Whitford HOLDINGS LLC

Markets Rock While Tanks Roll

With the exception of the Emerging markets, equity markets in March pushed through another outstanding month led by small cap performance. The momentum is carrying forward into April (as of this writing) as investors are starting to re-enter the market. The good times in the equity markets seem to be the sole positive coming out of the Federal Reserve's firehouse application of monetary policy. The expected boost from this policy has yet to make any discernible difference to fiscal policy.

Table I: Global Equity Market Returns -%

	Mar. 2013	YTD
Russell 1000	3.86	10.98
Russell 2000	4.62	12.39
MSCI- Developed	0.39	4.38
MSCI- Emerging	(1.87)	(1.92)
S&P 500	3.75	8.52%

Source: Russell, MSCI and Standard & Poor's

Economy

Globally the economic environment is still suffering from an extended case of anemia. The expectations of another recession hitting parts of Europe are growing. The consensus for the U.S. is that while growth will slow again, it will avoid slipping into another recession. That consensus is subject to revision.

Greece hit a record 27.2% unemployment in January (latest date reported). The Euro-area saw a record unemployment rate in February of 12% for the 17-nation area. There is rising sentiment that Germany may hit a recession in the second half of the year, which will endanger the EU's already faltering, fragile state. Italy, the third largest economy in the Euro zone, we expect to contract by 1.5-1.6%. Italy is experiencing its longest recession in 20 years.

We briefly mentioned Cyprus last month and the issues the tiny country is facing. The financial crisis has crippled its banking system as government spending was out of control. The government, in a desperate grab at more revenue, reached into savings of bank depositors to extract a 20% tax on savings above 100,000 Euros ($130,000). This created a run on banks which were then closed for days as the EU tried to arrange a bailout and re-establish order. The original bailout of 17 billion Euros has now increased to 23 billion Euros. Eurozone GDP is expected to contract 9% this year and contract an additional 4% in 2014. This sent alarms around the world. The experts here in the U.S. assured us that a government grab such as that which occurred in Cyprus could never happen here. We remain unconvinced at this time. We will elaborate a little later.

There is stronger activity in China, where output was previously dampened. Economies such as Korea, Taiwan, Indonesia and Vietnam, which are sensitive to changes in China, also showed gains last month. The lift from rebounding output in China has not had as powerful an effect, most notably in Brazil, India and Russia, which largely reflects harsher global headwinds.

To compound weak economies there is noise coming out of N. Korea which has moved tanks toward S. Korea while positioning rockets pointed at the U.S. and Japan. For those old enough to remember, Democrats skewered Ronald Reagan for his missile defense shield. It does not seem as silly an idea today. Washington should keep this in mind as it carelessly begins to cut defense budgets.

In the U.S. we are witnessing a complete decoupling of the investment markets from the economy due solely to the QE activity of the Federal Reserve. The Fed confirmed it would continue to hold interest rates essentially at zero. The Fed will maintain its monthly pace of buying $85 billion in asset purchases, comprised of $40 billion in mortgage-backed securities and $45 billion in Treasuries. Much more interesting, as seen in Table I, the Fed has reduced the upper end of its expectations for unemployment and GDP for 2014 and 2015.

Table I. Federal Reserve Bank Estimates

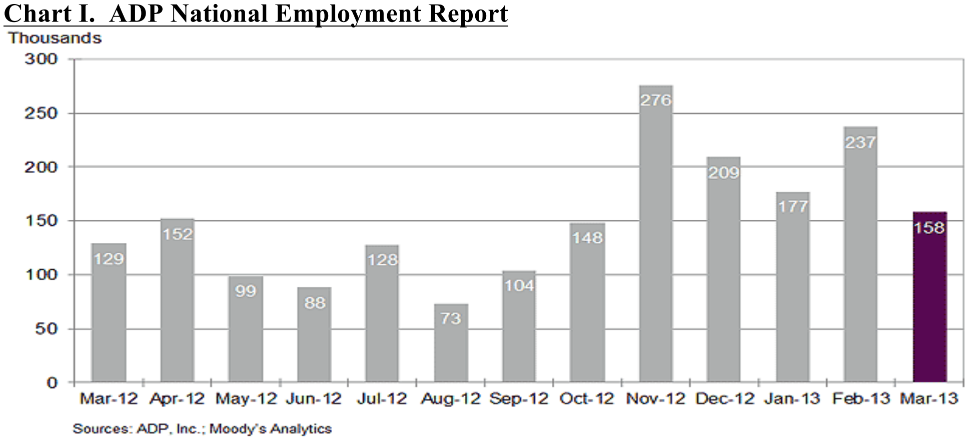
	Unemployment		GDP	
	New	Prior	New	Prior
2013	7.3-7.5	7.4-7.7	2.3-2.8	2.3-3.0
2014	6.7-7.0	6.9-7.2	2.9-3.4	3.0-3.5

