

The Euro Crisis



I don't like alarmists, especially those who write about financial matters, manage money, or publish investment advisory services. Many do so to grab headlines to get your attention so that you will subscribe to their service. The internet is full of them.

At the risk of sounding like one, I think the Euro crisis is a serious matter and is certain to be disruptive very soon. We explain the reasons for our concern in this Issue. Accordingly, we are disposing of 12 of our model portfolio positions – those most vulnerable to these disruptions. (See the Portfolio Updates on page 5.)

We are publishing early this month because we believe our advice in this issue should be considered sooner rather than later, and January is often a month we make investment decisions for the new year.

The green light given by our Diffusion Index of Leading Indicators in March 2009, very close to the bottom turning point of the market, remains in force. So we are still constructive on the overall market, and our model portfolio positions have done well since the last Issue.

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Here is to a happy and prosperous new year.

-Gray Emerson Cardiff

Europe is our largest trading partner. It purchases 20 percent of our exports. Our largest companies tend to be multi-national; have considerable assets in the Eurozone and generate a substantial portion of their earnings from these nations. The economic health of Europe is vital to the prosperity of the US. We are making some changes in our model portfolio because, as we explain below, there are forces on collision paths in Europe that are likely to have an adverse effect on the performance of some of our current holdings.

Genesis

Prior to the adoption of the Euro as a single currency, European countries were free to use monetary policy as they saw fit. They could adjust their own interest rates in accordance with their respective economies, increase their money supply to fight recessions, and even print money to stimulate growth or pay for public services instead of raising taxes. Among these countries were a wide range of historical and deep-set cultures, work ethics, ideologies, inflation tolerances, and economic practices. Whatever was going on among these countries, the ultimate adjusting factor was floating currency exchange rates. The marketplace would simply push exchange rates up and down, to adjust for the differences.

Ever since the end of World War II, Europe has had the desire to unite. Europe Day celebrates the merging of French and German coal and steel production in 1950, making wars impossible, and the first major step to unifying Europe. An economic union developed whereby goods could cross borders freely.

A single currency was the logical next step in the unification. A European Union summit in Maastricht in 1991 laid the foundations for a single currency. As part of the agreement, each member nation pledged to limit its deficit spending and debt levels in order to avoid disruptions inside the union.

A single currency meant that commercial trade across borders no longer involved currency costs, and travelers would not have to exchange currencies on their trips. Commerce would be bolstered by the elimination of uncertainties caused by fluctuating currencies. Forward contracts could be written and the value of future payments would not be changed by currency fluctuations. Credit could also be extended more easily because the debt would be repaid in the same currency. Interest rates would be more uniform and lower because credit risk from currency fluctuations would be gone. More importantly, interest rates could be set for the new single currency from a new European Central Bank (ECB), much like the Federal Reserve does for the US. European leaders believed that unification under a new single currency would greatly enhance economic growth for the continent. Accordingly, the Euro was introduced on January 1, 1999, and the individual currencies of each member country began phasing out.

Although there are 27 countries in the European Union (EU), the official Eurozone

The SoundAdvice Portfolio



SoundAdvice vs S&P 500

Since 1/1/2000
\$25,000 becomes:

\$74,549

VS

\$26,403

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SoundAdvice



countries initially included 11 nations: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. Greece joined in January 2001, Slovenia in January 2007, Cyprus and Malta in January 2008, Slovakia in January 2009, and Estonia in January 2011.

With its new single currency, along with easy credit conditions set by the new European Central Bank (ECB), economic and real estate booms were propelled across Europe into 2008. The ECB set interest rates at low levels, appropriate for Germany, where inflation was low. In other countries, where inflation was higher, these low interest rates were very attractive and encouraged excessive borrowing. During the excitement, the pledges to limit government spending and deficits given in the Maastricht pact were exceeded by all nations, even Germany.

Interest rates were even negative in Spain after accounting for its inflation, and encouraged both households and businesses to borrow heavily which fueled an enormous real estate boom. In Ireland, the state guaranteed the financing from its major banks who were making real estate loans to developers and homeowners. Low interest rates and access to easy credit also fueled over-spending in Portugal which resulted in investment bubbles in both public and private programs.

Greece's government also enjoyed the low interest rates and easier credit it was afforded as a new member of the Eurozone. It borrowed heavily and ran large deficits to finance its defense spending (against its ancient enemy the Turks) and pay for public programs and services without raising the necessary tax revenues.

When financing dried up after Lehman collapsed, and the world economy took a nose-dive in 2008, so did the economies of the Eurozone nations. Hardest hit were Greece, Spain, Portugal, and Ireland. The wind whistled out of the European real estate markets which was particularly devastating to Spain and Ireland. The Irish government borrowed from the European Central Bank to pay off bond holders of its major banks while the unemployment rose to 14 percent. In Spain, the unemployment rate climbed over 20 percent as a newly elected government began imposing new austerity measures.

Portugal's unemployment rate has climbed to 12.4 percent as their sovereign bonds were demoted to "junk" status along with those of Greece, and will likely need a second round of bailout funding.

Greece's major industries of shipping and tourism were devastated, compromising the entire Greek economy. Its 10-year sovereign bonds currently yield 35 percent and are worth somewhere south of 50 percent of par. Unemployment has risen to 18.4 percent.

Fiscal Space

A new report from Moody's *Economy.com* called *Fiscal Space: A New Gauge of Sovereign Risk*, indicates that much of Europe is in a precarious situation. A concept introduced by the International Monetary Fund (IMF), called fiscal space, is defined as the amount by which a nation's sovereign debt-to-GDP ratio can increase before a nation becomes a high default risk.

Once having run out of fiscal space, the interest rate a country pays on its sovereign debt becomes very important (as measured by its 10-year bonds.). There is a critical interest rate,

above which a nation's debt load spirals out of control because the cost of servicing its debt increases more quickly than its GDP. If a nation reached this "critical mass", the risk of default is high.

For example, for the US to be considered a high default risk, its debt-to-GDP ratio would need to increase by 171 percentage points, from its current level of 65 percent to 236 percent, and 10-year Treasury rates would need to climb sustainably above 8.7 percent from roughly 2 percent currently.

Although the US debt-to-GDP ratio has grown by an alarming 30 percentage points during the last several years, we are not close to running out of fiscal space. Such is not the case for much of Europe.

