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Firm Inception 08/03/10

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Quarter in Review

The Markets

The fourth quarter for 2012 was mixed among asset classes and even between similar sectors. The Russell 1000 Large Cap Equity index was up 1.53% for the period while the S&P 500 index was flat. Most equity indexes saw a recovery from the October losses in November and December. International equity, both developed and emerging markets, also posted strong returns up 7% and 5% respectively in Q4. Fixed Income sectors were also up with the high yield sector showing equity like returns of 15% for the year, and 3.54% for the quarter. Commodities however didn't fair as well, down over 3% for the quarter, but Real Estate was up over 2.5% for the same period.

In September I wrote that I was concerned on many fronts, but mostly from a political perspective. The Presidential election was coming up, the fiscal cliff was approaching, we could be hitting the debt ceiling and I didn't see clear plans for Greece and Europe as a whole to solve their fiscal woes. Only one of the previous issues has been resolved and that is the president was re-elected for four more years. The Senate and House still have the same majorities, and the bill that recently passed both houses (although it truly originated in the Senate which is a constitutional problem) is estimated to reduce revenues and increase spending by \$4.0 trillion dollars over the next 10 years, (<http://cbo.gov/publication/43835>) while the debt ceiling issue remains. In fact we have made the situation worse. Now in the next month the Treasury will run out of options and will have to stop paying something. Whether that is social security, veteran's benefits, government paychecks or government debt is yet to be seen, and there is no precedent, but most are unconstitutional. Yesterday, President Obama indirectly stated that we would simply not default on our debt and choose other areas to stop payment, and yet continued his statement that he would not reduce the budget deficit or engage in talks about it to stave off a government shut down. The market's reaction seems to say they have seen this act before, and are confident that some agreement will be met. I am not so confident, Republicans are still licking their wounds from being taken to the woodshed on the fiscal cliff, and I am worried this time they might want to make a point, while the economy is still trying to recover.

The US Economy in Q4 continued its expansion. Another 453k jobs were created, housing continued to recover and interest rates remained very low. The Federal Reserve has continued to buy bonds to keep downward pressure on interest in the back end of the curve. Industrial production and manufacturing look positive, but orders are pretty flat. The consumer's balance sheet is better, but their confidence took a hit, mainly because they knew new taxes were on the horizon. Overall not bad, but those things aren't the cause of our problems.

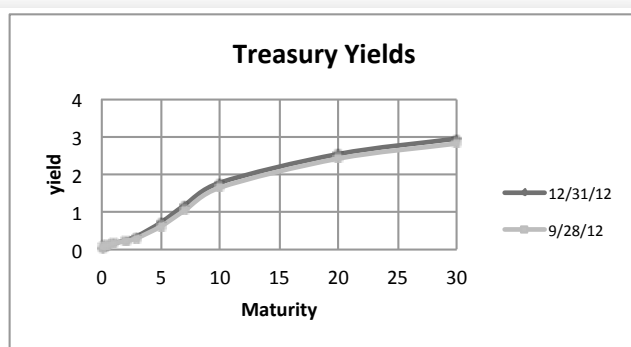


Interest Rates

The December FOMC minutes saw nothing really new or any change in direction from the Fed's current programs. There seems to be an agreement that the "full employment," and "inflation" targets are 6.5% and 2.5% respectively. Therefore I believe the Fed will continue its bond purchases through the end of 2013 because both employment and inflation are nowhere close to these targets. Although bond buying could stop at the end of this year, Chairman Bernanke's previous statements about keeping monetary policy accommodative could be carried out in alternative ways. (Still this doesn't bode well for bond yields by the end of the year)

Last fall I taught a section of Debt Markets at Columbia, and while covering the Federal Reserve an interesting piece of data presented itself. (I remember Professor Greenwald bring this up in class when I was there). The Fed is currently paying 25 basis points on reserve balances (both excess *and* required). Now even though the reserve requirement for most depository institutions is only 10%, the current reserve amount over our money stock (WRESBAL/M2) is about 14%. What is even more interesting is the ratio of our money stock (M2) over the Board of Governors Monetary Base (M0). This is a quick measure of the money multiplier, which if all money deposited at banks, other than the reserve requirement, were lent out it would be 1 over reserve requirement ($1/10\% = 10$). For every one-dollar in currency printed or coined, 10 more would be "created" from the normal course of lending. Up until October 2008, when the Fed *only* paid interest on the excess reserves the ratio was around 8.5. Looking at our 8.5 ratio of M2 over money stock this is pretty close to a multiplier of 10 created by a reserve requirement of 10%. The reason it is not exactly 10 is do to the drain ratio, or the money that is not re-deposited at the bank or re-lent. Now lets look at M2 over the monetary base today... it is currently 3.891 as of December 2012, or **the equivalent to a 26% reserve requirement**. Why are the banks keeping so much in reserve you ask, simple, why would you lend a portion of you balance sheet to the market at less than 5 bps, when you can go to the Fed and lend at 25 bps.