Source: Federal Reserve Bank

The markets seem unconcerned or have ignored the contradictory Fed expectations that the reported unemployment rate will fall while GDP will slow. On the surface the declining unemployment rate would suggest that there would be more people working which, in turn, would boost GDP. What this adjustment likely suggests is what we discovered in the March unemployment report. The unemployment rate dropped from 7.7% to 7.6% as thousands left the labor force and the labor participation rate fell to 63.3%, the lowest since 1979. Not exactly a recipe for growing the economy. The number of food stamp recipients (over 48 million) and disability filers (nearly 9 million) again hit record highs in March. And it is worth repeating that this is occurring now while the economy has been out of a recession for two years, making this one of the worst recoveries ever.

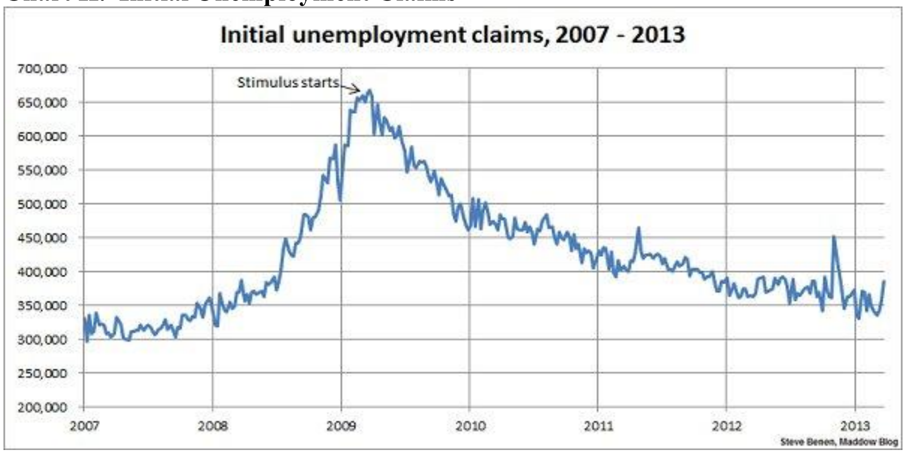
The major disconnect in the economy has been and remains jobs. Brushing aside political rhetoric, job growth two years following the end of the recession is anemic. As seen in Chart I, the ADP Employment report illustrates that job growth over the past year has not been at a level sufficient to even account for population increases. For the past year the ADP jobs report has averaged 152,000 jobs per month.

Chart I. ADP National Employment Report



The biggest hit to jobs was a 24,000 decline in retail and 3,000 drop in factory workers. Government jobs reported a decline of 7,000 as the Postal Service dropped 12,000. Adjusting for the USPS longer-term reductions, the net increase of 5,000 government workers is not a sign of any robust job activity but of government continuing to kick the can down the road while ignoring their budget woes.

Chart II. Initial Unemployment Claims



Initial unemployment claims confirm that the job market is at best weak. As seen in Chart II claims declined steadily from its peak in 2009; however, since the start of 2012, claims have remained in a very tight range; well above a level that suggests any strengthening in the labor markets.

Housing is still a mixed bag. Existing home sales rose 0.8% in March as inventories rose to 4.7 months. Distressed/foreclosure/short sales accounted for 25% of the sales, keeping prices in check. New home sales declined 4.6% in February and have a 4.4 month supply. Median sales price was $246,800 while the average price was $313,700. By maintaining interest rates at these levels and encouraging lending institutions to slow the write-down process, the recovery process is being prolonged and fosters a misallocation of capital as the economy (and housing in particular) probes for an actual bottom.