Greece, Ireland, Italy, and Portugal have already run out of fiscal space, and are at critical mass. This means that the policy makers of these countries cannot conduct business as usual. They must take extraordinary steps in order to avoid a default. At their current debt loads and growth prospects, to change their status as a high default risk, the interest rate on the sovereign debt of these nations will need to drop sharply from current levels, the prospects of which are not likely in the near future. The interest rate on Greece's 10-year bonds would have to drop to 1.6 percent (from 35 percent); Ireland's sovereign debt would need to fall below 6.3 percent (from 8%+); Portugal's to 6.1 percent (from 13%+).

Italy's sovereign debt yield would have to fall below 4.3 percent. In November 2011, the rate on Italy's 10-year sovereign bonds fell from 7.5 percent to 6.7 percent as a new emergency government replaced Prime Minister Silvio Berlusconi and new austerity measures were proposed. Dropping below 7.0 percent was significant because a rate above 7.0 is considered to cause a nation to lose access to the financial markets. Italy's progress is very important because it is "too big to fail." Italy is Europe's third largest economy and does not have a coherent strategy for dealing with its €1.9 trillion of debt.

Other European countries are in danger zones because their economies are weakening with debt-to-GDP ratios currently close to 125 percent. These countries include France, Spain, Belgium, and Iceland. The rates on the sovereign debts on these countries must stay under 7 percent in order not to be considered a default risk.

The Moody's report concludes that ECB purchases of sovereign debt are critical to ensuring that yields remain below these critical rates. Otherwise the European debt crisis could quickly spiral out of control.

In December, the Fitch rating service announced it was considering downgrading Italy, Spain, Belgium, Slovenia, and Cyprus.

European Debt Maturities in 2012

European nations have €1.1 trillion of sovereign debt maturing in 2012. It must be repaid or rolled over into new debt. Greece's portion is €31 billion. Italy has €168 billion maturing with €157 billion due in the first four months: €16 billion in January, €53 billion in February, €44 billion in March and again in April. Spain has €61 billion maturing in 2012, €54 billion of which is due in the first four months. France has €52 billion in January, €36 billion in February, €17 billion in March, and €34 billion in April.

European banks also have a high debt load coming due in 2012 -- close to one trillion Euros. When added to the sovereign debt, there is close to €2.1 trillion in debt that will need to be repaid or rolled over into new debt in 2012.

Contagion

The concern is that so many European banks are holding substantial quantities of debt from countries that have reached critical mass or are dangerously close.

French banks own €393 billion of debt of countries that have reached critical mass: €309 billion of Italian debt, as well as €41 billion of Greek debt, €19 billion of Portuguese debt, and €24 billion of Irish debt. French banks also own €112 billion of Spanish debt.

Spanish banks own €94 billion of debt of critical mass countries: €65 billion of Portuguese debt and €29 billion of Italian debt.

An increase in Italian rates will put upward pressure on debt costs for French and Spanish banks.

German banks own €254 billion of debt of critical mass countries: €120 billion of Italian debt, as well as €16 billion of Greek debt, €26 billion of Portuguese debt, and €82 billion of Irish debt. German banks also own €132 billion of Spanish debt, and €123 billion of French debt, both of which are in the danger zone.

The European Central Bank (ECB)

The European Central Bank (ECB) resembles the structure of a corporation in that it is capitalized with €5 billion by its stockholders which are the national central banks of the Eurozone countries.

Monetary policy for the Eurozone is the responsibility of the ECB. It has the sole authority to issue Euros and is charged with keeping inflation under control. In similar fashion to US central banking and the Federal Reserve, member banks can borrow from the ECB to gain liquidity by pledging collateral in exchange for Euros. Collateral can include a wide variety of debt held by the borrowing member bank, including sovereign debt.

However, the weakness of the sovereign debt pledged from Portugal, Ireland, Greece and Spain is now considered compromised collateral and is impairing the ability of member banks to borrow from the ECB, which is in turn impairing the liquidity of the European banking system.

To counter this liquidity problem, questionable sovereign debt has been moved off the balance sheets of weak member banks onto the balance sheet of the ECB. This is effectively monetizing the questionable sovereign debt because it is being exchanged for a new supply of Euros -- a potentially inflationary threat.

As a counter measure to this inflationary threat, the ECB is urging weaker member nations to allocate more national income to servicing their debts and scale back on national expenditures including welfare, education, infrastructure, and other popular social programs. Such cut backs have led to riots and political protests in Greece.

As an injection of liquidity into the system, in late December, the equivalent of a quantitative easing program, was launched by the ECB. Three-year loans were offered to European banks

at an annual interest rate of 1.0 percent. Loans totaling €489.2 billion were taken. Although the net injections were €208 billion after subtracting shorter term loans owed to the ECB from these banks, it calmed things down because it moved out maturities of existing debt and gave banks some breathing room. Another quantitative easing program is scheduled for 2/29/2012 (leap year).

The European Financial Stability Fund (EFSF)

In May 2009, the European Financial Stability Fund (EFSF) was created to provide financial assistance to Eurozone countries in financial difficulty by providing loans, recapitalizing banks, or buying sovereign debt.

In order to raise funds, the EFSF can sell bonds that are guaranteed by the Eurozone countries in the same proportions as their paid-in capital to the ECB. Including a €250 billion pledge from the International Monetary Fund (IMF), the total lending capacity is €750 billion. Efforts are ongoing to increase the size to one trillion Euros.

The EFSF has been assigned the best possible credit rating (AAA by Standard & Poor's, Fitch Ratings, and Moody's).

The EFSF can act once a request for support is made from a euro area nation that is unable to borrow on the markets at acceptable rates. A program for the nation must be negotiated and unanimously accepted by the finance ministers from each of the other Eurozone countries.

Scheduled to take over for the EFSF in July, 2012, is the European Stability Mechanism (ESM), which will operate the same way on a permanent basis.

Implicit in this arrangement is that wealthier countries are guaranteeing the sovereign debt of the weaker countries who are default risks.