Years	12/31/12	9/28/12	Difference
0.08	0.02	0.06	-0.04
0.24	0.05	0.1	-0.05
0.5	0.11	0.14	-0.03
1	0.16	0.17	-0.01
2	0.25	0.23	0.02
3	0.36	0.31	0.05
5	0.72	0.62	0.1
7	1.18	1.04	0.14
10	1.78	1.65	0.13
20	2.54	2.42	0.12
30	2.95	2.82	0.13





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The reason I am pointing this out is that the action of the Fed paying interest on required reserves is contractionary, whereas keeping the federal funds rate near zero and buying bonds is expansionary. I know the Fed wants banks to recapitalize, but isn't this counterproductive?

Leading Economic Indicators

The Conference Board's leading indicators have remained at the 95.5 area the entire year. With the diffusion index also stuck around 50, we are just treading water. Average weekly hours for manufacturing was flat this past month, while unemployment claims are down since the last LEI report. Manufacturers' new orders for consumer goods and materials won't come out for another week, but November's number looked flat. ISM new orders were exactly the same as last month. Manufacturers' new order for nondefense capital goods excluding aircraft was up month over month and quarter over quarter. Building permits were also up in November, both over the month and year. Stock prices as per the S&P 500 were also up in December, but Fed Funds to 10 year has widened. Consumer expectations dropped substantially in December with anticipation for the fiscal cliff. As it stands, from the above components in leading indicators, I expect a flat to slightly positive number over the next several weeks.

Jobs

At the time of this write-up **nonfarm payroll** posted an increase of **155k for December 2012**, and **453k jobs gained** in the **third quarter of 2012**. The total gain for the last twelve months was **1.8mm (the same as LTM for Q2 and Q3)**. The unemployment rate is now at 7.8% as of December, unchanged from September. Median unemployment fell again from 18.7 months in June to 18 months in December. The aggregate weekly hours worked index continues its upward trend from 96.4 to 96.9. This looks identical to the 3rd quarter and only does a little to reduce the unemployment rate. We must produce 100k jobs a month just to accommodate for new work force entrants.

Temporary or part time job services increased from Q3 to Q4, but fell between November and December. The year-over-year increase continues to decline. The **4-week moving average of unemployment claims** declined by 10k; **365,750 from 375,500 in Q3**. Lastly the Institute of Supply Management (ISM) employment index continued to have a level above 50, with a lower average near 51 for the quarter caused by Hurricane Sandy.

The JOLTS report (<http://www.bls.gov/news.release/pdf/jolts.pdf>) continues to show 3.7 million job openings, an increase by 100k jobs from last quarter. The hire and separation rates and amounts are almost identical. We are not adding jobs in any meaningful amount. The Fed is failing in this mandate... and the question really is should it be their mandate.



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Production

Industrial production for December won't be released until after this quarterly review. The numbers for Q4, barring a terrible December, look like they will be positive. With manufacturing employment up, and hours worked flat, we should probably have a positive IP for December and thus the quarter. But this is nothing to write home about. The interesting thing is once again we could see another quarter designated as chaos (growth positive, inflation negative). But this time around equities outperformed the long bond, whereas in the past the long bond did much better during periods of Chaos.

Orders for durable goods, (items whose use last three or more years) rebounded in September, up 9.15%, but October and November were only up around 1%. The **ISM diffusion index for new orders** is right at 50, not moving from November to December. The total **non-manufacturing index** reported a **56 for December**, which continued its positive trend. Production both domestically and abroad continues to look flat or declining.

Housing

Year-over-year changes in **new single-family home sales** have continued their positive trend since January. The twelve-month average is moving up, around 360k annual sales, with the most recent print at **377k**. Price data from S&P/Case-Shiller Home Price Indices ending October 2012 showed **annual increase again, this time of 4.3%** in the 20 city composite while up 3.4% in the 10 city composite. On the building side, permits for new home construction were **900k in November, still over 25% YOY gain**. Housing looks stronger again this past quarter, and is really the only bright spot in the data.

The Consumer

Consumer confidence took a nosedive in December dropping to 72.9 before the fiscal cliff vote. Even though personal balance sheets looked better, the fear that Washington wouldn't come to an agreement, and the likelihood of increased taxes made confidence drop. Last quarter I wrote "I still don't think though that anyone has fully calculated the ramifications of the fiscal cliff and the debt ceiling debate in the next few months. As the effects haven't been felt yet, people's views remain positive, but when tax increases, and higher medical costs are felt the sentiment should reverse the positive course." Looks like they woke up.



