Market Commentary
Mid-Year 2012
Prepared July 1, 2012

Dear Clients and Friends,

The Stock Market. The market rallied from October 2011 through the end of March 2012. The rally was unique in that corrections were shallow and short, especially during the January – March period. A correction of some magnitude was expected that would serve to work off late March's overbought condition. A correction began in April and accelerated in May with the Dow Jones Industrial Average falling 12 out of 14 days, during one stretch. As May ended, the market began to register extreme oversold readings, arguing for a June rebound which did occur. For the quarter, the S&P 500 index fell by 3.3%.

Bull/Bear Market Scorecard. While bearish behavior is beginning to appear, the weight of the evidence indicates that the bull market that began on March 9, 2009, is still in force. Primary attributes of market tops, stretched valuations and investor euphoria, are notably absent.

TECHNICAL, SENTIMENT AND TIMING CHARACTERISTICS OF TYPICAL BULL OR BEAR MARKETS/ CURRENT STATUS

Bull or Bear. A bull market has been in progress since March 9, 2009. As of June 30, 2012, the bull market is 40 months old, within the outer limits of an extended cyclical bull market advance. The 2003-2007 bull cycle ran for 52 months and the super-bull market of the 1990s ran for most of that decade, illustrating the potential for bull cycles to far exceed the averages. **CONCLUSION: INCONCLUSIVE**

Initial Public Offerings (IPOs). With the exception of numerous social media IPOs, excitement surrounding the IPO market has been muted throughout this entire bull market. IPO euphoria normally comes late in a bull cycle – but so far IPO euphoria has been absent. **CONCLUSION: BULLISH**

Noteworthy are the recent IPOs of private equity companies Carlyle Group (May 2012) and Oaktree Capital Group (April 2012). The principals of these entities are the ultimate knowledgeable insiders, so I take special note when folks such as these turn to the sell side. A similar IPO, the Blackstone Group, came public in July 2007, within weeks of the top of that bull market. **CONCLUSION: BEARISH**

Technical Indicators. The advance-decline line made a bull market peak at the end of March 2012. If that does turn out to be a peak in the A-D line, then a bull market top should be expected within six months after the peak. **CONCLUSION: INCONCLUSIVE**

Stocks making new 52-week highs have remained far below the bull-market peak registered on April 26, 2010, a negative development. So far, even during the April-May correction, the new 52-week low statistic has been well behaved - a positive development. **CONCLUSION: INCONCLUSIVE**

Non-Divergences. There are a slew of non-divergences that have surfaced in recent months. For example, the Dow Jones Transportation Average failed to confirm the late March high in the Dow Jones Industrial Average, a sell signal according to Dow Theory. Also, small cap stocks and industrials have under-performed the large-cap, blue chips in recent months, indicative of late-bull market behavior. **CONCLUSION: BEARISH**

Investor Sentiment. Investor sentiment has been unusually dour during recent months. For example, The American Association of Individual Investors reflected more bears than bulls for 9 out of the last 10 weeks, an expression of persistent bearish sentiment. Also notable, funds flowing out of equity mutual funds exceeded inflows for an incredible 10 months out of 39 (since March 2009) and 14 straight months through June 2012. The current negative investor sentiment is completely wrong if a major top were in place. This phenomena would support the thesis that any decline in upcoming quarters would be another correction in an ongoing bull market, and that the final top will not be made until the money of the always late, retail investor, finally arrives. **CONCLUSION: BULLISH**

The chart below (courtesy Asbury Research) measures investor sentiment according to small retail option traders. The point of the chart is to illustrate that this group of small retail option speculators reached bearish extreme, coinciding with, or leading, every intermediate-term (multi-month) rally in the S&P 500 since 2006. **CONCLUSION: BULLISH**

Fear Spikes. Accompanying the intense sell-off in May was a furious rally in the 30-year U.S. Treasury Bond. The flight to the 30-year Treasury Bond is the ultimate expression of fear and panic by investors due to the perceived safety of that instrument. The angle of ascent of the May rally replicated the treasury bond rally of late 2008 while the 2008 financial meltdown was still in progress. I note that the price spike in the 30-year bond preceded the explosive kickoff of our current bull market by about 9 weeks. I would offer the general comment that major stock market rallies are born in an atmosphere of panic/fear and out of depressed economic conditions. **CONCLUSION: BULLISH**

