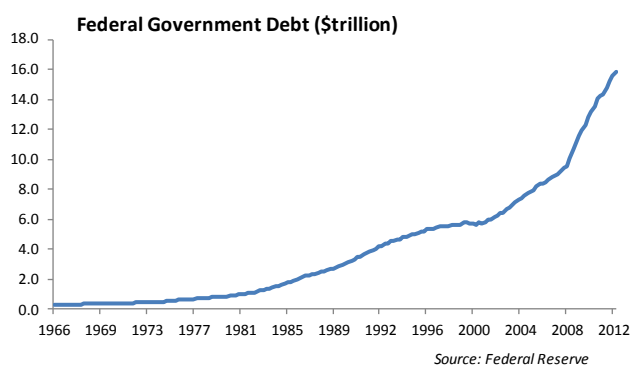


*It took our country 229 years to accumulate \$8 trillion in federal debt. It only took the next eight years to double it to \$16 trillion. History shows that when a country accumulates debt at this rapid pace, economic growth languishes. Not surprisingly, Congress is pursuing policies that attempt to inflate the economy. Five years after the Financial Crisis, we really haven't fixed much. Instead, we've issued more debt in order to pay our bills and sustain a quality of life society cannot afford long term.*

We maintain our view that the U.S. and global economies are stuck in a slow growth, low interest rate environment. While domestic economic data is improving, we do not believe this is the beginning of a sustained acceleration in domestic growth. To the contrary, some of the growth is related to the improvement in the housing market and we are seeing continued follow through in manufacturing. But, the growth in consumer credit, which is helping to drive consumption, is masking a general decline in wages. Monetary policy has clearly helped provide stability to the financial system and inflate asset values. *However, we need fiscal policies that provide integrity for the economic system to work alongside monetary policy. In our opinion, economic growth is still not sustainable without continued monetary stimulus from the Federal Reserve, especially in the face of meager job growth, until more of the structural problems are addressed.*



In 2013, we expect that the domestic economy will continue to muddle along at a relatively slow pace that is below potential. However, we are nearing the point where the economy could stand on its own without aggressive monetary stimulus. This year, economic growth could surprise to the upside if we can actually address some of the structural problems that have impeded credit expansion and job creation. While a meaningful plan to reduce the deficit which includes reforms to entitlement programs may slow economic growth over the short term through reduced consumption, we believe the foresight and clarity provided will help to remove structural barriers that are inhibiting fixed investment and job creation in the corporate sector.

The flood of money from the Federal Reserve in the system has proven effective in allowing commerce to continue unabated. Private credit expansion is improving as the banks, flush with cash and replenished capital, are more willing to make loans. Looking ahead, we believe there are three major risks to the economy in 2013. First, the dysfunctional Congress which failed miserably to address the "fiscal cliff" in a manner that showed any fiscal discipline is faced with increasing the debt ceiling. If partisan politics continues, it will hurt progress toward sustained economic growth. We still have to face the \$1.2 trillion in automatic spending cuts which is looming in March. Second, monetary policy will continue to be highly accommodative; *however, the Federal Reserve may begin managing the market's expectation that it will reduce its bloated bond portfolio toward the end of the year.* Third, the geo-political risks continue to grow around the world. While friction between China and Japan has subsided over territorial rights to islands in the East China Sea, we expect the significant growth in China's military capabilities, coupled with the 5 to 1 male dominant society, will likely lead to continued aggression over the next decade. Conflict in the Middle East will take an ugly turn as Iran's economy is choked and Pakistan becomes another epicenter of violence. The Middle East remains a powder keg.