The Power Struggle

Germany, the strongest of the nations and 27 percent of the EFSF, is taking a hard line against the weaker countries. It staunchly opposes any solution that incorporates issuing more debt, or any other approach that could be inflationary. Their aversion to inflation comes from their own history. Grainy films of Germans rolling wheel barrels of marks remain emblematic of their hyper inflation after the first World War. The Deutsche Bundesbank (Germany's national central bank) continuously urges the ECB not to buy up too many sovereign bonds from heavily indebted countries. In the eyes of Germany and its Chancellor, Mrs. Angela Merkel, the only solution to saving the Euro is greater austerity and fiscal discipline.

On the other side of the struggle are those who believe the austerity being imposed on the more troubled countries will prolong and deepen their recessions, and are deflationary forces for all of Europe. Christine Lagarde, the managing director of the IMF has been quoted: "the global economy is faced with threats similar to those which triggered the Great Depression of the 1930s."

Jens Weidmann, head of the Bundesbank, asserted that the IMF poses additional risks to Germany's €211 billion share of the EFSF because the IMF's debts get paid back first. He was quoted at a recent summit: "The risk structure of Germany's maximum guarantee of €211 billion changes significantly if the

IMF becomes significantly involved in additional programs for Eurozone countries.”

He also insisted that before Germany sends its €45 billion share to the IMF, it needs assurances that other IMF members outside Europe are also willing to help out. But the US and Canada are showing no interest in devoting more money to the IMF.

Weidmann remains openly and vociferously opposed to the ECB buying any more bonds to keep borrowing rates down for countries such as Italy and Spain. Mario Draghi, the head of the ECB, has become a convert. He has stated that he doesn't want the ECB to be Europe's lender of last resort: “There is no external savior for a country that doesn't want to save itself.”

Conclusions

There is not an easy way out of the Euro crisis. This outcome is uncertain at best, and no solutions are painless. There are a variety of possible scenarios, ranging from disastrous to not pretty.

The disaster scenarios include a financial meltdown of the European banking system which has close to one trillion Euros of debt coming due in 2012. In addition, these banks hold €1.1 trillion of sovereign debt maturing in 2012. Critical mass countries total €199 billion (Greece and Italy), and danger zone countries (Spain and France) totals €141 billion coming due in the first four months alone.

There is the safety net of the EFSF. However, it may not be enough both in terms of lending capacity or credibility. The majority of the EFSF, established to help the weakest countries and their banks, is made up of the weakest countries. Italy is 17.8 percent of the EFSF. Adding Greece (2.8%), Ireland (1.6%), and Portugal (2.5%) brings the total from countries in critical mass to 24.7 percent of the EFSF. Adding countries in the danger zone: Spain's portion of 11.8 percent brings the total to 36.5 percent, France's portion of 20.3 percent brings the total to 56.8 percent, and adding Belgium's portion of 3.4 percent brings the total to 60.2 percent.

So there is a chance that all this financial engineering may not work. In the December EU summit, the Fitch rating agency “has concluded that a comprehensive solution to the Eurozone crisis is technically and politically beyond reach.”

There are plenty of triggers for disintegration: A failed bond auction, irreconcilable disagreement between Greece and its rescuers over the conditions of its bail-out, downgrades in sovereign credit ratings, or the bankruptcy of a major European bank.

On January 4, 2012, Unicredit, Italy's largest bank, offered €7.8 billion of stock rights to its existing shareholders. The rights allowed the purchaser to buy additional Unicredit stock at a 69 percent discount from its current market value. Only 24 percent of the offering was subscribed, which spooked investors causing a 14.4 percent drop in the price of Unicredit stock.

This failed attempt to raise equity is an indication that other European banks will have difficulty raising badly-needed capital.

Short of a meltdown, the Eurozone could break up whereby some or all nations return to their own currencies. That could still cause a run on banks as depositors panic to move their money to safer currencies and places. There would certainly be

a degree of capital flight to safer havens, and financial markets could deny funding or make financing prohibitively expensive for at least some European nations. Exiting countries would likely go back to their old habits of printing money to solve their fiscal problems and stimulate their economies out of deep recessions, eventually resulting in high inflation rates.

Short of a break-up or a meltdown, the current efforts may eventually succeed. However, there is a deep divide. At one end are those who want an immediate solution in the form of an unconditional backstop for European debt such as a larger bailout fund. However Berlin insists that any open-ended unconditional bailout funding would encourage errant governments to profligate spending and raise its borrowing costs. Instead, help should be conditional on austerity and strong fiscal rules with severe consequences if not followed.

So far, Germany is winning the battle because it has the biggest financial hammer, and it will continue to use it as long as it can. However, the disaster scenarios for the Eurozone, or even a significant number of countries, will not be good for Germany either. So Germany is likely to acquiesce if conditions get too severe.

The best scenario seems to be a genuine union, with the effective elimination of sovereign governments controlling their own fiscal policies. A central bank or power will need to be in charge of both fiscal and monetary policies of all Eurozone nations.

But the road will not be smooth or painless, and likely to take more time than anyone wants. There will be many months, if not years ahead of major negotiations and adjustments that will likely erupt from time to time in economic and political turmoil. Several nations are currently in the grasp of severe recessions, and a total Eurozone recession of some degree seems unavoidable, especially given the austerity measures taking place. The only question is how long and deep will it run.

The indexes for Eurozone purchasing managers for both manufacturing and services, are reliable leading economic indicators both here and abroad. They peaked in early 2011 for the Eurozone and have dropped significantly below 50 percent since mid-2011. (Readings below 50 is evidence that activity is shrinking).

The European Commission's indexes of business confidence in the Eurozone for both services and industry have been in sharp decline since early 2011. The indexes for consumer retail and trade confidence are also dropping, along with the Eurozone economic sentiment indicator. All of these confidence indexes are now in, or heading into the low territory seen in 2008 and 2009. These indices can be followed on www.euroeconomics.eu.com/surveys.

It is hard to imagine how the US will be immune. In even the best scenario, a Eurozone recession will be a drag on the US economy and dampen growth, especially for US companies doing a significant amount of business in Europe.

Accordingly, we are eliminating several positions from our model portfolio, particularly those with significant international exposure, along with highly-cyclical stocks most dependant on a robust recovery in the US economy to give us a good performance. SA

Portfolio Updates

Based on the disruptions ahead coming from Europe, we are selling the following positions in our model portfolio:

Honeywell International has its fortunes tied to the health of the global economy. We no longer believe that HON will outperform the market nor is it especially poised to bring us a particularly good return this year. We have more than doubled our money in HON, and it is time to take our profit.

