected analysts are pointing to an S&P 500 target identical to last year.

Déjà vu!

Looking ahead to 2012, is much like looking ahead 365 days ago. If you review the predictions from around "the street" for GDP, the level of the S&P 500, and the 10-year Treasury yield, you'll find them quite similar, if not identical, to the same time last year. In short, not much has happened this year, but a lot of news, a lot of can-kicking, and a roundtrip in the US equity markets. (The Europeans only wish they had it as good as us!) Even gold, one of the few winners to date tried to throw itself off a cliff in the final days of the year. (Though we may simply blame this on John Paulsen's hedge fund liquidating its holdings as he tries to grasp on to the only gains he had this year.)

So, if we are simply back where we started, why do we all feel so bad? In fact, considering what we've been through this year, things could be significantly worse. Part of the problem is that we started the year on a high, with the S&P 500 peaking early at 1363 on April 29th, giving us a sense of undeserved euphoria. Despite an Arab Spring, a debt crisis in Greece, and a Tsunami in Japan, we managed to stay near these levels throughout the early summer. Then July hit us like a tidal wave of another sort, sending the S&P 500 down 22% from peak to trough. Luckily we had been steadily reducing our equity exposure in the days ahead, due to the fact that volatility had been steadily increasing over this time period, acting as a warning sign of things to come. These moves helped to buffer some of the downside in our portfolios and smooth out the rough summer months. Initially our gold position helped during this time, but towards September, a spike in the dollar caused it to retreat. Then November saw the metal off and running again in anticipation of money printing out of Europe in response to their sovereign debt crisis, and corresponding liquidity issues. We feel that despite its recent pull back, the position still provides us some insurance and potential upside if a quantitative easing of sorts were to commence.

The other reason we feel so bad, is simply that people (we are human) actually look at December 31, 2011 as something that is significant. We quantify performance in calendar terms, when in fact it means very little. Part of this I will blame on CNBC, which seems to have infiltrated every home, begging people to watch every tick of the market. (I'm determined to prove a correlation between hours watched a day, and heart attacks in this country.) In reality, the markets are a breathing living thing that doesn't take breaks, and must be invested accordingly, dynamically, and patiently. Throughout the year we have made many adjustments; at times increasing risk, and at others reducing risk, without regard to year end, and where the S&P 500 might close. In fact, we have been more cautious regarding dates of European finance meetings, Congressional votes, hedge fund redemptions, and option expiration. We are focused on broad macro economic factors, and how they may affect every aspect of our portfolios. US fundamentals are improving, but our dollar is strengthening, which could hurt our manufacturing sector that is just returning to its feet. Unemployment is improving; however, we have many soldiers returning from the Middle East in need of work. Europe is improving austerity measures and leadership, but still has a tough road ahead. A falling Euro may aid German exports, and be just what the doctor ordered. China is slowing, but less dependent on foreign buyers, and becoming cozier with its emerging market brethren. Our job is to connect the dots, not monthly, not quarterly, but for the long haul, and will continue to do this throughout 2012 and beyond.

To this point, despite a nice little year-end rally, we have been particularly cautious. We have increased our exposure to high quality, high dividend paying stocks, reduced international exposure, and increased our high grade corporate debt, as spreads have

recently widened making them more attractive. We have raised cash in the belief that the early part of the year could be extremely volatile with so many unknowns in Europe, and much potential risk to the downside. We believe we will have the opportunity to selectively target attractive re-entry points, to capitalize on the many issues facing us.
In closing, many thanks for your business, your support, and we hope to not see you at the same time, same place next year!
Whitney E. Solcher, CFA

Partners Flagship Core Portfolio
Performance Net of Fees
(01-01-2010 to 12-31-2011)

Year	Q1	Q2	Q3	Q4	YTD	ITD
2010	**2.01%**	**-4.41%**	**7.94%**	**4.35%**	**9.84%**	**9.84%**
Benchmark*	2.18%	-7.92%	9.31%	5.68%	8.68%	8.68%
Difference	-0.17%	3.51%	-1.36%	-1.33%	1.16%	1.16%
2011	**3.06%**	**-0.31%**	**-10.24%**	**5.16%**	**-3.53%**	**6.52%**
Benchmark*	2.88%	0.19%	-11.49%	4.52%	-4.59%	3.64%
Difference	0.19%	-0.51%	1.25%	0.64%	1.06%	2.88%

*35% T-Bills/65% MSCI All Country World Index

Start the Presses!