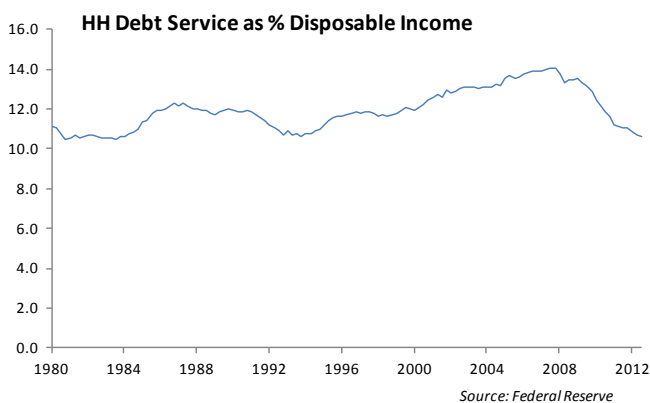
As investors, we want to be compensated for the risk we take and be vigilant of the risks inherent in the market. *While we expect that muted domestic economic growth will keep interest rates from going much higher, there are several reasons to believe domestic stocks will deliver another positive performance in 2013.* We also believe that there is value sifting through the carnage of Europe and expect to find more opportunities in emerging market economies.

*The banks are deleveraging. However, with the growth in consumer credit and federal debt, we no longer can make the case that the US economy is deleveraging. Denial is not just a river in Egypt.*

**The Consumer**

The consumer sector represents over 70% of the domestic economy. In spite of the recent tax increases, we expect consumers will actually be a bright spot in 2013. There are two reasons for this. First, the US housing market has shown significant improvement over the past year and will continue to improve. Housing prices rose again in November. So did the National Association of Realtors Pending Home Sales Index, which was up 9.8%. All of this is providing support for the consumer. Low interest rates have helped to support a continued wave of refinancing. Going forward, we expect interest rates will stay low, but the refinancing momentum will slow.

The second reason we think the consumer will be a catalyst for economic growth is pent up demand. While consumer credit is trending higher again, household debt service as a percentage of disposable income is trending lower. In this wacky world where consumers count their unused credit card balances as cash, we expect that this additional capacity to spend will find its way into economic statistics for 2013. *Until the economy shows consistent job creation and wages show meaningful growth, consumption at this pace is not sustainable.*



Over the past five quarters, personal consumption expenditures have contributed a minimum of 1% to economic growth. Consumers have made great progress in repairing their balance sheets since the financial crisis as the household debt-to-GDP ratio has fallen by over 15% from its peak three years ago. *The bottom line is that the combination of rising home prices and an improved equity market has helped to boost household net worth which is*

*reinforcing the wealth effect, which in turn will help to support consumer spending in 2013.*

**The Corporate Sector**

The corporate sector has been a solid contributor to economic growth over the past two years. While we have some concerns that prior momentum will not necessarily be sustained at its current pace into next year, the corporate sector will likely remain a strong contributor to GDP growth this year. Corporate balance sheets remain flush with cash and have benefited from lower interest rates which have contributed to higher profit margins. However, that contribution to earnings has likely been discounted into earnings for the year and we do not anticipate any improvement in margins next year. Some uncertainty with respect to Healthcare reform and taxes has been removed through the election since the potential threat to repealing the Affordable Healthcare Act has diminished. However, the economic outlook is still uncertain in the face of the debate to raise the debt ceiling. As a result, the corporate sector has not made significant investments in fixed assets over the past two years. This could change if Congress provides clarity to tax policy early in 2013 which could provide a significant catalyst for economic growth.

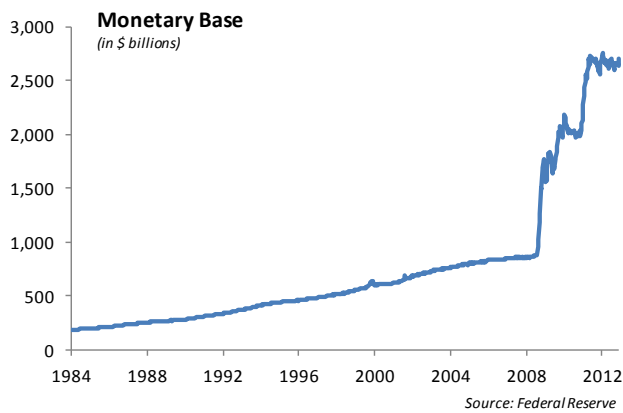
The uncertainty provided by weak global demand and tax policy should clear up mid-year. Further, the strength of corporate balance sheets and operations will help drive the next investment cycle. We expect corporate earnings in 2013 to be under some pressure, but we may start to see an improvement in top line revenue as global demand improves.