The recent release of first-quarter earnings of the large money center banks has also offered a window into the issues of the U.S. economy. Net interest margins are slowly declining which are reflective of an artificially low, depressed interest rate environment. New regulations on bank risk capital have limited banks' ability to make riskier loans to small businesses, as higher bank reserves are now required. It also appears the banks are beginning to structure their businesses for a higher interest rate environment. Banks have also written off $3 billion in student debt in the first two months, up 36% from a year ago.

The nightmare overshadowing the U.S. economy remains fiscal policy. Despite the barrage of press from the mainstream media about obstruction and lack of compromise, the real problem remains unchanged – the pursuit of failed policies. Or, to be more specific, governments at all levels refuse to acknowledge that debt and spending are out of control and punitive taxation on a tiny portion of the populace is a recipe not only for economic failure, but quite possibly economic collapse. While we may be accused of being conspiracy propagators, we are merely connecting the dots of incidents that we warned about two years ago that are now slowly coming to the forefront which investors can little afford to ignore much longer.

First, let us start with ObamaCare. The centerpiece legislation (to date) of President Obama is now being viewed in the light of day. Republicans who warned of dire issues were ridiculed as naysayers and haters of the President. Slowly we are seeing they may not have been harsh enough. This program, which is supposed to add, by some accounts, over 44 million people who currently do not have health care insurance, will experience some issues. Compound this with insurance companies inability to exclude individuals because of pre-existing conditions. For good measure, ObamaCare's idea of cutting costs is to reduce payments to Medicare service-providers by nearly $800 billion. AARP who was a strong booster of ObamaCare, now projects there may be a shortage of 45,000 primary care doctors by 2020. The resulting system will suffer from escalating costs and a shortage of services. Health and Human Services Secretary Sebelius recently admitted that the administration's insistence that ObamaCare will reduce premiums might have been a slight miscalculation. Adding to the rising costs of this program, it was also recently announced that the state exchanges would now cost over $5 billion to set up, doubling the original estimate of about $1.7 billion. These "miscalculations" immediately confirm that there has never been a government program that did not exceed its original cost estimates by a factor of at least two.

Position this on top of President Obama's attempt at a budget, which arrived two months later than required by law. We can firmly question whether this administration has any grasp of simple economics. What was presented is an utterly unimpressive re-hash of similar tax and spend budgets of the past. The actual deficit reduction over a decade is a mere $0.6 trillion out of total spending of $46.5 trillion and the entire deficit reduction is premised on more tax hikes. Obama's request for spending exceeded not only the Republican budget, but also the one from the Democrats in the Senate. President Obama's nod to entitlement reform is a change in the way inflation is measured which will reduce the social security payout by 0.25% of one penny on the dollar (25 basis points). Many Democrat and liberal groups shrieked over the harshness of this proposal. The true silliness of the administration's budget is the underpinning assumptions of 3+% GDP growth and interest rates remaining near record lows. The miniscule $0.6 trillion deficit reduction is not likely to appear particularly heroic in hindsight.

In an above paragraph we mentioned the confiscation of money from citizens' accounts in Cyprus and how something that scandalous could not occur here. President Obama may have deflated that promise with his new "tax" on IRA's over $3 million dollars and limiting asset accumulation to cap annual distributions to no more than $205,000 per year. This is simply a confiscation of wealth by a government who has now pre-determined how much savings any individual may have. Now let's leave alone this horrendous suppression of an individual's right to determine how much they can or should save. Anyone with an ounce of common sense looking at the devastation entitlements have inflicted on our fiscal system would welcome anyone that will be able to self-finance their retirement years. Social justice? Economic incompetence? Purposeful destruction? They seem to be blending together.

We have warned for years of the issues that public pensions and municipal bonds may face as a result of overly generous pensions and under-funded budgets. Again, looking at a $4 trillion pension deficit, confiscating money from those who saved seems almost psychotic. Retirement plans are beginning to be channeled into defined contribution plans to try and head off the day governments will be forced to spend 50-70% of their budgets for retirement benefits. This will finally be getting more attention as a judge recently ruled Stockton, CA could file for bankruptcy. Stockton owes creditors over $1 billion with $900 billion of this being owed to CALPERS to cover accrued pension contributions.

