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QtrNotes

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More to Climb:
At its 3/30/12 closing value of 1408, the S&P 500 is just 11% below its all-time closing high of 1565 set on 10/09/07.
(source: BTN Research)

Higher Today:
The aggregate annual earnings of the S&P 500 companies are 12.4% higher today than they were just 1 year ago.
(source: S&P)

Double-Digit:
The average interest rate nationwide on a 30-year fixed-rate mortgage was at least 10% for the 12 consecutive years from 1979-1990.
(source: Freddie Mac)

From Europe:
14% of the revenue of the S&P 500 companies is derived from sales to European customers.
(source: S&P)

Selling to China:
US exports to China have more than doubled over the last 6 years, growing from $42 billion in 2005 to $104 billion in 2011.
(source: Commerce Dept)

Economic Progress: Markets Rebound, Outlook Improving

The first quarter of 2012 closed with the best market performance since 1998. All major equity indices were positive (see the table on the right). Developments in Europe marked the region's initial steps towards crawling out of the doldrums. As economic risks subsided, so too did the appeal of treasury bonds. During the quarter, ten-year treasuries fell in price, with rates climbing to 2.2% from 1.9%. After a frustrating 2011, diversified portfolios, which include bonds and other investments designed to moderate portfolio risk, finally rewarded the patient investor.

Notable in this quarter's markets was a lack of the volatility and wild swings of the prior six months. Fear and greed haven't left the playing field, but perhaps clearer heads are prevailing.

The US economic indicators have made solid gains during the past six months, after a dismal period last summer for both domestic and global economies. At that time, the tragedy in Japan had disrupted supply chains and production schedules, Congress was playing politics with the US debt ceiling, the European sovereign debt crisis was coming to a head, and there was fear of a hard landing in China. While none of these problems have disappeared, overall progress is visible at last.

On this side of the Atlantic, we are starting to see some compelling data that gives our US economic outlook a guardedly positive direction. Recent employment figures are encouraging: the last three months have seen the strongest payroll gains since May 2006. A stronger labor market should push up consumer spending and cause businesses to ramp up activity. Consumer confidence is up, along with big-item purchases. Motor vehicle sales jumped to over 15 million units annualized, the fastest pace since March 2008.

Index	3/31/2012	% YTD
Dow Industrials	13,212.04	8.1%
S&P 500 Index	1408.47	12.0%
Russell 2000	830.30	12.1%
MSCI EAFE	1553.45	10.0%
Barcap Global Bonds	450.94	0.9%
10-Year Treasury	2.2%	

Core inflation picked up slightly, to 2.2%, amid concerns that higher energy prices, cheap money, and an improving labor market will ignite higher inflation. If so, the Fed may not be able to keep its commitment to maintain low interest rates through 2014, but many economists think slightly higher rates, if accompanied by higher economic activity, would be a positive overall.

Taxing Issues

The Bush-era tax cuts will expire on December 31st, 2012, unless legislation is enacted to extend them. The expiring tax cuts will mean income tax rates, which currently run from 10% to 35%, will return to the 15% to 39.6% range (39.6% for joint filers with over $379,150 in income) – a 50% tax increase for those paying the lowest rate. Long-term capital gains tax rates will return to a maximum of 20%. Dividends will once again be taxed as ordinary income.

In addition, some tax breaks for college tuition, certain child care credits, current reductions in payroll taxes, and the alternative minimum tax patch (which reduced the number of taxpayers subject to AMT) will disappear unless legislative action is taken.

The health care reform law adds a 3.8% tax on investment income for families with income of over $250,000 starting in 2013. Tax-free municipal bonds, as well as tax-deferred

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Aggregation Update:

As announced last quarter, our new account aggregation software platform is up and running. Many of you have already been contacted regarding additional accounts you might want us to incorporate into your managed portfolios.

If you have accounts at custodians other than Schwab, including 401(k) plans, 529 accounts, and annuities, give us a call.

Two-Day Tax Holiday:

April 15, 2012 falls on a Sunday, and April 16 is the Emancipation Day holiday in Washington, DC. Federal income taxes aren't due this year until April 17.

Annual ADV Offer:

Each year, the SEC requires that we notify clients when we have updated our disclosure brochure, known as the Form ADV Part II. You can download the PDF file for the updated form from our website at firestonecapital.com/docs/FCM Form ADV Part II.pdf. If you would like a copy sent to you directly, please call our office. We will be happy to mail or email you one.

International Markets: Crisis Averted, Proceeding With Caution

With all eyes on Europe, it now appears the region's problems are slowly being resolved. The European Union announced a second bailout for Greece in February. Most of the $170 billion was used to repay maturing debt, and private holders of Greek bonds were forced to take a 75% write-off on their holdings. Despite efforts to prevent Greece's default, insurance payments on Greek bonds (credit default swaps) were nonetheless triggered. However, total claims of approximately $3 billion were only a fraction of what was feared.

The major driver of Europe's reform was the establishment of the European Central Bank's Long-Term Refinancing Operation (LTRO), which added much-needed capital to bank balance sheets. LTRO can be compared with the TARP program in the US: the central bank makes loans to the banking system, which reinvigorates credit markets and investor confidence. As the banks stabilize, they are able to repay the loans.

Despite similarities in these two programs, Europe's difficulties remain more stubborn than our own. However, current expectations indicate even more support is on its way. The markets have reacted positively, sending international stock and bond markets higher.

Looking forward, what do we expect?

Until we see a strong resurgence in economic growth and decline in unemployment, we worry about the debt of Europe's more vulnerable nations. However, the ECB will probably maintain a loose monetary policy and may initiate new targeted support to other nations, while countries implement further budget reforms.

Europe represents the single largest economic region in the world. Despite the likelihood of slow future growth, we expect companies domiciled or doing business in Europe to continue to generate profits.

China and other emerging markets are slowing too. China is in a major transition, striving to increase domestic consumption and reduce reliance on exports. Aggressive growth in construction and manufacturing created a surplus in housing and production capacity that now overhangs China, but will eventually be absorbed. A slowdown is already in motion, witnessed by declines in steel and cement production this year.

To offset the slowdown, the Chinese government has eased restrictions on banks, increasing the amount that can be lent to businesses. Inflation in China has recently fallen to 4.5%, giving the government flexibility to provide more aggressive stimuli in case growth falls more than expected. It's important to note that slowing Chinese growth is relative, as GDP targets remain three times the expected rate in the US.

The US economic recovery continues, with consumer sentiment showing its strongest improvement since February 2011. Confidence has edged up as more favorable income and job trends offset rising gas prices. We are also experiencing compelling shifts in our country's growing energy production capabilities and manufacturing sector.

Despite signs that the economy continues to improve steadily, we remain cautious. We can't anticipate what actions will be taken on taxes, and it seems unlikely that Congress will allow major changes in an election year prior to the lame duck session. However, the US must ultimately adopt some form of austerity via lower spending or higher taxes (or a combination of both) that could hinder economic growth in the short term.

Taxing Issues

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retirement accounts, are excluded from this additional tax.

The tax tail should never wag the dog, but we'll need to take a hard look at realizing some of the built-up capital gains while the 15% tax rate applies. Of course, any actions taken have the potential to be viewed differently in hindsight. Legislators can make changes retroactively, gains realized may affect tax brackets, or new laws might make waiting a more attractive proposition. Although it's difficult to predict future tax legislation, we can still prepare for the most likely possibilities and be ready for what comes.