**The Government Sector**

The government sector will likely be a mixed bag providing little contribution to economic growth. State and local governments are still under severe pressure to reduce budgets and cut headcount. At the same time the regulatory burden has increased, putting pressure on already reduced staff levels.

Defense spending could be impacted due to the sequester and negotiations over the debt ceiling. While it is impossible to predict the outcome from the debt ceiling, it appears this administration is leaning toward a larger role for government in the lives of Americans. That comes at a cost and we will likely see some increase in government's contribution toward GDP in 2013 as a result.

Make no mistake; the Federal Reserve will continue to provide excessive liquidity to the markets next year. In its last FOMC minutes, Fed Chairman Bernanke indicated that until the unemployment rate hits 6.5%, the Federal Reserve will continue to purchase bonds in the open market. We estimate the Fed owns over 70% of the debt outstanding issued by the US Treasury. *It's the same pair of trousers, just different pockets. One leg of the government issues the debt to fund ongoing operations and the other leg is there to purchase the debt.* In the absence of the Federal Reserve, there would be fewer buyers of US Treasury debt which would result in higher interest rates. Inevitably, with the increase in the monetary base comes the risk of higher inflation.

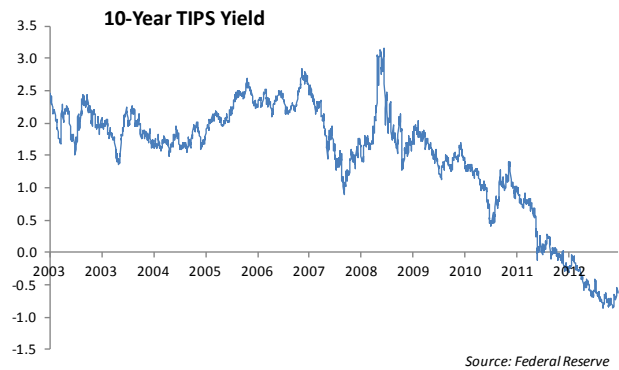


To us, this is a huge danger signal, the blinking red light on a lonely road in a dark night. Traditional monetary policy initiatives, which included changing the discount rate, managing the money supply through bank reserves, and calibrating the targeted level of the Fed Funds rate no longer, work in these extremely stressed capital markets. The lesson learned well is that when the capital markets seize up, the Fed needs to provide as much liquidity as possible. During the summer of 1987, leading up to October Crash, the Federal Reserve increased the Fed Funds rate from 6.5% to 8.38%. However, when the market crashed, Greenspan (who had only been in the job for two months) reversed the tightening by reducing the Fed Funds rate back to 6.5%. The recovery was startling as consumer spending picked up as the DJIA rallied 11% by the end of that year.

This time around, the monetary easing process is more primitive and dramatic and in our mind calls into question whether we actually have a free market economy. Since the Financial Crisis, the Federal Reserve has increased its balance sheet to \$2.6 trillion and has simply bought bonds in the open market with the objective of lowering interest rates.

The result of lower interest rates is that those consumers that can lower their mortgage payments and corporations can lower their cost of capital which provides for better profit margins and earnings. The other result of these aggressive monetary policies is that asset valuations have been supported at higher levels and in many cases pushed to extremes. Housing prices have increased to levels not seen in two years, commercial real estate valuations have increased, as well as the prices of corporate debt and equity securities.

The government is openly manipulating the level of interest rates. We shouldn't be so chagrined. UBS paid \$1.5 billion in fines for its part in the banking consortium that manipulated the Libor rate for the past several years. Last we checked it's illegal to manipulate the markets. The SEC is still investigating high frequency trading algorithms that helped to shut markets down last year and forced Knight Capital to put itself up for sale. Some of these computer programs use fake sell orders that are quickly cancelled before being executed in order to help push the market in a direction. Tell us how this is not market manipulation.

