Lindisfarne Investments, LLC

An island of safety in a sea of risk

Market Update
December 14, 2012

The holiday seasons are upon us once again. We typically rush around making plans for getting together with family and friends and searching for those perfect holiday gifts. And even though the dark clouds are more numerous than usual, the holidays remind us that there is more to life than the hustle and bustle. Take time to appreciate and acknowledge those people and things that we too often take for granted. As Newton, CT has reminded us, they can be gone in an instant. Give something to those with less than we have been blessed with. Volunteer, donate your time, contribute to the Salvation Army Santa on the street corner, move out of doing the same holiday routine that we seem to fall into. You'll find new meaning to "peace on earth" when you express "good will toward men".

I wish each and every one of you a Merry Christmas, Happy Hanukkah, Joyous Kwanzaa, and whatever is the most appropriate expression for you and yours.

General Economic Conditions

All I want for Christmas is a good old fashioned compromise among our elected leaders. One that is an appropriate, effective solution to the philosophical and economic divide we are in. We are now paying for all the excesses, largess and pandering that has been the modus operandi of our political system for decades. You can only kick the can down the road for so long until you come to a wall. The time has come to man up.

But it's hard to forge an effective solution when there seems to be such a difference in basic beliefs about what to do. The Pew Research Center's poll on the major ideas being presented shows a lack of consensus across the board. Everyone is saying the equivalent of "Not in my backyard, don't cut what is important to me".

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On the taxation side:

Taxation

Subject	For	Against
Raise taxes on income over $250,000	69%	28%
Limit deductions	54%	40%
Raise tax on investment income	52%	43%
Limit home mortgage interest deduction	41%	52%

For entitlements:

Entitlements

Subject	For	Against
Reduce Medicare for high income seniors	51%	46%
Reduce Social Security for high income seniors	51%	46%
Gradually raise Medicare retirement age	42%	56%
Gradually raise Social Security retirement age	41%	56%

For defense, education, roads and low-income benefits:

Defense, education, welfare, infrastructure

Subject	For	Against
Reduce military defense spending	43%	55%
Reduce funding for low-income Americans	38%	58%
Reduce funding for education	21%	77%
Reduce funding for roads and transportation	30%	67%

Taxes: our taxes are going up….the debate has centered around rich vs non-rich. The table below shows that even without a fiscal cliff solution, you will be paying much more taxes. Shh – don't tell anyone. It seems that the number one job for any politician is to increase taxes…

Individual Income Tax Rates

Tax Brackets (2012 Dollar Amounts)				Marginal Rate	
Unmarried Filers		Married Joint Filers			
Over	But Not Over	Over	But Not Over	2012	2013
$0	$8,700	$0	$17,400	10%	15%
8,700	35,350	17,400	70,700*	15%	15%
35,350	85,650	70,700*	142,700	25%	28%
85,650	178,650	142,700	217,450	28%	31%
178,650	388,350	217,450	388,350	33%	36%
388,350	...	388,350	...	35%	39.6%

Long-Term Capital Gain Rates

Maximum Rates	2012	2013	2013 (including Medicare contribution tax)
Long-Term Capital Gain	15%	20%	23.8%
Qualified 5-Year Capital Gain	15%	18%	21.8%

Dividend Income Rates

Maximum Rates	2012	2013	2013 (including Medicare contribution tax)
Qualified Dividend Income	15%	39.6%	43.4%
Ordinary Dividend Income	35%	39.6%	43.4%

Entitlements: the best comment that I have heard about the demonization of Medicare and Social Security benefits is "These aren't entitlements! I paid for them." It seems that yesterday's politico promise is today's renege.

Defense, etc.: these are the funding areas that keep this country safe and make it the kind of place that we want to live in. For both education and infrastructure, we have nickeled and dimed them for far too long.

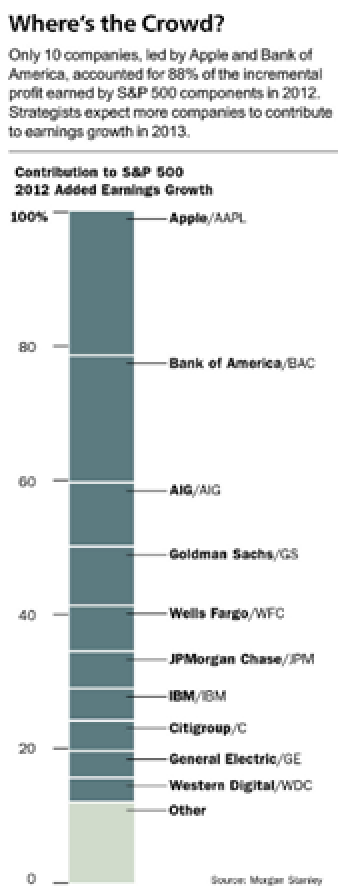
In reality, the fiscal cliff is much more like a fiscal "slope". The world doesn't end if a compromise is not reached. As we mentioned last time, it is much more likely going to be a "Patch and Promise" followed by a promise of a "Plan" sometime in 2013.