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There is one thing that any stock market investor has become accustomed to over the past decade, volatility! First, there were overleveraged companies, inflated stock market valuations, and a tech bubble. Then there were overleveraged consumers and banks, which brought about a financial crisis. Finally, as we enter 2012 we have reached another stage, the deleveraging of sovereign governments. Because the last decade has also been associated with mediocre stock market returns, does that also mean more of the same lies ahead in 2012?

To answer such a question would require a crystal ball, as well as the ability to read into the minds of politicians in Frankfurt, Berlin, and Paris. There are a few things that we do know, however, that make this crisis different in some important ways from the last two. Unlike the beginning of the last decade, stock markets are not overvalued. In fact, they are exceedingly cheap by just about any measure. Corporations are not overleveraged; rather, they are drowning in liquidity. Consumers have also paid down a significant amount debt, and US banks have 1/5 the amount of leverage that they did five years ago. But most importantly, what distinguishes a sovereign deleveraging from that of a corporation or consumer is access to one blunt tool, a **printing press**. Printing presses do not solve problems in the long run, but they do buy time for governments to make structural changes to their economies with the eventual goal of stabilizing their debt levels. They prevent a government from defaulting on their debts in the short term, which is the black-swan event that investors fear heading into 2012.

Therein lies the paradox of 2012. As investors, there is one primary question that must be asked, will they or won't they? That is, will the ECB (European Central Bank) act like the US Fed and the Bank of England and crank up the printing press? After all, the United States and Britain both sport a higher debt-to-GDP ratio than the Eurozone as a whole, yet each are able to finance debt for 10 years at a rate below 2% in no small part due to their use of the printing press. In contrast is Italy, who despite having a much smaller annual deficit and much less indebted consumer base than both America and Britain, is paying over 7% on their long term debt. Italy is no Greece or Portugal, in fact, the country would actually have a budget surplus if not for the interest they are paying on their debts. Besides sharing a common currency with 16 other nations, Italy has one big problem. The key to the printing press does not rest in their hands, but rather in the hands of the Germans. With memories of rampant inflation in the early 20th century, Germany is much more reluctant than the average country to crank up the money printing machine even though that is the obvious way to put a floor under the current crisis. When a government cannot find buyers for their debt at reasonable yields, the job of their central bank is to act as a lender of last resort so as to prevent a run on that country's debts. That is done through creating new money, which is used to buy sovereign bonds. Because Europeans have been reluctant to buy their sovereign debt, a run has in fact been occurring on Italian sovereign debt.

With this scenario in mind, investors must approach 2012 with two possibilities. One is that Europe eventually cranks up the printing press, which would cause a rally in risk assets worldwide. This is what happened in 2009 and 2010 when the Federal Reserve initiated their bond-buying programs. The reason we are so confident that this would lead to higher

stock prices again is due to current valuations. The equity-risk premium (the amount of excess return that stocks provide over risk-free bonds) is about as cheap as it has been in 50 years. **In almost all previous occasions where corporate earnings were yielding so much more than bonds, stocks were higher a year later.** Furthermore, at current prices, high quality stocks across the globe could conceivably return 7-10% a year for the foreseeable future, and still not be overvalued.

However, it is likely **that more pain is needed** before Germany puts a floor under the crisis; signs of outright deflation in Europe's economies are likely needed for this to occur. With such an event potentially months away, the first half of 2012 will likely witness a further restructuring of Greek debt, elections in France, continued austerity in Italy and Spain, and capital continuously leaving European banks and Italian bonds. During the first quarter alone, Italy needs to refinance 112 billion euros of sovereign debt. That can only continue at rates above 7% for so long. All of this uncertainty could lead to continued strength in the dollar, which is worrisome considering the nearly 80% correlation between dollar strength and stock market weakness over the last two months. A strong dollar is bad for the profits of US multinationals which do the majority of their business overseas.