Economic Conditions. The gloomy media would have you believe that the American populace spends most if its time in soup lines and that the economy is bad, bordering on catastrophic. The conditions in 1981/1982 were much worse, I can tell you, with unemployment exceeding today's rates and both inflation and interest rates in the double digits. Out of the really bad economic conditions of that time period, when no one was looking, in August 1982, the stock market launched one of the greatest bull markets in the history of the U.S. stock market! Today, you can refinance a home with an interest rate less than 4%, inflation is tame at 2%, corporate profits are at a record, and the economy is moderately expanding. **CONCLUSION: BULLISH**

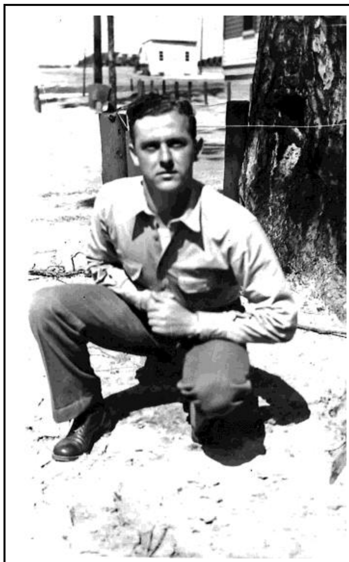
Valuations. I find that the market is not overpriced, and in many instances, is dirt cheap. At projected earnings of $100 per share, the S&P 500 currently trades at a PE ratio of 13.5, which, by historical standards, is about 10% below the long-term average of 15. But the PE ratio is overstated by some factor because corporations, in the aggregate, carry significant levels of "excess" cash on their balance sheets. For example, CISCO Systems earns about $1.70 per share, and at a price of $17/share, the simple PE ratio calculation is 10. A business valuation expert would consider the fact that the company's balance sheet contains more than $8.50/share in cash and equivalents. If you stripped away $7.50/share of that cash from their balance sheet and left $1/share ($5.5 bill) for operations I would not hesitate to say that their operations would not be adversely affected in the least. When you pay $17 for a share of CISCO, $7.50 is allocable to the excess cash sitting on their balance sheet and the balance, $9.50, is allocable to the earning capacity of the company (an adjusted PE of about 5.5 is cheap, cheap, cheap!). The low level of stock valuation should establish a floor under declines that we may experience in subsequent quarters, and helps explain the sharp rebounds from the harsh corrections of the summers of 2010 and 2011, and April/May 2012. **CONCLUSION: BULLISH**

Potential Outlier Events. Current events, such as the potential for economic catastrophe in Europe, an inability of our government to competently address our country's debt problem, or a return of recessionary conditions, all have the potential to adversely affect the stock market in upcoming quarters. Caution is in order in the near term. **CONCLUSION: POTENTIAL SHORT-TERM BEARISH OUTCOMES**

Update on the US Budget Problem. A year ago, I turned to my 8-year old niece, Tiffany, for her thoughts on the subject. In a nutshell, the little mathematics wiz opined that if the government stopped spending more than it takes in, the problem would be solved. That sounded concise and simple enough, so I twittered her analysis to Treasury-Secretary Tim Geithner, to make sure he understood it. Apparently he did not, since one year later, the deficit (currently running about 9% of GDP) is actually increasing, in spite of our country involved in one less war and the economy in expansion mode. I ask the questions: What would happen to the deficit if we fall back into recession? And, since the cost of financing our national debt is budgeted to be a blended average of less than 1.5%, what would happen if our debt buyers suddenly demand to be compensated at a rate closer to the long-term blended average of treasury securities (5% or so)? In my commentary one year ago I stated: "Perhaps the Greek debacle might be a wake-up call to, at long last, do the fiscally prudent thing". Well, our government has chosen not to do the fiscally prudent thing, so the train appears to be off the tracks and racing toward the cliff which is about 100 yards away! President Obama, Treasury-Secretary Geithner – are you listening??

The Greatest Generation - Remembering My 3 Fathers. Watching the U.S. Open final round that concluded on Father's Day, I thought about my '3 fathers'. My own father, John Sr. was born in 1919 and Barb's father, Roy Boyle, in 1920. Joyce's (my deceased wife) father, Dick Hazlett, born in 1928, is the last man standing. The three shared many common characteristics. I am certain they would have made fast friends had they had known each other. Each served our country in true 'Greatest Generation' fashion. John Sr. in WWII, the big one, drove a truck transporting supplies to the front lines in the battles of Luzon and Solomon Islands in the Phillipines. Roy spent much of 1945 training as a B29 and B17 pilot. Dick missed WWII, but served in the Navy shortly after the war ended. The three pursued a variety of careers, in dogged fashion – for all of their adult lives they rose every morning, slugged out a living, and then did it all over again, day after day.