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Personal Income and Disposable Income both increased for October and November. Real personal income less transfers (removing social security, unemployment, welfare and disability payments) was up 2.78% year over year. The surprise in November was the reversal of the savings rate decline. It now stands at 3.6%. We are still expanding credit at a greater rate than savings. To argue this point **Total consumer credit expanded at 5.86% year over year in November**. Ever report I read talks about how student loans are a large bulk of the credit expansion... at some point those are going to have to be paid off, and unless there are jobs for those students, those loans will start to default. And since the bulk of them are government based, we the taxpayer will be paying them off.

Inflation

With only **PPI** being reported for **December (down 1.12%)** prior to this report going out, CPI-U looks like it will report a negative number for Q4. PPI has been down each month this quarter, and CPI-U turned negative in November. The Fed continues to get support for its quantitative easing policy, with inflation numbers like these. Will inflation ever rear its ugly head? In my view this only happens if the job market begins to firm up. As long as employers don't have to pay up for employees, then salaries will stay the same, and salary expectations will stay the same as well, and the costs of goods and services will remain relatively the same.

In Closing

We are now **42 months** into an economic expansion, with the **average expansion being 42 months** for the past 33 cycles. Equity markets finished the year well, up 16% for the S&P 500 (up from 2% in 2011) The Federal Reserve continues to buy bonds, expanding its balance sheet and monetizing debt. The interest rate curve is slightly steeper but nothing meaningful. The presidential race is over, Washington looks exactly the same, and the rhetoric is the same if not worse. Industrial production looks positive, but not strong. The employment situation remains unchanged, in that we are adding jobs but at a slow pace. Inflation has turned south, and the consumer doesn't feel great about their future earnings. There is nothing terrible going on in the economy and housing continues to recover, but I still don't feel like I want to jump into risk assets right now because of it, especially when looking at the sequester and debt ceiling issues.

I put my client's and my own money in mostly bonds for Q4. I didn't know the outcome of the fiscal cliff, and felt caution was the better measure. With the "sequester" and the "debt ceiling" looming, I may move that money now to cash (and equivalents for the 401-Ks). The economy isn't doing that bad, which under normal circumstances the portfolios would be allocated in a less defensive stance. I have been researching the ability to hedge our currency risk in the dollar if the U.S. does default on the debt. The problem is the alternative ETFs that have liquidity, those investing in bonds of foreign countries, have the bulk of investments in Japan and the UK. Or if I wanted to buy a German Bund ETF, there is no liquidity at all. These simply aren't good alternatives, and I believe the loss taken in



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foreign bond declines as the world reacts to a US default would be equal to or greater than the currency loss of staying in dollars.

So then why don't we just stay in US bonds instead of cash? Having worked in structured finance during the 2008 and 2009 markets, I learned a couple valuable lessons. First, know what is liquid and what isn't. If you need to sell a security tomorrow can you? Second when there is whole lot of money sloshing around, bond spreads tend to get tight... probably tighter than they should. And when the Federal Reserve is pushing everyone, institutional and retail investor, out of treasuries by keeping their rates low, people start looking for yield. It is like every lesson learned from the previous crash, all the previous mistakes, simply vanish in the search for yield. New issue markets are once again churning out deals, deals that are 3 to 4 times oversubscribed. Credit spreads are relatively tight, but looking at 12/31/07, right before the crash, Yields to Maturity for the Asset Backed Security Sector (credit cards and auto bonds) were around a 5.8%... today they are only 0.90%! Commercial Mortgage Backed Securities were 5.36% and today 1.71%. Now I know that Treasury and Swap rates have declined drastically since that time, so much of the yield compression is because of that (around 300 bps), but to get some perspective, CMBS at the end of 2008 (in the middle of the crash) had a Yield To Maturity that was 11.57%. So have the underlying assets become that much better that they don't require such a return? I don't think so. I am getting increasingly concerned about the ability to generate returns in the bond sector and with Barclays Aggregate showing a 1.79% YTM, I just don't think we have much more room to run.

Lastly I recently discussed with one of my clients the simple fact a participant in a 401-K not only has far too many equity choices, but in most cases there is truly no cash option. Stable Value funds are bond funds with an insurance wrapper, and if the wrapper fails you have much longer duration than with a money market fund. Secondly and more importantly, there is truly no other option than U.S. currency. How well does ERISA work if 401-K are tilted to equity (the first loss piece of corporations) and can only invest in U.S. currency based mutual funds.

So as I try to defend our money in a very troubled and difficult market I am frustrated with the fact that our government is causing the majority of our problems, and that we are not left with many alternatives to hide out in. Let's all hope for a quicker resolution than we have seen in the past, but I fear the worst.