With so many questions as to what will transpire in Europe, we have positioned our accounts accordingly, in case a scenario of a euro zone default occurs. Risk has been taken off of the table, with cash levels significantly higher than before, and a tilt towards lower-risk dividend paying stocks. The high-yielding telecommunications sector is now our largest overweight, with positions also added in pharmaceuticals and technology and reductions in emerging market exposure. We remain significantly underweight European equities, as we have been since the beginning of this crisis. We remain poised to re-allocate and risk up as data points unfold, and the direction from the Euro zone becomes clearer.

With 2012 now upon us, we should all hope that Germany becomes more like the rest of the world and discovers the joys of a printing press, the modern-day pacifier for developed global stock markets and economies.

Stephen A. Palmer

Modern Money Theory

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Modern Money Theory

Modern Monetary Theory (MMT) or "Charlatism" is an economic perspective that best explains our domestic "balance sheet recession." Politics aside, as was witnessed by the bi-partisan budget deadlock, an MMT paradigm argues that a sovereign nation that is the sole supplier of currency can always print money and will not run the risk of default. Unlike a private household that can spend only as much is it earns, collects, or borrows, the government does not need to "balance" the budget through the collection of taxes. Taxes act to create demand for the currency and to remove liquidity from the system, but the government is not limited to spending what it collects. Because it has no traditional solvency constraint, the true constraint for a sovereign currency issuer is always inflation. In reality, the government can instantly create money into existence regardless of how much it collects in taxes; "a modern monetary system can be best thought of as a system of debits and credits where government deficit spending credits the private sector and payment of taxes debits the private sector."[1]

Richard Koo has best described the recessionary afflictions of the Western economies as a balance sheet recession resulting from highly leveraged asset prices (think housing market) collapsing resulting in the private sector (corporations and households) to deleverage in an attempt to restore financial stability.[2] This in turn reduces aggregate demand as the private sector is attempting to restore savings and minimize debt, which stymies borrowing activity, regardless of how attractive the interest rate may be. Despite the quantitative easing (spending) by the central government, we continue to experience a deflationary environment as real asset prices (vs. consumer prices) continue to fall as a result of continuing deleveraging and therefore weak demand. Koo argues that, "when the private sector deleverages in spite of zero interest rates, the economy enters a deflationary spiral because, in the absence of people borrowing and spending money, the economy continuously loses demand equal to the sum of savings and net debt repayments. This process will continue until either private sector balance sheets are repaired or the private sector has become too poor to save (i.e. the economy enters a depression).[3] It is this contraction in money supply that the federal government hoped to counter with its quantitative easing programs although it failed in the transmission of providing liquidity to the private sector as banks were also in the process of deleveraging and minimizing their appetite for extending new credit.

Given that we are in a current balance sheet recession, much of our current political action appears to be detrimental to restoring private sector balance sheets. Under a MMT perspective, budget cuts will only exacerbate the pain as the private sector AND the public sector will be reducing aggregate demand reinforcing tailwinds to a deeper recessionary cycle. Furthermore, an increase in taxes under the pretense of balancing the budget is also counterproductive as this will only decrease the money supply by removing liquidity from the system. Under the current recessionary environment it makes sense for the public sector to run a deficit in order to help balance the surplus that the private sector is attempting to restore. In other words someone needs to spend, and as the government is able to spend without borrowing from the private sector, it is incumbent upon the public sector to increase spending in areas that will benefit the domestic economy and not add to the unemployment. What's interesting to observe is that despite the liquidity already injected into the economy and the rise in consumer and commodity prices, we have continued to see housing prices decline. Until housing prices stabilize (typically the largest household asset) and the private sector restores its balance sheets, inflationary pressure from deficit

spending will be curtailed by private sector deleveraging. Lower mortgage rates may entice residential buyers on the fringes, but housing demand will only stabilize once asset prices are realigned with household incomes and private sector fiscal health has been restored.