Dodge & Cox International Stock Fund has been having a tough time, and based on its focus on international exposure, times are bound to get tougher. This fund has not done particularly well and we are moving on.

Dodge & Cox Stock Fund has also been having a tough time recently due to its heavy weighting in international stocks as well as the financial sector. We think we can do better elsewhere.

Microsoft continues to extend its reach into the PC market with *Windows 7*, but growth is being limited by the popularity of tablets and smartphones. MSFT is trying to enter high growth arenas with *Windows 8*, which is aimed at HP and Dell tablets, but it has been delayed until at least the middle of 2012. Its Xbox is finding appeal with gamers and is a growth prospect, but it is a relatively small part of this software giant. With international growth limited due to global conditions, and without immediate growth prospects for a substantial portion of earnings, we think MSFT is too big to move and will not bring us attractive gains ahead. We have made a profit from this stock, but we think we can do better elsewhere going forward.

International Speedway is showing declines in revenues due to disappointing attendance, lower food sales, and in hospitality events and sponsorship. Growth resurgence is now much more dependent on a vibrant US economy. This position has not been profitable and it is time to move on.

CarMax is also showing weakness in both same unit sales and in new car sales. Because it is a highly-cyclical stock dependent on a robust US economy, our views have changed regarding its growth prospects. We have a nice profit and it is time to cash in.

Superior Industries is having problems with deteriorating margins. Tied directly to the automotive industry, the growth prospects of this cyclical company have diminished. This stock has not been profitable and we can find better places for our money.

Fastenal faces risks similar to those of a traditional industrial company, since nearly half of its customers are in the manufacturing sector. Sales have been slowing down recently, both on a company-wide and a same-store basis. FAST is trading near its 52-week range high. We have a nice profit. It's a good time to take it.

United Parcel derives more than 20 percent of its revenue from international sources and its health is tied to the global economy. UPS is counting on expanding its international

package shipping for growth, but we think growth has likely peaked and the next several quarters could be disappointing. We think it is a good time to take our profit.

Time Warner is stagnating mainly because advertising in its print media is a significant portion of its earnings. We think the time is right to put our money to work in a more dynamic situation.

Wal-Mart has had 3 straight quarters of margin declines. It has 4,557 international stores, 753 more than in the US. It caters to lower-end consumers who are the most affected by reductions in government expenditures and poor economic conditions. International operations are treading water and we don't see any reason for them to improve. It is a good time to take our profits.

Anglo American is highly cyclical because it has a heavy stake in industrial metals and minerals, and is sensitive to commodity prices. In view of the current deflationary forces at work in Europe, Japan, and recent weakness in China, this stock is likely to be lackluster at best. Copper is known as the "metal with a PhD in economics" because of its many uses as an industrial metal throughout the world. Copper prices are in a serious downtrend as world demand slows. We have made our money in this stock and it's time to move on with our profits.

Here are brief updates of the holdings we are retaining in our model portfolio (and changes from the last Issue):

USAA Precious Metals and Minerals Fund (-5.9%) has consistently turned in a strong performance in a variety of economic environments. We are nervous about the prospects for gold and other precious metals due to the current global deflationary forces currently at work. On the other hand, weakness in the Euro will encourage gold purchases from Europeans as their currency declines. We have made money with this fund over the years and are sticking with it for the moment because of its balanced approach to investing in solid low-cost producers.

All of our REITs advanced. **Associated Estates (+4.4%)** remains deeply undervalued to its underlying portfolio of high-quality apartments.

Commonwealth REIT (+6.8%) has announced it will spin off its Hawaii light industrial property as well as its remaining 25 suburban office properties into another REIT: Senior Income Properties. This culminates the transition CWH has been undergoing as it moved its portfolio away from suburban properties toward office buildings in central business districts (CBD). Wall Street places better values on CBD REITs which should help its image now that CWH derives more than half of its revenues from CBD properties. We expect that CWH, as it has done with other spinoffs, will retain a major position in the other REIT.

CGM Realty Fund (+2.8%) continues its bet on apartment

REITs with 30.7% of the portfolio in that sector followed by retail (16.3%) and hotels (14.3%) with office/industrial trailing at 12.3%.

Retail Opportunity (+5.1%) is different than most REITs. It is not saddled with debt on a portfolio of real estate purchased before the meltdown. Quite the contrary: it is a recently-formed REIT with a fresh \$400 million to invest in a landscape replete with outstanding buying opportunities.

Third Avenue Focused Credit (-5.6%) is at the low end of its 52-week trading range and sports a 7.9 percent yield. While higher-risk credit investments are generally not desirable when recessionary forces are at work, this fund is focusing on carefully selected distressed debt and special situations, and the risk/reward looks favorable from here.

Boston Scientific (unchanged) stock was purchased by three insiders during the past month. On Nov. 29, N.J. Nicholas purchased 10,000 shares at \$5.56. Nicholas also purchased 30,000 shares of the stock in total at around \$6.67 per share in May. On Nov. 28, Ernest Mario and Katharine Bartlett bought 100,000 shares and 8,000 shares respectively at around \$5.40 per share. Mario also bought 25,000 shares at \$5.30 on Nov. 21 and 50,000 shares in total at around \$5.50 per share in October. Like Nicholas, Mario bought the stock in May as well. He purchased 2,500 shares at \$6.72 in mid-May. Insider purchases in BSX sends "strong buy" signals and outsiders can imitate insiders without paying a premium in this case. Omega Advisors had nearly \$100 million in BSX at the end of the third quarter.

Leucadia (+3.3%) is a holding company, which occasionally teams up with Warren Buffett, that is aimed at purchasing lucrative investments substantially below their intrinsic value. Skillful investing has produced double digit growth rates in its assets since 1979, and higher growth rates since 2008. This is a great way of participating in the private equity market with a diversified array of undervalued assets at the direction of world class investment managers.

Masco (+22.9%) is a manufacturer of a wide range of products for home construction and remodeling, and its share price was crushed during the unwinding of the housing bubble. We recently added it to our portfolio in October 2011, at \$7.49. It has increased 54% since then. The shares rallied along with home builders and related industries after the National Association of Realtors reported that pending home sales rose 7.3 percent in November. It is still a buy below \$11.60.