With the federal public debt at nearly $17 trillion and showing no signs of abating, the federal government may be approaching its last attempt achieve fiscal stability. The lesson being learned in Europe is lost on the U.S. under a mis-placed belief that "it can't happen here". News Flash: it already is happening here. Yes, it is undeniable that there will be short-term pain in cutting spending and entitlements in order to regain fiscal sanity. Tax increases on a tiny segment of the economy may be a politically popular (and cowardly) move; we will discover that we will run out of other people's money to spend.

While we see a robust bond and equity market despite the economic background, we are beginning to see some interesting movements at local levels. We have seen an enormous sell-off of gold in recent weeks as hedge funds have exited their positions. It is quite likely gold, in the near term, will remain under pressure as the traders lighten up their positions. Globally, central banks continue to repatriate gold back to the mother country. Turkey, for one, has not only seen imports of gold hit an eight-month high but a 30% surge in silver as well. Closer to home, there have been more than a dozen states that now recognize gold and silver coins as legal tender. The growing distrust of Washington and dissatisfaction with Bernanke's monetary policy is leading the push. In

Texas, lawmakers are considering a way to establish the Texas Bullion Depository to store gold bars valued at about $1 billion and owned by the University of Texas Investment Management Company. The plan also calls for the Depository to accept deposits from the public and provide an intra-state payment system in the event of a systemic dislocation in the national and international financial system. Other states are considering methods to accept gold and silver as currency for tax payments.

The other interesting note is that as gold sells off, Bitcoin has hit the headlines. Many have written off Bitcoin as a speculative bubble and a whim of libertarian-anarchists. Driven by a global shift to mobile payments and a rise in online retail, Bitcoin's status as an independent currency on a decentralized network is attracting more attention. The impact that warrants attention here is that Bitcoin may impair two central monetary functions of government: taxation and macroeconomic stabilization. As governments become desperate to trap more revenues this may pit more government regulation against the people's ability to protect their capital.

Additionally Australia and China have come to an agreement to use their local currencies instead of U.S. dollars as the means of exchange for trade. This is not China's first foray into a non-U.S. dollar exchange. A year or so ago, China set up a similar system with Russia as a payment system for energy trade. China continues to go direct to secure natural resources and local currency trade systems that may decrease the perceived value of the US Dollar as the currency of choice.

It is our view that equity and bond markets will continue to see positive results as the central banks flood the system with liquidity and artificially depress interest rates. The power of the Fed is in full force; however, the danger when that position shifts must be noted. The Third Law of Thermodynamics will replace "don't fight the Fed". For those of you who slept through science class, it simply means the force will be equal in magnitude but opposite in direction. Our analysis still confirms that this market will not end nicely for those unprepared to react to the catalysts already firmly in place.

There is one interesting note about the equity markets as firms have stashed trillion of dollars on their balance sheets. A study has shown over the past year, 146 companies have completed stock buybacks and 106 companies chose to increase dividends while 33 did both. The result of price movement among this universe showed dividend increasers saw stock price increases of 17.8% and buybacks 15.2% while the S&P rose 10.6%. Stocks with strong cash flows that focus on shareholder returns will provide solid intrinsic value to its holders. One would expect this to be especially true in private equities where the concern is long-term stockholder value and not quarter-to-quarter expectations.

The scenario that continues to build is one of low- to no-growth and spiraling inflation. The time frame is unknown but once in motion, it will be difficult to contain. That is why it is imperative for investors to enjoy the current ride, vigorously monitor risk and be prepared and positioned to take advantage of the shifting sands. Precious metals, real estate, farms, timberland and agricultural products, as well as other inflation friendly areas should be foremost in investors' minds.

The consumer is fairly deep into its process to scale back excesses of the past few decades. Unfortunately, the western governments have yet to truly begin to de-leverage, which will remain a significant headwind to economic growth and eventually the investment markets. Capital protection and risk-adjusted returns will help investors ride out the negative volatility of this overdue de-leveraging process.

 April 12, 2013