CAZ Investments
Quarterly Letter

The Spring Did Not Uncoil, But We Will Take It Anyway!

Last year in our 4th quarter letter we talked about the possibility of the "spring uncoiling" and the markets providing an upside surprise. We felt like there was so much idle money that we could see a surprise surge higher, if the politicians would make some meaningful reforms on the debt front. Well, the spring did not uncoil, but the markets accepted the "kicking of the can down the road" by the politicians and the promises to do "whatever it took" to stabilize the situation in Europe. The result was a nice year of returns for almost every asset class.

The central bank policy to flood the markets with liquidity and unprecedented low interest rates is working, right? That depends on your perspective. The stubbornly high unemployment rate would lead to one conclusion, and rising stock market prices would lead to a different conclusion. What is irrefutable is the fact that the central banks around the world did an excellent job feeding the "animal spirits" and coming to the rescue anytime there was a real or perceived threat to economic stability. The result was a year of "nothing too bad" happening. When one combines a lot of cash on the sideline with the belief that the central banks would be a backstop if anything were to go wrong, "the Bernanke Put", the logical progression for prices of risk assets is to go higher. Indeed that is exactly what happened, and we saw prices of stocks, bonds and virtually every asset surprise on the upside.

Regardless of how it happened, we are not one to complain about a profitable year! We enjoyed the ride and, even though we would have made a lot more money if we had blindly believed that everything was going to be peachy, we are happy to look fondly upon the increase in the value of our assets!

Round One was a Draw – Round Two is going to be Bloody!

The Fiscal Cliff has been avoided, and markets are cheering. Congress has now presented themselves as our "knights in shining armor". They would have us believe that they made grave sacrifices and voted for a bill that they really did not like in order to save us from the horrible fate that THEY had prepared for us. How bizarre and twisted is that?!

What do we know?

First a very brief summary of the positives:

1. The Bush Era Tax Cuts have been made permanent for those that make less than $450,000 per year as a family.
2. The Estate Tax Exemption has been left at $5mm per person.
3. The AMT debacle has been improved and, hopefully, somewhat resolved.

4. Capital gains and dividend rates will rise for high income earners but will not be taxed at the same rate as ordinary income.

Now a very brief summary of the negatives:

1. The 2% payroll tax cut has been eliminated. This negatively affects every single person who has a job.
2. The top tax rate has gone back up to 39.6% on income over $450,000.
3. Some deductions are being phased out based on income.
4. There was no solution included for the debt ceiling which means the government will be unable to function past the end of February without congressional agreement, which will not be easily obtained.
5. There were virtually NO spending cuts of any kind in this package. As a result this legislation is estimated to INCREASE the deficit by $4 TRILLION dollars over the next 10 years, compared to allowing the mandatory tax increases and spending cuts to kick in, according to the Government Congressional Budget Office.
6. While not part of this legislation, the “healthcare tax” of 3.8% goes into effect today for high wage earners, and it will have a significant impact on economic growth.

<u>What we do not know?</u>

1. When Congress is going to demonstrate courage and do what is best for the country. (How is that for direct?)
2. How Congress is going to address the debt ceiling debacle that faces us in the next 60 days.
3. How/when Congress is going to start reducing the deficit and our national debt.
4. The magnitude of the drag on our economy that will result from this legislation. Estimates we have read today range from ½ of 1% to a 1.5% reduction for 2013.
5. If the “coiled spring” in our economy will be able to overcome the uncertainty of the debate around the debt ceiling and the higher taxation.

On to Round Two!

At the end of the day, the elimination of the fiscal cliff uncertainty is a positive for the markets and for the economy. Unfortunately, we will still face intense debate over the next few months concerning spending cuts and the debt ceiling. From there the path could be very favorable, or we may have a substantial setback to our economy. The estimates we have seen state that a prolonged and messy debt ceiling debate could reduce the U.S. Gross Domestic Product by as much as 4 – 6%. That would not only cause a slowdown but likely a severe recession.

Like the fiscal cliff debate, we believe the politicians will wait to the very last moment to reach an agreement that prevents Armageddon, yet that still allows both sides to declare victory. Ultimately, we do not expect any meaningful reform, and we do not have much hope that the economy will benefit from the negotiations.

What really matters?

What matters the most is cash flow and earnings. Companies are primed to grow profitability. They will succeed in generating reasonable cash flow in this environment as long as we do not see a substantial hit to consumer spending, or a freeze up of the capital markets, caused by a U.S. default or a debacle in Europe.

The company specific concern we face as we look toward the future is profit margins. Company profit margins are far above historical norms. Management teams all over the world deserve a great deal of credit for managing their businesses well in a very difficult environment. However, there is only so much in costs that can be cut. We must see meaningful revenue growth in order to sustain profit margins at these levels. This is especially true if cost inputs begin to increase and it remains difficult to pass along price increases. The surprise that we are afraid of, outside of the macro-economic landscape, is the possibility that company profits do not meet expectations, because profit margins begin to contract.

There are many things we like about the economy, and we believe significant growth could be forthcoming if meaningful fiscal reform can be achieved. Unfortunately, we are going to continue to be held hostage by political wrangling, which is the most unpredictable of all variables.

We are maintaining our “2” rating on the CAZ Scale, which is moderately negative. Stock market valuations are decent, cash levels held by companies and investors remain at record levels, central banks continue to be very supportive and the economy really acts like it wants to improve. However, we still see significant risks to economically sensitive assets from the uncertainties in Washington, the negative impact on jobs and growth from legislation, the powder keg that Europe remains and the continued escalation of the debt level of our country.

Therefore, we are going to remain cautious in our allocation of assets and focus on protecting our client capital. There are interesting developments that we see in the world, and we will continue to seek ways to profit from those opportunities. We will monitor our allocations and will gladly become more optimistic if we see meaningful reform in Washington. Stay tuned, and we will notify you if we change our position. We appreciate the confidence you have in us, and we value our relationship with you. Two thousand and twelve was a good year, and we are excited to see what the future will bring. Please let us know if you have any questions, and we look forward to speaking to you soon.