The thing that bothers me most is the statements made by the bond rating agencies. I paraphrase here "Lack of a fiscal cliff resolution will most likely lead to a further downgrade of the U.S. bond ratings." Our last ratings downgrade in 2011 was based in large part on the lack of political will to do what was necessary to put the U.S. back on the road to the highest fiscal standards. And a year and a half later, nothing has changed.

What the Charts Are Saying

"Short term, the markets are a beauty contest. Long term, they are a weighing machine". Translation: In the near term, the markets are driven by news, hype and hope. Longer term they are driven by performance (earnings).

I was quite surprised when I saw the following chart that put the earnings of U.S. companies in a different perspective. Was it such a great earnings season after all?



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Revisiting a chart from last time, we have marked the same support, resistance and trendlines on the following 6 year chart of the S&P 500. The market marginally penetrated and pulled back from the overhead resistance that must be surpassed to give us the all clear, things are back on track.

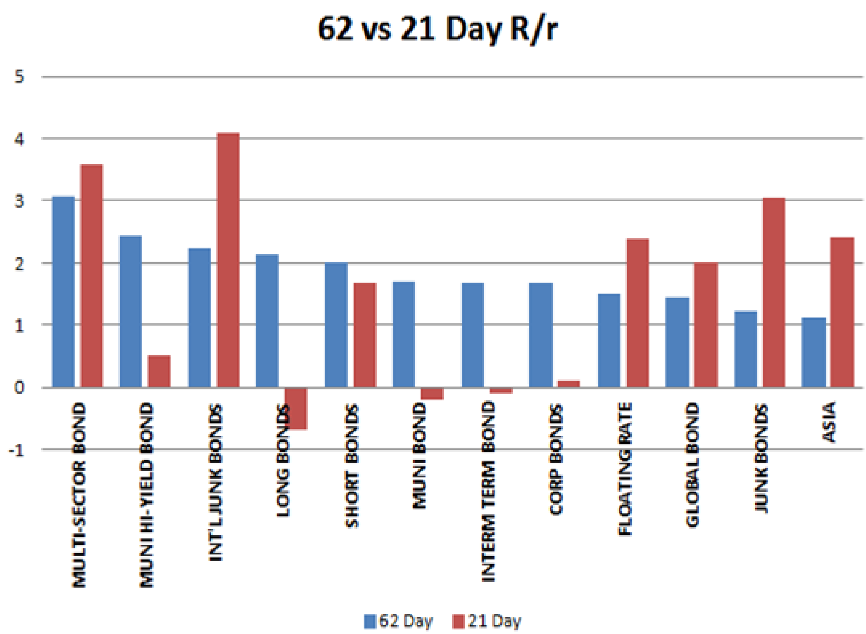
If we get a significant fiscal cliff solution it remains to be seen if the market can pierce the top of this resistance zone. If not, then we can expect at minimum, a prolonged sideways experience and at worst a retracement to support (-30%) or to 2009's lows (-50%).

The next chart gives a one year look at the S&P 500 and shows more clearly the encroachment and pullback from the overhead resistance area.

S&P 500 … 1 Year Chart

Next, we look at the market behavior over the last month and compare it to that from the most recent high on September 14th (62 days ago). From an R/r perspective, for the first time in a long time, we see a significant shift in the leaders. If you recall, previously, the top ten sectors where dominated by bond related mutual funds.

Five of the better performing bond sectors have dropped significantly in their performance. The exceptions are Hi-Yield (junk) funds, both domestic and international, and multi-sector bonds. Asian securities have also done better.