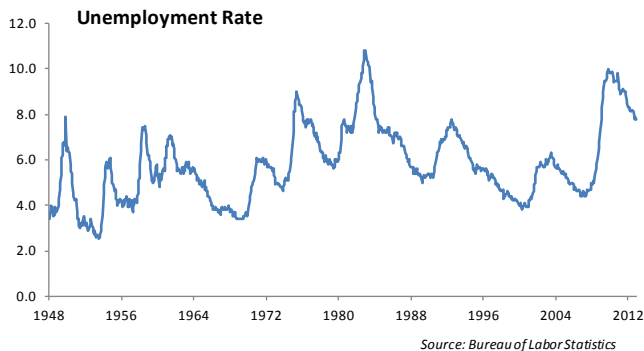


**Inflation**

The rate of inflation, measured by the CPI index, has been tracking roughly 2.5%. While we do not expect the rate of inflation to move sharply over the near term, one of the biggest risks for investors is a sharp spike. Inflation could surprise to the upside in the second half of the year as wage gains, productivity improvements and excess resources in the economy are put back to work. As we have discussed in our prior musings, the Fed's Quantitative Easing programs are planting seeds for inflation to rise rapidly in the future. *We are approaching the time in which the Fed will no longer have the luxury of implementing aggressive monetary policies without the consequences of rising inflation.*

### Prospects for Employment

Ultimately, the health of the economy will be measured by its capacity to produce meaningful jobs. While the unemployment rate has dropped to 7.7%, this recovery has shown tepid growth in job creation relative to past recoveries. The unemployment rate measures the estimated number of unemployed workers compared to the population of the labor force. However, because it only intends to capture those unemployed that are actively seeking work, the unemployment rate can be a bit deceptive as a measure of employment. Current unemployment benefits, which have been extended under Obama's stimulus program in 2010, may be underestimating the real rate of unemployment as more Americans have chosen to sit out the job search for now and simply collect their unemployment checks.



The labor force participation rate is the ratio between the estimated size of the labor force and the overall population of people eligible to work. Looking at the Labor Force Participation rate data published by the Bureau of Labor Statistics, shows a steady decline in the population of the labor force which confirms our suspicion that a larger portion of the labor force has opted out of seeking employment. This is proving to be a drag on economic growth as well as the federal deficit since we are paying for these unemployment benefits with debt issued by the US Treasury. *In order to experience sustained economic growth, we need to create the incentives for unemployed workers to seek employment. This means that the economy needs to create meaningful jobs where Americans can earn a wage that exceeds the current incentive to stay out of the work force.* This will only happen when corporations have transparency on fiscal initiatives which include tax policy, healthcare and regulation. Monetary policy alone cannot create jobs.

### Financial Regulatory Reform – 9,000 Pages and counting

*One of our key tenants for measuring progress after the Financial Crisis is implementing financial regulatory reform that has a consistent set of rules that we all play by. We still aren't there.*

The Glass-Steagall Act was the piece of legislation enacted after the market crash of 1929 that separated traditional banking from investment banking. It was 27 pages long and without legislating compensation, it was the single most effective method for regulating what management paid itself. After all, banking is a single-digit margin business that has required capital levels. A bank takes deposits and makes loans. After the securities and Exchange Act of 1933 which created the Federal Reserve, banks have played an important role in our monetary system and were the primary means for capital expansion which, in turn contributes to private investment.

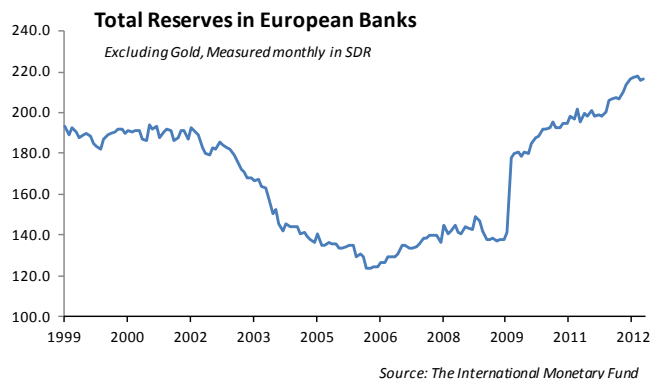
The Dodd-Frank Act is the primary piece of financial regulatory reform after the Financial Crisis of 2008. To date, the rules that govern the Dodd-Frank Act totals over 9,000 pages and it is still not finished, having not yet reached agreement on important aspects of regulation including derivatives trading and money market mutual funds. The process of moving through financial regulatory reform has created structural problems which has impeded private credit expansion and fixed investment. In order for the largest banks to meet the new capital requirements required under Basel III, they need to raise their Tier 1 capital to over 10%. In addition, there is still not agreement from global regulators over the "living wills" that large banks are required to implement in order to assist in an orderly wind down similar to Lehman Brothers .

