Paul Comstock Partners ®
Your Partner in Investment Decision Making

COMSTOCK ®

1ST QUARTER 2012

Market Commentary

Looking Back At The Quarter

Relief over an orderly Greek debt restructuring and strong US economic data led to the best first quarter rally in the equity markets since 1998. Major developed market indexes returned 10-12% for the quarter while emerging markets gained 14%. Growth tended to outperform value, driven by strong performance of technology stocks and the consumer discretionary sector. Financials rebounded from their poor performance last year. The Energy sector lagged despite increasing crude prices. Defensive sectors such as Utilities, MLPs, and Consumer Staples that performed well last year underperformed the rally. These reversals generally meant that managers who outperformed last year lagged their index for the quarter and vice versa.

The US economy grew at an annualized real rate of 2.8% during the quarter, the best performance since mid-2010. Unemployment declined to 8.3% from a combination of private job creation and discouraged workers leaving the workforce. The unemployment figure reflects the stark reality that approximately 9 million jobs were lost in the 2008-2009 recession and only three million new jobs have been created in this recovery. Inflation declined to a 3.0% annualized rate as several key commodity prices moderated over the last six months. Despite current inflation levels, the Federal Reserve restated its commitment to maintain a zero interest rate policy through 2014.

Where We Are Now

S&P 500 Profit Margins at Record Levels

In a widely noted piece, James Montier of the investment management firm GMO recently observed that S&P 500 profit margins are at record levels and accordingly predicts poor equity returns as margins revert back to historical averages. Indeed the mean cap-weighted trailing twelve month net profit margin on S&P 500 companies now stands at over 13% - higher than the peak of the market in 2000 and only slightly below 2007 levels. The simple median profit margin – which is not skewed by large, highly profitable companies such as Apple or Microsoft – stands at 9.7%. These margins are a product of decisions made in 2009 when, fearing a depression, companies dramatically cut costs and locked in needed financing. When the economy began recovering later that year, they found their streamlined businesses able to handle the increase in activity, even when revenues per share for the S&P 500 regained their 2007 level last year.

While record high profit margins can only decrease in the long run, the conditions that created them can potentially persist for several years. A weak labor market keeps labor costs down. While oil remains expensive, cheap natural gas has reduced the cost of electric power which is a more important energy cost for most industries. Many established companies are better protected from competition in a more regulated environment where new startups find it difficult to attract capital. The companies in the S&P 500 are also the beneficiaries of globalization and have re-engineered their value chains to maximize the economies of scale available from global supply chains and markets. The S&P 500 is still trading at under 15 times earnings, which provides a reasonable margin of safety from permanent capital losses should the economy take a downward turn.

Outlook

Is Europe OK Now?

While the probability of a European collapse has largely disappeared from equity valuations, the situation remains far from stable. Spain and Italy continue to struggle with contracting economies and high debt loads. In the absence of a liquidity crisis, both economies face slow declines rather than the sudden collapse suffered by Greece. While the funds raised by the ECB are sufficient to avert a liquidity crisis, they do not address the longer term insolvency these countries face if they cannot resume a normal level of economic growth. Spain has a relatively low level of government debt but has an insolvent local banking system. Despite a housing bubble that rivaled the US, home prices have only fallen 20%. Italy faces a dire demographic future where the ratio of workers to retirees will approach 1:1 by 2030. Currently there is a bifurcated labor market where a segment of older, unionized workers receive guaranteed employment and early generous retirements while onerous employment laws relegate younger workers to part-time and contract labor. It remains to be seen whether the Euro can survive either country's temptation to devalue or default their debt problems away.

Political Uncertainty in the US

The US faces an election year that is bringing the worst aspects of its dysfunctional political process to the forefront. Nonetheless, events at year-end will force some difficult decisions and political compromise. The Bush tax cuts and the payroll tax cut both expire at the end of the year. On top of this, the mandatory spending cuts outlined in the Budget Control Act of 2011 expire. The combined impact of this fiscal austerity could cut 2013 GDP growth by two full percentage points. This abrupt lurch into fiscal austerity would likely throw the economy back into a recession. The difficulty both Congress and the Federal Reserve face is how to wean the economy from the fiscal and monetary stimulus that helped avert a more severe recession back in 2009. The US risks a future debt crisis if record budget deficits cannot be brought under control. Market volatility over the next several years will be driven by this policy uncertainty.

China in Transition

China's economy is in the process of transition to a lower growth economy less driven by low cost labor and exports. Wages are rising as the surplus of subsidence-level agricultural labor dries up due to the demographics of the one-child policy. Average worker compensation has risen by over 14% per year over the past decade. The over-investment in real estate and infrastructure that has been widely documented by observers in the West is also getting attention from Chinese officials. It remains to be seen how China can manage the transition from its current mercantilist system with its dependence upon government control of the country's savings through the system of state-owned banks and enterprises to one which allows a greater role for domestic consumption. Investment currently comprises over 50% of Chinese GDP, a number that most recognize as unsustainable (investment is 13% of US GDP). Martin Wolf observed in a recent piece in the Financial Times that to maintain 7% GDP growth (well below the 9-11% achieved over the last decade) and reduce investment to merely 40% of GDP, China would have to grow private and public consumption by 9% per year. As China has become the most important marginal consumer of most commodities, the growing recognition of these dynamics contributed to the underperformance of the Energy sector this quarter and recent weakness in commodity prices despite the relatively good economic news in the US.

What to do with your investments

Deleveraging continues to define and shape the global economic environment. The most likely scenario remains that the United States and other economies around the world will muddle through their respective problems at the cost of subpar economic growth and higher levels of volatility. We continue to believe that Comstock's investment strategy, which has always focused on owning quality productive companies and real assets purchased at reasonable valuations, is the only way to deal with an uncertain world. Knowing what you own and why you own it remains the only sensible way to stay the course. Not being pressured to sell depressed value assets when all looks bleak is the proper use of "bullet proof" credit for lifestyle needs. Participating in the current "hot" strategies or timing when or when not to be in the markets is a sure way to permanently impair or lose your investment capital. We continue to believe our diversified, high quality asset strategy can add substantial value over the coming years regardless of the short-term market activity.

- By Steve Browne, CFA, CIO

Questions? Please give us a call! (713) 977 2694.

Smart Investing Webinar

Download the recording of the First Quarter Market Update Webinar recorded Tuesday, April 10, 2012 from the Paul Comstock Partners website under First Quarter Market Update Webinar.

Listen to Steve Browne, CFA, Chief Investment Officer as he discusses the highlights of the first quarter's record market performance and provides perspective through the analysis in the presentation to help investors understand its impact on investment portfolios.

In addition to answering questions from participants, Steve addresses the following questions impacting 2012's outlook:

Has the Greek debt restructuring solved Europe's problems?

How will the election and expiration of the Bush and Obama tax cuts at year-end affect the financial markets?