I am the only person living who knew each of them personally. That makes me uniquely qualified to comment on their lives.

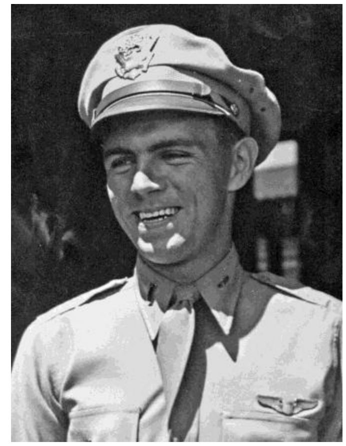


Angela and John Hegler

John Sr. worked in the CCC camps ("Civilian Conservation Corps") in the late 1930s, a depression-era infrastructure building program.

Returning from WWII, he and my mother opened the Corner Café, a shot-and-beer joint in a tough area of East Cleveland. Dad built homes, sold Electrolux vacuum cleaners door-to-door and wound up his career as a barber/part-time bookie (DBA John's Barbershop, East Cleveland). I am an only child, and grew up in an environment resembling that depicted in the movies "Sandlot" and "Caddyshack". Dad loved golf, had a congenial, gentle personality, and loved playing "craps" in Las Vegas. I have a hard time imagining him fighting a war, which, in hindsight, was fought in defense of my right to be an investment advisor!

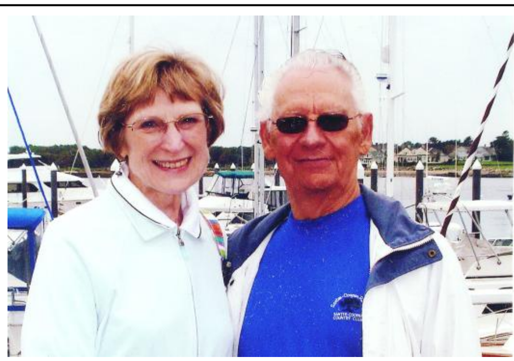
Rena and Roy Boyle



I met **Roy**, in 2004 when Barb and I began dating. He struck me as a friendly, up-beat, happy man. As I got to know him I discovered he was very much like my own father and Dick Hazlett. Roy grew up, like many during the depression, in a challenging family and financial environment. His character developed early and can be seen in the story Rena tells about Roy going to live with an aunt and uncle at the age of 13. Working in their family grocery store to earn his keep, Roy, a teenager, asked his uncle about 'spending' money. He was instructed to "take from the till only what you need to get by on and I will let you know if you take too much". Roy continued to work in the uncle's store and finished high school and college… taking 'only what he needed' for expenses, tuition, books, etc. After serving in the Air Force, Roy worked most of his career with the B.F. Goodrich Company, taking a slight detour to try his hand at owning his own gas station. Marrying the love of his life, Rena, and raising a family (5 kids) kept him busy and focused; his family was always his first priority. Roy's character, faith and love of country defined him and influenced me.

Dick was born in a very small Ohio town, Redhaw, and talks about riding to his 2-room schoolhouse in a horse-drawn wagon. Dick joined the Navy right after WWII, was stationed in Guam and Hawaii and served as a metalsmith, repairing aircraft. While in the Navy (photo to the left), he somehow managaed to attain an uncanny resemblance to Frank Sinatra.

After the service, a chance meeting at a dance led to a life-long marriage with the apple-of-his-eye, Cindy. Three children followed and Dick devoted his life to his family, never loosing that happy, genuine, ornery character that we all love. Like John and Roy, Dick's family was his motivation.



Cindy and Dick Hazlett

After the service, Dick worked in a printing plant for a short time. His friendly, outgoing, personality led him to a career in sales and, before he knew it, he had given 25 years of service to U.S. Ink, selling ink to newspapers and publishers.

Dick is now happily retired in St. Petersburg, FL, shooting 93's on the golf course and sipping martinis. He stays busy entertaining friends and family, is an avid reader and travels the country with Cindy. True to his character, Dick continues to serve his country as a member of the American Legion Honor Guard. They provide military funeral services (in full uniform) at church or grave-site, complete with rifle salute, taps and an American flag presented to the widow.

Thank you, Dad, Roy and Dick, for your influence on me and for your service to our Country!