Pfizer (+5.1%) is finally over the patent expiration for Lipitor (as of the end of November), and the share price has been rising ever since. Evidently the pipeline is richer than Wall Street credits it, and management continues to trim the company by getting rid of non-core assets (veterinary products) and extracting efficiencies from the Wyeth acquisition.

Transocean (-8.2%) operates the largest fleet of ultra deepwater drilling rigs in the world. Although high energy prices are generally a plus for Transocean, the company can flourish when energy prices remain above \$70 a

barrel, a level that energy companies consider sufficient to justify aggressive exploration and development programs. Transocean has gotten caught up in another spill incident, this time involving a platform in the Frade field off the coast of Brazil. The well, which Chevron is operating, sprung a subsurface leak, which let about 3000 barrels of oil escape. Brazilian authorities have taken a hardball approach, with the Brazilian government ordering both Chevron and Transocean to cease operations until an investigation is completed. In addition, prosecutors for the State of Rio de Janeiro are seeking \$12 billion in damages and fines, which works out to about \$3.6 million a barrel. Compare this to what BP is likely to spend on the far worse and much more complicated Gulf of Mexico spill from 2010: that works out to about \$3500 a barrel. We believe this is political posturing, since Chevron's total assets in Brazil are about a quarter of that amount. Furthermore, the idea that Transocean would be barred from operating in Brazilian waters is unlikely, since it has another ten rigs under contract. Many are contracted to Petrobras, the Brazilian national energy company. Chevron has said that the 3000 barrel seep was its responsibility both from an operational and a financial perspective. Nonetheless, all of this is burdensome for Transocean, which has enough on its mind and reputation starting with that Gulf of Mexico spill, its poorly received acquisition of Akers, and finally its underwhelming last quarter and concerns about the dividend. At its current price, this stock is a bargain.

Symantec (-2.4%) As the world moves to smart phones to handle many tasks we did on laptops, hackers are starting to capitalize on security holes. This is a relatively new arena for Symantec products. It's difficult to gauge how lucrative this new dimension will be, but we expect at some point this facet will catch investor interest. Meanwhile, the shares are cheap on a relative basis.

Xerox (-0.7%) dropped 27% in 2011 due to a cascade of negative events, including the tsunami earlier this year that created supply chain issues, higher costs due to appreciation in the Japanese yen, and as recession fears swelled during the second half of the year. XRX is now a compelling value play. The company's improving fundamentals include cutting costs, making its products the core of its clients' business operations, and generating revenues from servicing those products.

Strong advances since our last Issue occurred in some of our other holdings: **Agrium (+4.4%)** announced it was quadrupling its dividend as a result of its continued growth. **UnitedHealth (7.5%)** announced continued expansion of its OptemRX division. Although the price has doubled since our initial recommendation and is approaching its 52-week high, we think it has more to go. **Stryker (+7.0)** also jumped but is still in our buy range.

Lesser advances occurred in **Maxim (+2.1%)**, **Johnson & Johnson (+1.3%)**, **Fidelity Select Natural Gas Fund (+0.8%)**, **HQL Life Sciences Fund (1.0%)**, and **Paychex (+2.3%+)**. Minor declines occurred in **Tetra Tech (-0.7%)**, and the **Seligman Premium Growth Fund (-0.1%)**. SA

Income With Growth	Symbol	Exchange	Price	Yield	Limit	Action
Associated Estates Realty Corp	AEC	NYSE/Nasdaq	\$ 16.34	4.16%	\$ 18.25	BUY
CommonWealth REIT	CWH	NYSE	\$ 17.85	11.20%	\$ 22.00	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 11.89	4.04%	\$ 12.00	BUY
Diversified Growth						
CGM Realty Fund	CGMRX	800-343-5678	\$ 27.05	0.96%	N/A	BUY
Comcast	CMCSA	NASDAQ	\$ 24.95	1.80%	\$ 28.00	BUY
Johnson & Johnson	JNJ	NYSE	\$ 65.40	3.49%	\$ 71.00	BUY
Leucadia National Corp.	LUK	NYSE	\$ 24.03	1.04%	\$ 30.00	BUY
Masco	MAS	NYSE	\$ 11.54	2.60%	\$ 11.60	BUY
Paychex	PAYX	NASDAQ	\$ 30.76	4.16%	\$ 35.00	BUY
Pfizer	PFE	NYSE	\$ 21.60	4.07%	\$ 23.00	BUY
Stryker Corp.	SYK	NYSE	\$ 51.19	1.66%	\$ 60.00	BUY
UnitedHealth Group	UNH	NYSE	\$ 52.59	1.24%	\$ 53.00	BUY
Xerox	XRX	NYSE	\$ 8.10	2.10%	\$ 10.00	BUY
Energy/Natural Resources						
Agrium	AGU	NYSE/TSE	\$ 71.77	0.63%	\$ 100.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 31.27	0.18%	N/A	BUY
Tetra Tech	TTEK	NASDAQ	\$ 21.83	0.00%	\$ 28.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$ 32.26	0.25%	N/A	BUY
Aggressive Growth						
AMN Healthcare	AHS	NYSE	\$ 4.14	0.00%	\$ 7.00	BUY
Boston Scientific	BSX	NYSE	\$ 5.34	0.00%	\$ 8.50	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$ 11.70	9.23%	\$ 12.20	BUY
Maxim Integrated	MXIM	NASDAQ	\$ 26.16	3.36%	\$ 29.00	BUY
Seligman Premium Growth Fund	STK	NYSE	\$ 16.13	0.00%	\$ 20.00	BUY
Symantec	SYMC	NASDAQ	\$ 15.80	0.00%	\$ 22.00	BUY
Tellabs	TLAB	NASDAQ	\$ 3.90	2.05%	\$ 5.50	BUY
Third Avenue Focused Credit Fd	TFCVX	800-443-1021	\$ 9.60	7.90%	N/A	BUY
Transocean	RIG	NYSE	\$ 39.73	7.95%	\$ 60.00	BUY
Dispositions						
Anglo-American PLC	AAUKY.PK	PINK SHEETS	\$ 19.02	0.00%	N/A	SELL
CarMax	KMX	NYSE	\$ 30.91	0.00%	N/A	SELL
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$ 29.42	3.38%	N/A	SELL
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$ 104.10	1.24%	N/A	SELL
Fastenal	FAST	NASDAQ	\$ 45.13	1.24%	N/A	SELL
Honeywell	HON	NYSE	\$ 55.59	2.68%	N/A	SELL
International Speedway Corp.	ISCA	NASDAQ	\$ 25.53	0.71%	N/A	SELL
Microsoft	MSFT	NASDAQ	\$ 27.68	2.89%	N/A	SELL
Superior Industries	SUP	NYSE	\$ 16.96	3.77%	N/A	SELL
Time Warner	TWX	NYSE	\$ 36.79	2.56%	N/A	SELL
United Parcel	UPS	NYSE	\$ 73.12	2.84%	N/A	SELL
Wal-Mart Stores	WMT	NYSE	\$ 59.42	2.46%	N/A	SELL

