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Quarterly Newsletter

First Quarter 2012

US & World Economy - 2011 was a wild year for the economy and financial markets. Optimism and continued growth early in the year gave way to fear and double-dip fears in the fall, only to end the year back where we started. (The S&P 500 Index was up 0.003% but the average US Stock fund lost about 3%). The rest of the world did not fair as well: Latin America -22.2%; Europe -15.2%; China -20.2%; India -39.1%. Remarkably, despite continued negative headlines, no country is currently in an announced recession. In fact, worldwide growth appears to have picked up in the forth quarter, especially in the US where auto and retail had their biggest gains in years. The S&P 500 will report not only record earnings, but earnings 15-20% higher than their 2007 peak.

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While banking and debt problems in Europe and hard landing fears in China will dominate the negative headlines, the US will continue to quietly add jobs. We started 2011 adding about 100,000 jobs per month, grew to about 150,000 per month throughout the year and then gained 200,000 in December. 2012 should average 200,000 new jobs per month, which should slowly drop our unemployment to about 7.5% by year-end. Still high, but this improvement should be a catalyst to encourage businesses to invest in the future, and start spending their large cash holdings. All of which leads us to believe that 2012 will be an unexpectedly good year.

Two caveats to our bullish outlook this year: 1) Europe needs to either form a TARP type of fund and buy weak assets from banks or fund Euro bonds to replace debt. This last solution would force Germany to accept higher debt costs of about 3%, up from 1% (but Italy comes down from 7%). Germany wants steep spending cuts from the weaker European nations in exchange. And 2) Iran does not block the

Stock Markets - The S&P 500 closed 2011 about 3.3% shy of our mid-year forecast of 1300. The Asian/Latin American markets began our anticipated rally at the end of the fourth quarter. However, they need to break out of their nine month downtrends before we will be convinced they are in a sustainable new bull market.

For 2012, we anticipate continued above-average volatility and a growing sense of optimism as the year progresses. Specifically, we expect a few buying opportunity dips in the spring, then a solid year-end with an S&P 500 target of 1500+ (up 19%). This is compared with the street's consensus of up 6-7%, or 1350. Furthermore, we expect the markets to be led by energy, transportation, technology and a rebound in financials.

Emerging markets will remain volatile but clearly offer the best prospects for both stocks and bonds over the next 5-10+ years. In general, their government debt to GDP is considerably below the 100% levels of the developed world (China is only 17%). Low debt levels encourage economic growth. Young demographics, large amounts of natural resources, high savings rates, urbanization and the growing middle-class all favor emerging markets. Historically, these markets have had price/earning multiples 20% above the S&P 500. Today, those multiples are 20% below the S&P 500 and represent good values. If you can stomach above-average volatility, we recommend inclusion of Pacific-Asia (except Japan) and Latin America in your portfolios.

Speculation - It is often tempting to chase outsized performance, but it rarely works in the long run. The most recent glaring example is John Paulson and his Advantage Plus Hedge Fund. In 2008, Paulson correctly predicted the collapse of the US mortgage market and made large leveraged bets that worked so well, he grew his personal net worth from $300 million to $5 billion. This earned him the title of *Best Trade in History.* His fund went up 38% as the stock market went down 45%. Money flew in and he continued to be up 21% in 2009 and up 17% in 2010. Then, when his fund was one of the largest in the world, it lost an estimated 50% in 2011, wiping out all gains since his big winning bet (which few of his present investors participated in). It is very tough to get a big bet right once, and virtually impossible to keep winning year after year. Long–term (multiple decades), no passive investment has worked as well as commercial real estate and public stocks. We recommend a diversified portfolio of both, and suggest you leave the speculation to a small portion of your funds.

Fixed Income - Given our overall positive outlook for 2012, we expect funds will slowly move out from the safest fixed income (US long-term Treasurys) into the higher yielding corporate, municipal and foreign bonds. Inflation and interest rates should stay low until late in the year. Specifically, we continue to manage our "Inflation Balanced Bond Portfolios" with the goal of 5-7% income and limited volatility. This balances traditional bonds with income from inflation-friendly investments. Once the federal government stops its "twist" operation (manipulation), the 10-year Treasury Note will climb back to normal rates (about 3%+ in today's economy).

Real Estate - While commercial property, in general, bottomed in 2010, its upward progress has stalled until rents can start to move up from current depressed levels. That cannot happen until the economy and the job market improve further. The exceptions are apartments and hotels, where occupancy is near historic levels and new construction has picked up to meet demand. Distressed properties bought from bank REO's still offer good opportunities, while stabilized properties await renewed absorption - maybe 2013?

Long-term cycles in commercial real estate have been remarkably consistent. Every 18 years the markets have bottomed, and then started a 14-year growth phase (followed by a 4-year decline). If 2010 was the last bottom, 18 years earlier was the low brought on by the Savings and Loan problems in 1992. Before that, property bottomed during the deep recession and oil embargo days of 1974. Another 18 years takes you back to the Eisenhower recession era of 1956. Then in 1938 was the Great Depression, and 1920 was an earlier deflationary depression. A tidy pattern. There were of course smaller business and inflation cycles in between, however the big peaks and valleys have only come at 18-year cycles.

Will the next 14 years continue to repeat this pattern by providing a nice long-term real estate rally? Given the severity of the recent price drop and the record $10 trillion of investor cash on the sidelines, we think it is likely.

Residential real estate should bottom this year as artificially low mortgage rates make affordability the best in decades. However, lending requirements are still too tight and may need (and receive) incentives to qualify the "Average Joe." But don't count on this for your retirement savings; it's just a place to live.

Politics – According to the Cook Political Report (cookpolitical.com), if the election were held today, Mr. Romney would beat Mr. Obama for President, the Republicans would pick up a majority (53/47) in the Senate (allowing them to set the agenda but not hold a majority 60% vote) and Congress would lose about 15 Republicans but keep a small majority. However, the election is 10 long months away – a lot can happen. Expect Congress to only pass a payroll extension and raise the debt limit until year-end and little else. After the November election, expect a whirlwind of activity to address the looming issues in 2013: taxes, Obamacare, spending and deficits.

Summary - After the 1991 and 2001 recessions, it was not until the third year after the bottom that optimism finally replaced fear. We think 2012 will be that year as well. Wall Street expects another slow year and it was only months ago that sentiment was at 50-year lows. The last thing people expect is a big "up" year, but that is when it usually happens.

Optivest News – Please welcome our newest employee, Shannon Patton, Director of Client Services. Shannon will be expanding our "Family Office Services" and planning educational meetings, fun events and customized solutions to utilize our relationships and resources to help you with the "what keeps you up at night" issues. The Optivest Foundation will be conducting service/vision trips this year to Mexico, Haiti, Indonesia and Africa – we hope you can join us on one.

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