Undoubtedly, it would make sense from an MMT perspective if there were another quantitative easing program in line for 2012 as we continue to see a reduction of the money supply. With the expectation that 2012 may be similar to 2011, we see continued strength in the large cap space with companies that have strong balance sheets, global revenue shares, and strong margins that continue to generate cash flow. We are still leery of the financial sector as risk appetites of most banks will continue to remain low and we fear cross contagion of the European sovereign debt crisis. The current run-up in the dollar can be perceived as a flight to safety in comparison to European deposits, but we also feel the pressures to competitively devalue the dollar through another fiscal stimulus in order to help domestic growth. The emerging market consumer will continue to spend, but unlike the Eurozone countries that are heavily dependent on exports for continued economic growth and tied to a single currency, the United States can control its fiscal future to help reduce the recovery time of this balance sheet recession.

Omar Akhil

[1] *Cullen Roche, "Understanding the Modern Monetary System"; http://pragcap.com/resources/understanding-modern-monetary-system*

[2] Richard C. Koo, "The world in balance sheet recession: causes, cure, and politics"; Real-World Economic Review, issue no. 58; December 12, 2011.
http://www.paecon.net/PAEReview/issue58/Koo58.pdf

[3] Richard C. Koo, "The world in balance sheet recession: causes, cure, and politics"; Real-World Economic Review, issue no. 58; December 12, 2011; p. 21-22.

Getting Ready for Tax Season: Changes for 2012

The 2012 standard deduction increases to $11,900 for married couples filing a joint return, $5,950 for singles and married individuals filing separately, and $8,700 for heads of household.

Although most Americans will not have to worry about 2012 taxes until early 2013 when 2012 tax returns are due, self-employed individuals or anyone who must pay quarterly tax payments will want to plan ahead.

And there's good news for those that do. The IRS recently announced cost-of-living adjustments for the 2012 tax year that bump up brackets, deductions, and other thresholds for inflation.

The following is a summary of the key changes for 2012.

- **Exemptions are up:** The personal and dependent exemption increases to $3,800, up $100 from 2011.
- **Standard deductions have increased:** The 2012 standard deduction increases to $11,900 for married couples filing a joint return, $5,950 for singles and married individuals filing separately, and $8,700 for heads of household.
- **Tax-bracket adjustments:** Tax-bracket thresholds have increased for each filing status (see table below).
- **Estate tax exclusion has increased:** The estate tax exclusion increases to $5,120,000, up from $5,000,000 for 2011. The annual exclusion for gifts will remain at $13,000.
- **Earned income credits rise:** The maximum earned income tax credit (EITC) rises to $5,891, up from $5,751 in 2011. The maximum income limit for the EITC increases to $50,270, up from $49,078 in 2011.
- **Transportation benefits adjusted:** The monthly limit on the value of qualified transportation benefits exclusion for qualified parking provided by an employer to its employees for 2012 rises to $240, up $10 from the limit in 2011. However, the temporary increase in the monthly limit on the value of the qualified transportation benefits exclusion for transportation in a commuter highway vehicle and transit pass provided by an employer to its employees expires and reverts to $125 for 2012.

Several tax benefits are unchanged in 2012. For example, the additional standard deduction for blind people and senior citizens remains at $1,150 for married individuals and $1,450 for singles and heads of household.

Details on these and other inflation adjustments can be found in Revenue Procedure 2011-52.

2012 Tax Brackets

	Single	**Joint Filers**	**Married Filing Separately**
10%	$0 - $8,700	$0 - $17,400	$0 - $8,700
15%	$8,700 - $35,350	$17,400 - $70,700	$8,700 - $35,350
25%	$35,350 - $85,650	$70,700 - $142,700	$35,350 - $71,350
28%	$85,650 - $178,650	$142,700 - $217,450	$71,350 - $108,725
33%	$178,650 - $388,350	$217,450 - $388,350	$108,725 - $194,175
35%	Over $388,350	Over $388,350	Over $194,175

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