Prices as of Thursday, January 5, 2012

Yields on funds do not include distributions of capital gains. Note that ACTION OR LIMITall fund distributions fluctuate annually.BUY, HOLD, SELL OR LIMIT IN **BOLD** INDICATES A CHANGE IN

ACTION OR LIMIT

This table has live prices, charts & buy limits on our website: <http://www.soundadvice-newsletter.com/members>

The rising swell of home foreclosures began in 2007 as a symptom of faltering real estate markets across the country. But as the swell turned into a tidal wave, falling real estate prices have compromised the assets of the US banking system and the fabric of the US and worldwide economies. Indeed, the state of the nation's real estate markets and the economy have become one and the same. Clearly, the recession cannot be fully put behind us and a recovery kick into full gear until the inventory of foreclosed homes stops overhanging the market.

We have seen all this before. It was back in the 1980s. After years of loose and questionable lending practices, regulators were forced to liquidate hundreds of savings and loans and dump their foreclosed real estate onto an already-depressed real estate market. As values dropped, the downward spiral continued until most of the real estate was sold at steep discounts. The crash was worse in some parts of the country, but the damage to the whole US economy was substantial. Does this sound familiar?

We have the same situation today. It's like the old good news/bad news jokes, except this is no laughing matter. The bad news is that today's crash has been damaging to both real estate prices and the national economy.

The good news is that we have the tools to determine when the bad news will be over. This will give us a tremendous opportunity not only to invest in real estate for pennies on the dollar at the right time, but also in other investments as well as those that benefit from a recovering economy.

The Key Indicator

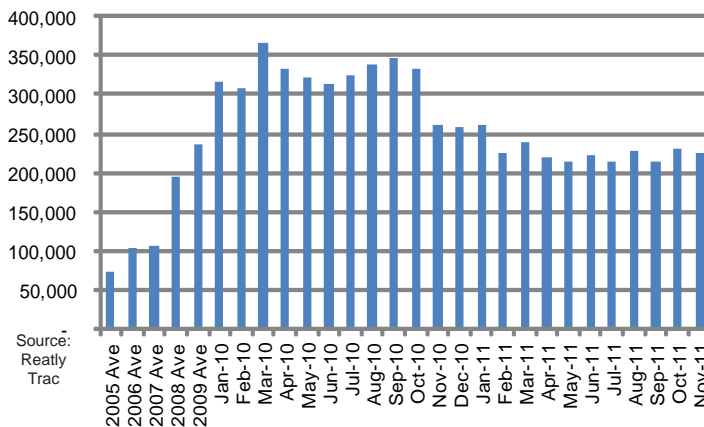
The secret is to focus on foreclosure rates. Realty Trac in Irvine, California has an extensive data base. You can access foreclosure information on local markets from their website www.realtytrac.com. We use some of their data here to gauge the state of the nation and its real estate, and plan to continue to do so in future issues of SoundAdvice.

What we are looking for is a significant decline in the number of foreclosures. When this happens, the bulk of the overhanging inventory of foreclosed properties will have been digested, and the real estate recovery can then begin as well as in the economy. In the late 1980s, this was the best indicator for knowing when the recovery was near. As foreclosure rates dropped, the ensuing recovery began. For nearly two decades, fortunes were made from real estate purchased for pennies on the dollar during the S&L Crises of the 1980s.

The following chart shows US foreclosure rates. In 2005, foreclosure rates averaged 74,892 properties per month. In 2006 and 2007, foreclosures were slightly above 100,000 per month. However, by January 2010, foreclosures climbed to over 300,000 per month, and foreclosures continued at over 300,000 each month through October.

We saw the beginnings of a decline in the 2010 fourth quarter. At first, the decline was due largely to a freeze in foreclosures by several major lenders. The downtrend continued as Federal and state foreclosure prevention efforts allowed distressed homeowners to stave off foreclosures.

US Foreclosure Rates - Monthly Averages



However, foreclosure rates remained stubbornly high throughout 2011.

Dissecting the Foreclosure Process

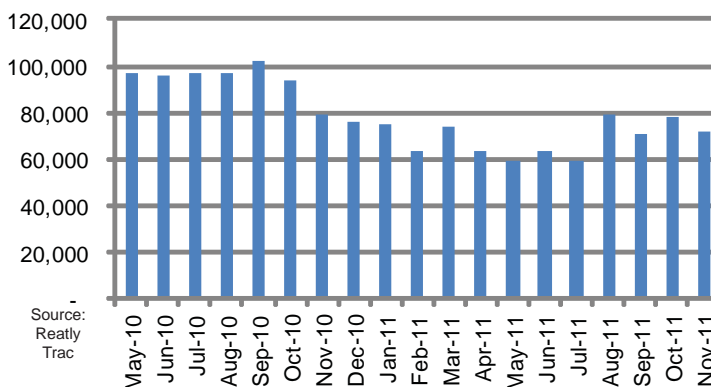
It's important to keep in mind that the foreclosure process is comprised of three distinct stages: new default filings by lenders; then auctions as lenders attempt to sell these properties; and finally, bank repossessions of those properties not sold through auctions. The sheer number of foreclosures is actually the aggregate of the number of properties in each of these three stages.

We can get an early glimpse of a change in trends by focusing on changes in the first step of the foreclosure process: new default filings. After all, a significant change in the first step of the foreclosure process must ultimately lead to a significant change in the aggregate number.

The following chart shows new default filings in the US by month since May 2010. Through October 2010, new default notices were hovering around 100,000 per month. However in November 2010 they began declining and dropped to a low of 58,815 in May, and July was almost that low at 59,516.