To have sustained economic growth, an economy needs to have a solid financial system. In order to improve profitability, the US banking system has gone through significant consolidation. The more accounts a bank has on its systems and infrastructure, the more it can spread its costs and increase operating efficiencies. In 2000, the top five banks represented 23% of the total assets. Today, the top five banks control over 50% of the total assets in the US. The potential impact that concentration has on economic growth is that if the top five banks decide at the same time to restrict loan growth to preserve capital, it reduces private credit expansion and impairs economic growth at the margin. And, that's what we're experiencing today.

We find it helpful to break the global economy into two areas: the developed countries and the emerging economies. The developed countries have too much debt which is impeding economic growth. While the economies of the emerging countries are suffering from the same downstream effects that have hurt the developed countries, their opportunities for growth are better. Global growth has been dismal for the past three years; however, we believe we are nearing a turning point. *It is important for investors to recognize that many of the structural problems which impede economic growth have not been fixed. But, there has been improvement in many areas including tax reform in the United States, a move toward a consolidated bank regulator in Europe, stabilization of the debt crisis in Europe, a new regime in China and a new prime minister in Japan.*

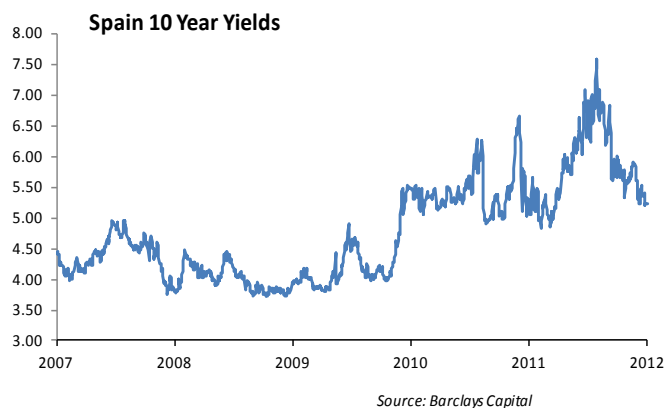
**Europe**

Last year the slow policy response to Europe’s debt crisis and the recapitalization of its banks continued to plague the capital markets. However, we believe that significant progress has been made through the actions of the European Union to initiate a common bank regulator and the European Central Banks initiative to provide low interest rate loans freely to the European banks in order to instill confidence and prop up the capital base. We are expecting that some of the low interest rate loans offered through the ECB will actually be repaid early. And, while austerity measures have pushed much of Europe into a recession, we expect that the worst may be behind them. The financial health of any country is measured through its banking system and the improvements in Europe have been material. Total reserves in European banks are well in excess of levels prior to 2000.



Spain has implemented severe austerity measures which have seriously impacted its economy. However, Spain’s banking system remains fragile and we are concerned that

the capital infusion last quarter was not enough to stabilize the system. In addition, Italy has been slow to address capital raising and asset write-downs at some of its weaker banks. So, we expect that there could be additional focus on the Italian banking system in 2013. However, evidenced by the lower borrowing costs for the Spanish government, the capital markets appear to better withstand the news of troubles with European banks today as the systemic problems appear contained.



One of the destabilizing initiatives for Europe over the next year is the United Kingdom’s recent proclamation that it desires to reform the European Union and repatriate powers. This will be a long process and difficult to predict the outcome and the consequences for investors. Still, we continue to believe that the most likely scenario for the EU is that it is reformed in some way over the next decade, and it now appears that the U.K. wants out.

