

October, 2012

2012 Third Quarter Update

Review: Equity markets around the world rose in the quarter, responding to increased liquidity provided by central banks to support lagging economic growth and to the perception that the Eurozone has made progress toward resolution of their ongoing debt crisis. The S&P 500 rose a healthy 6.4%, ending up 16.4% for the first three quarters. Bonds ended up 1.6% for the quarter. The Barclays Aggregate U.S. Bond Index was up 4.0% for the first three quarters.

Quarters	3Q12	2Q12	YTD	2011
S&P 500	6.4%	-2.8%	16.4%	2.1%
EAFE*	6.9%	-7.1%	10.1%	-11.7%
Emerging Markets	7.7%	-8.9%	12.0%	-18.0%
Barclays U.S. Aggregate Bond	1.6%	2.1%	4.0%	8.2%

*Europe, Australia, Far East

Domestic Economy: The economy appeared to soften modestly during the early part of the quarter, as businesses, reacting to the economic troubles in Europe and the uncertainty surrounding the coming election, held back. However, robust consumer trends in autos and housing spurred the economy to reaccelerate and finish the quarter on a strong note. Auto sales are at a four-year high as consumers replace older cars with more fuel-efficient ones. Housing starts, aided by record low mortgage rates, are at the highest level since October of 2008.

Businesses are cautious for three reasons: 1. The risk that the Eurozone debt problem becomes worse, affecting exports. 2. Global growth has slowed, reducing demand for U.S. goods. 3. Uncertainty surrounding the expiration in January of the Bush tax cuts and automatic Federal spending cuts. Our analysis runs like this:

1. The Eurozone crisis has been ongoing for three years, giving market participants ample time to manage the risks of default. We believe that, after forcing substantial reforms from the weak countries, the wealthy countries will provide the funds necessary to avoid a major crisis. The launch of the European Stability Mechanism on October 7th to provide a safety net for the weak economies should mark a turning point, although growth will probably not resume for a quarter or two.

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2. Global growth has indeed slowed. However, central banks around the world are providing sufficient stimulus to reaccelerate growth over the next few quarters.
3. The so-called “fiscal cliff” could reduce GDP by about 3% if left unchanged. There is bipartisan recognition that the tax increases and automatic spending cuts need to be mitigated, but that no agreement is achievable until after the election. It is possible that a six-month delay will be enacted to allow time for the new Congress to address the issues. While there is certainly reason for skepticism, we note that, in contrast to the drama of August 2011, the debt ceiling was recently increased by both houses with little controversy.

In summary, the problems we face are large but manageable. The consumer, who accounts for 70% of GDP, is showing resilience. Business confidence should follow.

International Economies: Global growth estimates came down steadily through the quarter. The recession in Europe was a major cause. In addition to the effect on European economies, weak demand slowed imports from emerging economies. Europe, for example, is the largest market for China’s exports, accounting for 20%. The combination of the stabilization of Europe and stimulus from global central banks will eventually lead to an acceleration of growth.

Strategy: Signs that the U.S. economy is recovering from the “Great Recession” are increasing. We believe that the recovery has several years to run and could be surprisingly resilient. Economic excesses that could lead to a recession are not visible. Under this scenario U.S. stocks are attractively valued, selling at 13 times next year’s earnings. Economically sensitive stocks, particularly those that can benefit from a domestic recovery, are especially interesting.

Among the other developed economies, European stocks are at low valuations, and could be good investments when their economies stabilize. Japan suffers from long-term structural problems and is of no interest.

The slowdown in Europe has been hard on emerging economies and their stocks will not be attractive until after Europe stabilizes.

The principal attraction to bonds has been their perceived safety, leading to excessive valuations. As the world economy stabilizes and the flight to safety reverses, we expect bonds to underperform.