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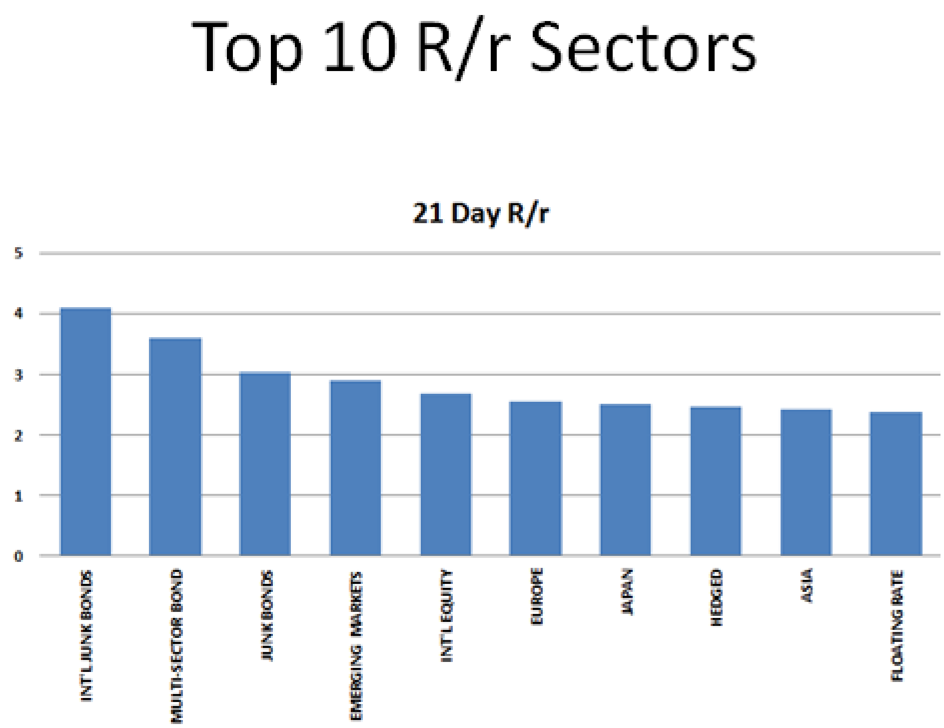
The best performers over the last month are show in the next chart. Three bond funds are still at the top of the ranking. However, we have equities securities entering the top ten for the first time in a long time. Emerging markets, international equity, Europe and Japan hold down the fourth through seventh positions, with Asia not far behind.

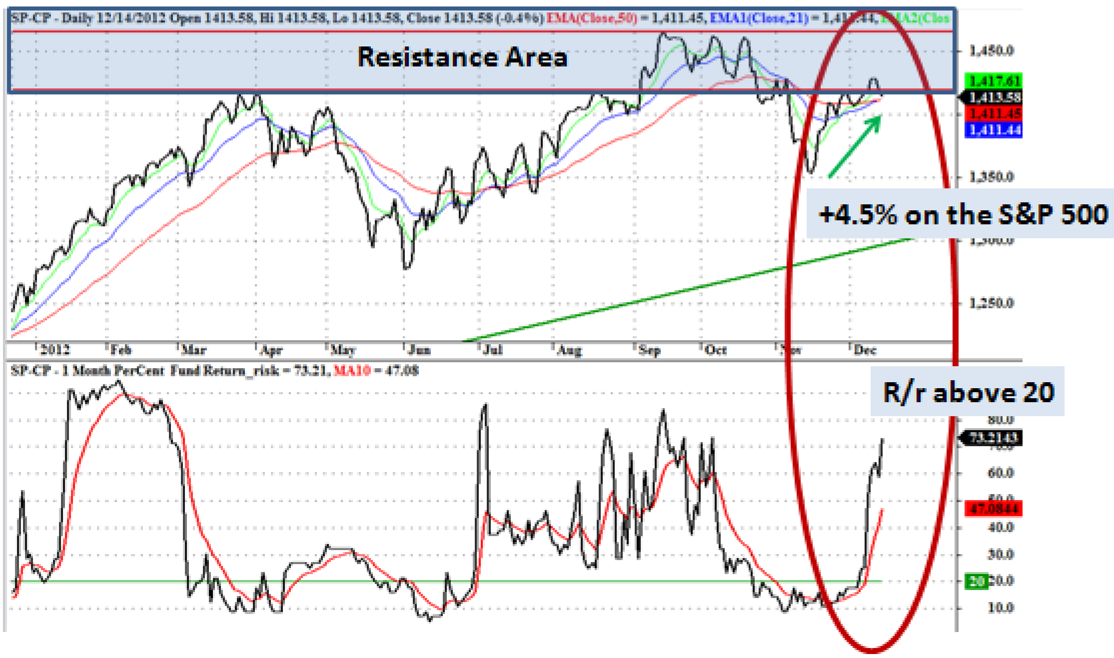
What is the equity theme here? It certainly is not the U.S.



Overall, the R/r has been increasing shorter term as the S&P 500 has moved back up to the resistance zone. The 4.5% increase in equities since November 15th has brought the percentage of economic sectors with R/r greater than one up to 73 percent as of Friday.

The question before us is will the overhead market resistance blunt the advance in the better performing groups. Or, since the market forecasts the economy 9 months or so from now, are we seeing the early signs of an overall robust market advance.

S&P 500 … Improving R/r ???



We Are We Invested

We remain invested in the safer sectors of the market, e.g. bonds. However, the nature of the market leadership seems to be changing. Our municipal hi-yield investments are close to giving us a sell signal. If it comes, we will lighten our holdings there. And we, as always, will continue to monitor our other investments for any sell signals and take the necessary actions. And we continue to watch for those equity buy signals that have been absent for so long….

Please feel free to pass this update on to anyone that you think might be interested in it. If they wish to be on the mailing list or would like more information about the services of Lindisfarne Investments, we can be contacted by phone at (440) 623-0775 or by email at bill@lindisfarneinvestments.com .

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