**China**

Admittedly, our read on China is as clear as a foggy morning in Milwaukee. China represents the second largest economy in the world and we believe that there has been improvement. With the change in their cabinet last year, we expected some stimulus initiatives that would spur infrastructure projects and business investment. Their manufacturing base has turned positive and profits of Chinese industrial companies are predicted to surge in the first quarter. The economic rebound is expected to continue at least through the first half of 2013. In addition to an increase in infrastructure and real estate investment, a mild improvement in export demand from China, cheaper raw materials and looser monetary conditions would all support faster growth through 2013. However, we don’t trust their numbers and we get mixed signals from our feet on the street. The bottom line is that if the market believes that China is experiencing strong growth, it will attract capital and investment.

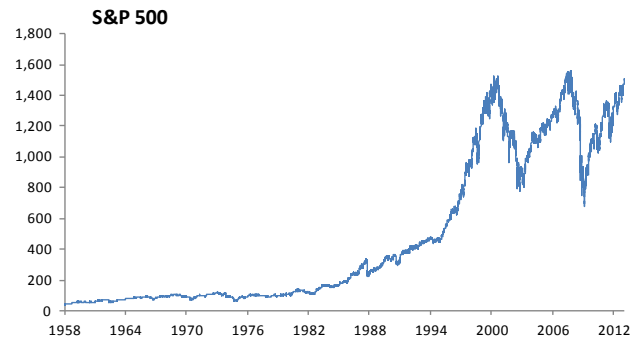
**Private Equity**

There are growing contrasts between private and public investments that are worth exploring, which makes Private Equity an interesting place to invest over the near term. First, there is a huge amount of money looking for investment opportunities in the market today and we are seeing an increase in fundraising activity. At the same time, business owners that are considering selling, especially in the smaller end of the market, have not been able to achieve their targeted value. At some point, we expect those owners that are the earlier baby boomers, will need to liquefy their investment. Pricing discipline and market conditions have resulted in a reduction in expected returns. We have always maintained that the stewardship over private investment has been better for shareholders than in public companies because compensation and incentives are better aligned. One needs to only look at Chesapeake Energy, JP Morgan, Citigroup, Goldman Sachs or any of the other major banks to see that compensation and governance in many public companies still require better mechanisms in order to reward shareholders for their risk.

**Equities**

U.S. equities posted a solid year with a 16% total return measured by the S&P 500 and there is a strong case for positive returns in 2013. In general, U.S. companies are characterized as having high cash positions, low levels of debt, strong profit margins, low costs and relatively strong earnings. U.S. companies are doing remarkably well, and we expect a strong operating environment to continue into this year. *In addition, we expect to see more shareholder friendly initiatives in 2013, including special dividends, share buybacks and leveraged buyouts.* Our long time readers know of our general disappointment with corporate management that searches the world over and decides that buying back their own stock is the single best initiative they can make on behalf of the shareholder.

In spite of our critical view on the general competence of management, the return on capital and cash flow generation from corporations is very high and cannot be ignored. Companies are benefiting from the lowest interest rates in history and have been able to lock in long term financing that lowers their after tax cost of capital. In addition, they have been effective at reducing operating costs including wages. So, while we expect to see volatility in response to our political environment and geo-political risks, we are increasing our allocation to domestic equities.



Source: Standard and Poor's

Earnings growth will likely come in below last year, but the quality of earnings has improved. Corporate America has probably experienced most of the productivity gains and peaks in profit margins; and, unless global demand picks up we expect these to put downward pressure on earnings in 2013. With GDP likely to expand only 2% and inflation kept low, we see revenues increasing 4-5% at best. If we add in overseas exposure, it may bring that total up to 6%. If profit margins are flat, we would expect earnings growth to be in line with revenues at about 6%. When you add in current dividend yields of around 2% that still gets us a respectable 8% total return in the equity markets. However, if global momentum picks up at all above projections, we could see a surprise to the upside. Currently P/E ratios are around 14x earnings. If we started to approach the 20 year averages of close to 16x, the market would return in excess of 20% and still not be overvalued. We are not that optimistic but we want to stress that the high quality and stability in earnings, strong balance sheets and increase in shareholder friendly initiatives should provide strong support to valuations.

