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Quarterly Review

After a dismal third quarter, when concern over the economy and debt ceiling drove stock prices lower, equities came roaring back in Q4 on improving economic data. Signs of a strengthening economy are numerous, and include consumer confidence, retail sales, pending house sales, lending activity, and employment. Corporate profitability, the untold story of recent years, continues to be outstanding. As fourth quarter earnings results filter in over the next few weeks, we expect the trend to remain in place.

Europe put forward its latest new plan to instill fiscal discipline to the Eurozone members. Markets received this relatively well, but some of the details have yet to be worked out and many remain skeptical. The continent is in the difficult position of needing to cut public spending in a time in which the economy needs that support the most. It seems clear that Europe has entered recession. The question is whether the US can continue to chug along while Europe slows. One economist recently wondered whether the US can possibly pull up Europe, something few are considering.

Cyclical stocks posted strong gains in the quarter, right after many investors had gotten defensive – which is the way it usually works. Some of the industries that had been left for dead, such as homebuilders and financials, were the standout performers. Our sense is that the economically-sensitive segments of the market should continue to perform well, as the economy strengthens. The long awaited improvement in the employment picture is especially encouraging, as it improves the sustainability of the recovery. There are many indicators (unemployment claims, job openings, jobless rate, business confidence, business formation, etc.) that, while far from ideal levels, are at least finally moving in the right direction.

As far as investment flows are concerned, investors have largely shunned domestic equities, and the ones that haven't have gravitated toward more defensive sectors. The reason for this is two-fold. First, people are nervous about the state of the global economy, and thus they are seeking the stability of areas like consumer staples and utilities, which are not as economically sensitive. Second, companies in these areas tend to offer juicy dividend yields, and with bond market rates at such low levels, investors searching for yield have broadened their search into equities. This has driven the prices of these stocks up, making less income-oriented stocks (i.e. growth stocks) more attractive by comparison. This relative attractiveness is only increased by the improving economy.

While many managers are playing catch-up by scrambling to get into these cyclical sectors, our portfolios are already positioned to benefit, and we are encouraged by the results so far in 2012.

Best regards,



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