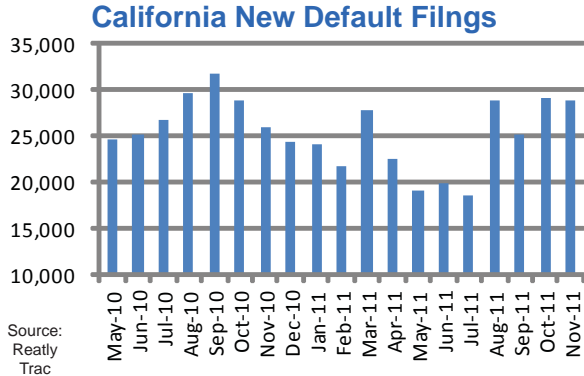
However, in a marked turnaround, August 2011, new default filings leaped by 33 percent, to 78,880. Although new default filings declined ten percent in September, they increased again in October to 77,733, and dropped slightly in November to 77,130. These high readings since August reveal that the crisis will be getting worse in the immediate future.

US New Default Notices



Further confirmation comes from our largest state, California. Below is a chart of new default notices there.

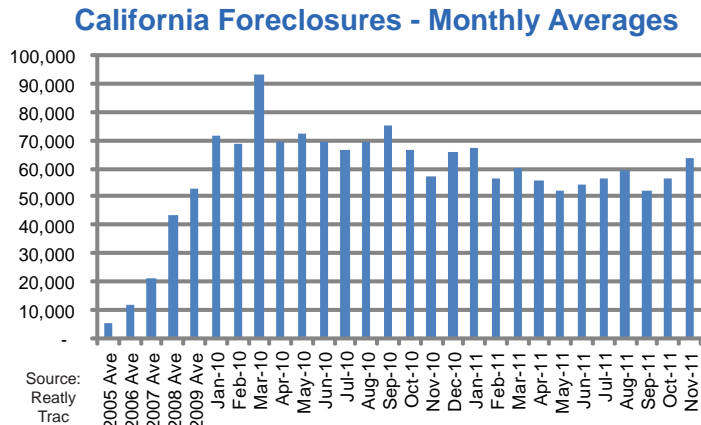
In August 2011, new default notices in California jumped a whopping 55 percent to 28,961. After a decline in



September by 13 percent, new default notices in California increased in October to 29,240 and in November to 28,897.

The chart below shows all stages of the foreclosure process in California (including auctions and bank repossessions).

In 2005, California foreclosures averaged 5,138 properties per month. Foreclosures doubled in 2006, and

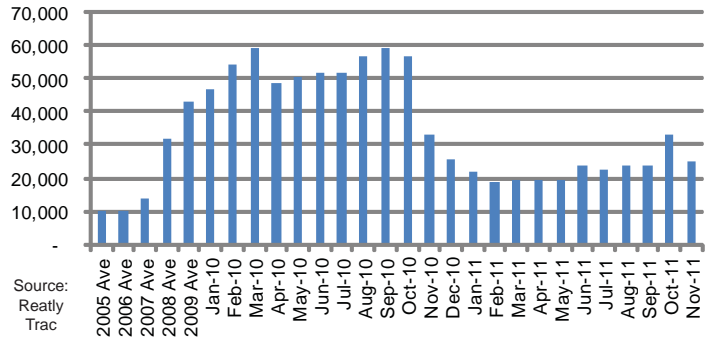


again in 2007, and again in 2008. By 2010, foreclosures were close to 70,000 each month, with a spike of 93,000 in March. Foreclosure rates remained high in 2011. We know from the high amounts of new default filings recently that foreclosure rates in California will be climbing in the months ahead. This is significant because one fourth of the nation's foreclosures have been in California for the last few years.

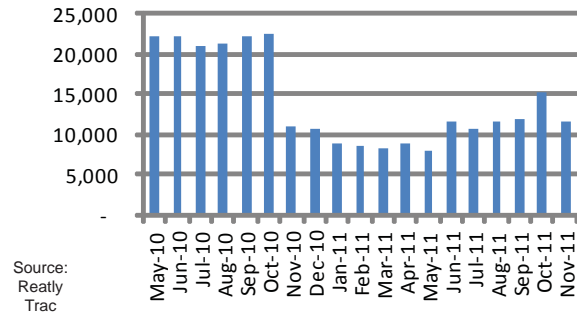
Florida is the next highest foreclosure state with 11 percent of the nation's foreclosures. Foreclosure rates climbed from 10,000 per month in 2005 and 2006 to 47,000 in January 2010, and stayed in the 50-60,000 range through October. Then the monthly rates dropped sharply through May 2011. However, foreclosure rates have been creeping up again, and spiked in October. See the following chart:

As an indication of what lies ahead, new default notices have been increasing during the last four months, with a spike in October.

Florida Foreclosures - Monthly Averages



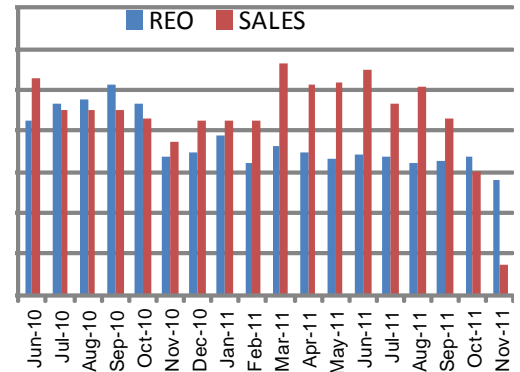
Florida New Default Filings



The Inventory

At the other end of the foreclosure process is what the banks have not been able to sell. This inventory is called "real estate owned", or REO for short. Each month more REO is added to the inventory. However, each month there are a number of properties sold from the inventory. Above is a chart of the REO (in blue) and sales (in red) during the last year.

On balance, there have been 228,799 more properties sold than have been added to the REO inventory since June, 2010, or 16.5 percent of the current inventory of 1,384,537 foreclosure properties listed for sale. In November only 14,654 were sold.



Conclusions

The high levels of new default filings and slow sales of foreclosed properties is evidence that the crisis will be getting worse before it gets better.

We will be tracking foreclosure metrics closely both nationally and in key states in these pages of SoundAdvice to be among the first to know when the end of the foreclosure crisis is at hand. Stay tuned.

