April 2013

COMMENTARY

NOTE TO READERS:

As Pinnacle Capital has grown, we have increased our product offerings. Last quarter, we published our first **PAGGE Update**, which is more relevant to investors in our Pinnacle Aggressive Growth Global Extended Fund than is our **Economic Update**. However, the first half of both publications encompassing our general commentary about the economy and markets were identical. Therefore, going forward, we will publish this **Commentary** in a separate piece as well as **Updates** for both PAGGE and our separate account and mutual fund clients.

Crisis Fatigue

ECONOMIC STATISTICS					
	1st Qtr (3/31/13)	4th Qtr (12/31/12)	*% Change*	1 Yr Ago (3/31/12)	*% Change*
S&P 500 Index	1,569.19	1,426.19	*10.0%*	1,408.47	*11.4%*
10 Year Treasury Yield	1.85%	1.76%		2.21%	
Gold Spot ($ / oz)	$1,596.82	$1,675.35	*-4.7%*	$1,668.35	*-4.3%*
WTI Crude Oil (next future)	$97.23	$91.82	*5.9%*	$103.02	*-5.6%*
GDP Qtr / Qtr	N/A	0.4%		2.0%	
CPI Y / Y	2.0% (Feb)	1.7%		2.7%	
Unemployment Rate	7.6%	7.8%		8.2%	

Despite the drama and turmoil we witness every day coming out of Washington, Europe, and elsewhere, the S&P 500 managed to generate a return of 10.6% (including dividends) for the three months ended March 31. While double digit return quarters are not that unusual – there were 14 such quarters in the last 20 years and seven in the past 5 years – it is still not a bad way to start the year. Why such returns may seem so hard to imagine is that these results occurred on the heels of both the "fiscal cliff" and "sequestration" crises. Meanwhile, there appears to be more chaos than stability in the Middle East, and North Korea has displayed new found belligerence. And of course, the latest crisis involving the nation of Cyprus threatened to bring down the entire European currency as if it were a house of cards.

Cyprus? How can that country be so significant? The population of Cyprus is a little over one million people, though somewhat under 900,000 if you exclude the breakaway Turkish zone which is not effectively under the control of the nation's government. Cyprus needs approximately €15.6 billion ($20.3 billion) to avoid defaulting on its loans and being effectively forced to exit the Euro. Of course if one country exits the Euro, then it is possible that more countries might, thereby bringing down the entire common currency. We'll pass on going over all the implications of such an event, but the European central bank and most European governments are committed to NOT letting that happen.

So a bail out is necessary. The problem is, while Europeans in general want to preserve the Euro, Europeans are tired of bailing out spendthrift / risk taking nations.

How did Cyprus and Europe get into this mess? Cyprus got itself into trouble as its banks offered high interest rates on deposits. They managed to do this by mostly investing in Greek government debt. Why did they think they could do so? Because European leaders virtually assured the world that no one would lose money in sovereign debt of European nations. Of course, this was only true until it was no longer true. Greek debt holders, including Cypriot banks, were forced to take a haircut on their debt. This haircut for the most part wiped out the capital of the Cypriot banks. Unfortunately, because of the high interest rates these banks offered, by mid 2012 Cypriot bank deposits grew to a multiple of total GDP and just about equaled the total bank deposits of much larger Germany. The banks could not pay back their depositors (many of them Russian) and the government didn't have the resources to bail out the banks. Enter the international community.

The Germans, facing elections later this year and tired of bailing out others, limited the bailout to €10 billion. An additional €5.6 billion was needed to save the country from default, and here's where the European bureaucrats made – in our opinion – a colossal blunder. Instead of leaving it to the Cypriots themselves to determine how to raise additional capital, they dictated to the nation that depositors, large and small, would have to lose much of their deposits. Now there is nothing wrong with this in theory. After all, if one lends you money, you can accept it with the terms offered or decide not to take the money. And by insisting that depositors take a hit, the concept of risk has been reestablished to some degree. This is a good thing. But by having an unelected supranational body dictating that an individual's insured deposits can be confiscated, investor confidence in all European banks has been placed at risk. To make matters worse, the Dutch finance minister announced that this would be a template for future such situations. Suddenly, the soundness of the entire banking system of Europe came into question. Realizing that these actions might precipitate a bank run, the Dutch finance minister reversed course and said that Cyprus was not a template. Further, small depositors (those with deposits of less than €100,000) were spared from having to forfeit their savings. So far, there has been no pan-European bank run, but trust – the foundation of any banking system – has been severely shaken.

So where does this leave us? First, we believe Europe will continue to remain weak and lose ground relative to the rest of the global economy. This is nothing new. The continent will likely continue to muddle along, lurching from one crisis to the next. At times it will do well as global demand continues to rise. At others, contraction in one European nation or another will partially derail recovery. This does not mean game over for Europe. Gradually, a weakening currency will create a competitive advantage for the more productive segments of the European economy. In particular, the Germans will have a weaker currency than they would have had if the Germans had their own currency. The corollary to this is that the less productive sectors of the European economy – particularly the Mediterranean south – will find that they have to compete utilizing a continental currency that is stronger than their own national currencies would have been. This means the adjustment to competitiveness will be even tougher and their economic downturn will be prolonged.

The good news for investors in the U.S. is that though we will certainly feel the impact of events transpiring across the Atlantic, there are a multitude of investment opportunities that are not captive to these rolling European crises – especially in the long run. Yes, we have our own issues on this side of the ocean, not the least of which are excessive government debt at all levels, policy uncertainty, and growing pension and health care liabilities. Still, productivity remains strong – ironically one factor negatively impacting employment in this country. Corporate balance sheets, as opposed to those at the governmental level, are generally in excellent shape; and individual balance sheets have been improving steadily. As we have oftentimes stated, a growing middle class, particularly in Asia and Latin America, has the potential to stimulate global economic demand for years to come. Additionally, equity valuation levels are still quite attractive despite the recent run up in prices.

With respect to this latter point, it is true that the broad markets have finally reached and exceeded the highs of 2007. But then again, nominal GDP in the fourth quarter of 2012 was roughly 11% higher than nominal GDP in the fourth quarter of 2007. Further, the cost of capital, which strongly impacts assets prices (lower costs should result in higher asset prices), is significantly lower as well. As a rough proxy, according to Bloomberg, 10 year BBB industrial bonds yielded on average 5.9% at the end of 2007. Today they yield 3.5%. These statistics do not in themselves mean that equity prices will continue their recent run. Certainly, a near term reversal is possible. But given our overall outlook for economic growth and corporate profitability, we still believe investors should maintain equity holdings toward the upward limits of their individual tolerances.