We continue to focus on quality companies with strong balance sheets, consistent earnings, and strong cash flows. We are overweight stocks in the Technology, Industrials, Energy, and Healthcare sectors, and underweight companies in the Telecom Services and Utilities sectors. We also believe that domestically focused stocks will generate higher EPS than global stocks in 2013. Most analysts have recently made deep cuts to their estimates of global stocks, but have slightly raised 2013 estimates for domestically focused stocks. Of our overweight sectors, 73% of Industrial stocks, 43% of technology stocks and 67% of energy stocks derive less than half of their revenue from global sources giving us good domestic growth opportunities.

### Investment Grade Corporate Credit

The U.S. investment grade corporate bond market, measured by the Barclays Credit Index, produced a solid 9.39% total return for the past year. Risk spreads across all the major debt asset classes are extremely tight. After the Fed announced its third Quantitative Easing Program last September in which it would purchase \$40 billion in Agency MBS per month, investors cobbled up anything that offered a premium over US Treasuries. We are nearing a crossroads for US dollar denominated fixed income. With interest rates at historic lows, spreads near their tightest levels and the Federal Reserve manipulating the level of interest rates, we do not believe investors are adequately compensated for the risk in fixed income both in absolute terms and by historical standards.

Our sanguine outlook for the economy should help to keep a ceiling on interest rates over the near term. However, stronger than expected economic growth will surely force rates higher. Our strategy remains to focus on credits with maturities of five years and shorter in companies that have strong operations, strong balance sheets and adequate liquidity regardless of the credit ratings. Since the rating agencies apply ratings within the capital structure without regard to maturity, we believe there are anomalies in the short maturities where the risk of default or downgrade is less.

### High Yield Fixed Income

U.S. high yield, measured by the Barclays High Yield Index, produced a remarkable 15.81% total return for the past year. What makes this impressive is the low interest rate environment in which the return was achieved. Much of the return was the result of further compression in spreads, with the option adjusted spread contracting 40 bps to 511 bps. Companies that issue high yield quality debt have experienced earnings momentum and improved balance sheets over the past two years. Credit quality remains stable and we still expect default rates to remain below historic averages in 2013.

What disturbs us in the high yield market is the valuation. At year end, 84% of the Barclays High Yield Index had a rating of B3/B- or higher. That portion of the market, which we consider the investable portion, had a meager yield of 5.1%. The remaining 16% of the index which is rated Caa1/CCC and lower has a yield of 9.73%. We are still finding good investment opportunities in high yield credits; our strategy is to move down the curve and invest in those credits that

have maturities of four years and shorter. Valuations in the high yield market will respond to changes in volatility. The unsettled political environment, uncertainty with the domestic and European economies, and the geo-political environment could force credit spreads wider.



### Preferred Stocks

For investors looking for income, we continue to find value in the preferred stock market, particularly in the regulated banking and utility industries. As domestic and European banks have bolstered their capital levels over the past four years, the hybrid securities portion of the capital structure has been strengthened. Dividend yields have dropped into the 5% to 7% range and opportunities for capital appreciation are more limited. We are less excited about the REIT sector given our concerns on the valuations of the underlying real estate collateral and the operating performance for some of the property types.

### Municipal Bonds

Like other fixed income sectors, the municipal bond market posted solid performance last year. With the changes in tax rates for the highest bracket moving to 39.6%, some of the uncertainty in the municipal bond market has been removed. There are wonderful investment opportunities investing in municipal bonds, however buyers need to be prepared for sticker shock. While we believe that general obligation bonds and essential service revenue bonds are some of the safest investments, we still expect problems in municipal credits down the road. The problems will likely be concentrated in projects, tax increment finance districts and economic development zones that have poor structures and insufficient revenues relative to projections to fund debt service over the next several years.

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