Capital Competition: Real Estate versus Stocks: The SoundAdvice Risk Indicator

There are few forces that are more important to a market's destiny than the amount of capital that is available to it. In a normal situation, capital will flow easily between markets as their underlying conditions change. But if a market becomes dangerously superheated, it will absorb a larger proportion of available investment capital than economic conditions and market demand can justify. This change will be reflected not only in the rising market's prices but also in the prices of competing markets, which will be lower than their underlying fundamentals would indicate they should be. Over the last 100+ years, we can see this titanic struggle between the stock market and its foremost competitor for investment dollars: real estate.

To reveal this phenomenon, we have set up an equation in which we divide the Standard and Poor's 500 Stock Index average by the median price of a new house for each month over the last 100+ years. This equation exhibits an elegant financial minuet as each market has taken turns outperforming the other.

As we look at the historical data, we find that there is a range in which the price disparities are so strong that they are too great to be accounted for by the fundamental economic conditions underlying each market. Every time prices get into these danger zones it has meant that the prices in one market or the other have gone too high, and that they are in imminent danger of falling.

We can, therefore, label this new tool a "Risk Indicator," since it will allow us to locate the point at which prices are so high when compared to competing markets that they have come loose from their moorings and are on the verge of declining or underperforming the other market.

What is too high? When stock prices are very high relative to house prices, the Risk Indicator will rise over the line marked 2.0, revealing a high-risk time for stocks. In

contrast, when the indicator drops below the line marked 1.0, it means that it is a very low-risk time to buy stocks. Notice from the chart how the Risk Indicator has oscillated back and forth, revealing the ongoing struggle between Stocks and houses for investment capital. We have labeled these long vacillations Supercycles.

The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$7,307,706 in stocks and to \$1,138,830 in houses.

But though an investment begun with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the Risk Indicator he would have made \$290,451,293, or 39.7 times more money—the difference between profits the buy-and-hold stock market strategy would have yielded by itself and the profits that the Risk Indicator would have provided.

These figures illustrate why it is so important to remain aware of the Supercycles that are at work within markets. A recent example was during the 1998-2000 stock market mania, when most investors were chasing high-tech stocks, our *Sound Advice* portfolio was buying Real Estate Investment Trusts (REITs.) Most investors got killed with 75 percent-90 percent losses during the ensuing decline. However, REIT shares during the same period soared 25 percent, and had locked in nearly double-digit dividends. When the bear market ended in late 2002 and tech stocks recaptured some of their losses, REITs rolled to mind-boggling highs as speculation drove them to excess that climaxed in 2007.

The SoundAdvice Risk Indicator

The latest reading for the **Sound Advice** Risk Indicator is 1.38. This reading reveals that stock values are below average in relation to house prices. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

See *The Science of Making Money in Turbulent Markets* for a complete explanation of the **Sound Advice** Risk Indicator and its track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you renew your subscription.)



Business Cycles and Stocks: The SoundAdvice Diffusion Indexes

If the Supercycles identified by our Risk Indicator are the solemn, inexorable seasons that roll across the market's landscape, business cycles are the highly visible, sometimes serene but frequently blustery fronts and storms that we actually perceive as weather. The Risk Indicator has given us a reliable tool to determine the investment season in the stock market. This information is all-important; there will be no heat waves in January, no blizzards in July. But in our search for fair winds, we need to know more than the season. We also must be able to predict the shorter-term weather -- the bull and bear markets that fluctuate along the path of Supercycles.

The data we need is contained in the leading and lagging economic indicators published monthly by The Conference Board. We have hand picked the most sensitive of these economic indicators to produce our "Diffusion Indexes" which function with amazing accuracy as predictors of the birth of cyclical bull and bear markets in stocks.

To construct our Diffusion Indexes, we observe changes in each of our selected indicators over a six-month period. For every indicator that is unchanged from its value during the six month span, we will attach a value of one half point (0.5). If an indicator falls below its level six months prior, it will be given a value of zero. If an indicator is higher than it was six months before, it is assigned a value of 1.0. The sum of all of these figures will be expressed as a percentage of the total number of indicators. If, for example, one indicator is up (+1) at the end of a six-month period, one is unchanged (+0.5), and one is down (0), the diffusion index will be (1.5)/3 or 50 percent.

When the Diffusion Index of Leading Indicators drops to zero, it is time to buy stocks aggressively, regardless of how negative the atmosphere may be. This is not just an empirical coincidence. It is also logical. In order for all of the leading economic indicators to be giving off a zero value compared to six months before, it is nearly certain that the economy as a whole must be very soft, which is the atmosphere necessary to produce a lasting decline in interest rates.

The Diffusion Index of Leading Indicators: As far back as February and March 2009 we were projecting that our Diffusion Index of leading indicators soon would hit zero and mark an important buying opportunity. We made that projection by assuming that the leading indicators would not improve in the current economic environment. In fact that signal arrived in March, very close to the bottom, officially

giving us an "Aggressive" signal.

An "Aggressive" signal coming at a time when the Risk Indicator is close to 1.0 reveals that Supercycle 5 has come to an end, and that Supercycle 6 is born. The current reading of the Diffusion Index of Leading Indicators is 50 percent, which does not change our market perspective. That will change only with a signal from the Lagging Indicators.

The Diffusion Index of Lagging Indicators gives "Caution" signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading which would reveal an overheating economy with immediate inflationary pressures ahead. Our next signal will come from this Index. This Diffusion Index currently stands at 66.7 percent.

Track Record of the Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 produces an annual average return of 22.1 percent. During "Caution" signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased at an annual rate of only 1.62 percent during caution periods.

Aggressive	S&P	Caution	S&P
Sep-74	68.12	Apr-76	101.90
Nov-79	100.00	Oct-83	167.65
Dec-84	164.48	Jun-85	188.89
Jul-86	240.18	Aug-87	329.36
Mar-88	265.74	Jun-88	270.68
Mar-89	280.00	May-89	313.93
Oct-89	347.40	Mar-93	449.74
Feb-97	798.38	Dec-98	1,141.00
Oct-00	1,429.40	Dec-00	1,320.28
Jun-03	974.50	May-05	1,191.50
Jul-06	1,276.66	Mar-08	1,325.43
Apr-09	865.33		

See *The Science of Making Money in Turbulent Markets* for a complete explanation of the SoundAdvice Diffusion Indexes and their track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you renew your subscription.)

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