



Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

First Quarter of 2012

Leigh Bivings, Ph.D., CFP®



Artemis Financial Advisors, LLC

54 Chandler Street
Boston, MA 02116
617-542-2420



Executive Summary

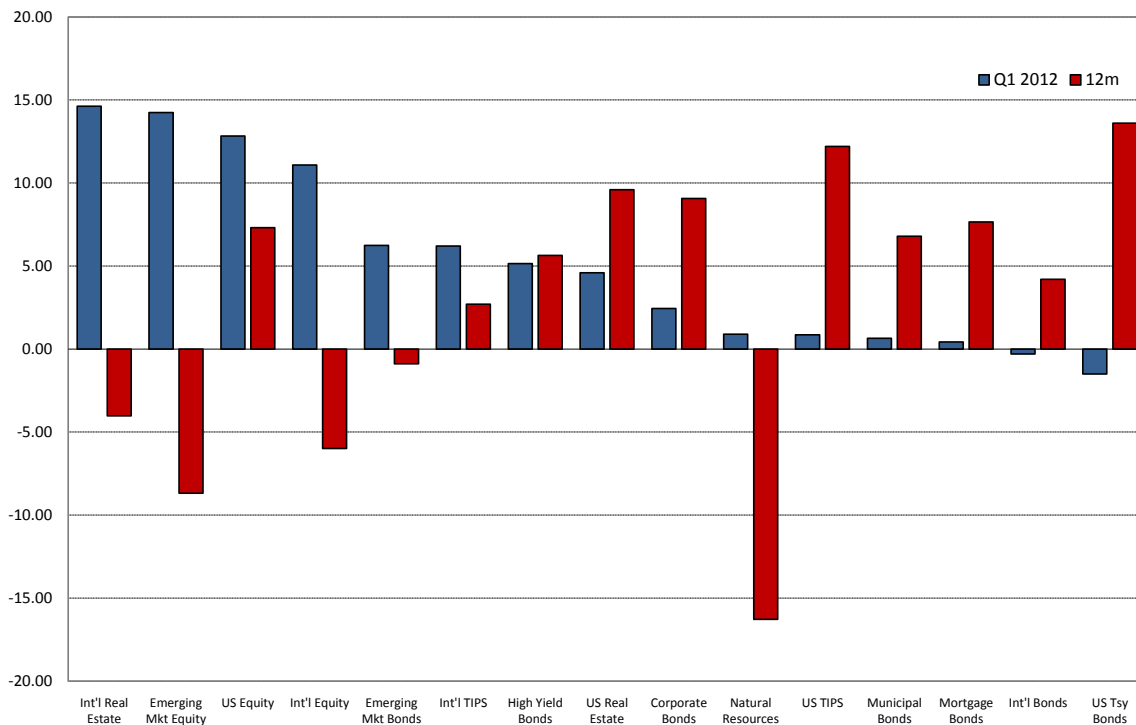
- Equity markets worldwide delivered eye-popping returns in the first quarter of 2012. Emerging markets led the way by posting a 14.2% gain. U.S. and EAFE markets (developed Europe, Asia and Far East) were not far behind, increasing by 12.8 and 11.0%, respectively.
- The principal trigger for the rally was the European Central Bank's decision to provide more than \$1.3 trillion in loans to European banks for three years at low interest rates. This helped to avert a credit crunch and remove the risk of an imminent banking collapse, thereby restoring investor confidence. Continued positive economic news in the U.S., particularly on the jobs front, also bolstered investor confidence and led to a classic rotation away from perceived safer parts of the market (e.g., U.S. Treasuries, municipal debt) into riskier asset classes.
- ***In this issue ... We focus on recent trends in the U.S. housing market and conclude that the worst may be behind us.*** Evidence includes the recent stabilization of housing prices, sales, and inventory levels. Housing has also become much more affordable, with the ratio of home prices relative to average household income at its lowest level in at least the last 45 years. Mortgage rates are also at an all-time low.
- Several 'headwinds' remain, including a potentially large "shadow inventory" of houses. These are houses destined for market, but not yet counted as inventory. Another concern is continued tight credit standards that are interfering with lending to even creditworthy borrowers.
- In the meantime, rents have risen rapidly, fostering a mini-boom in multi-family housing starts and growing interest in purchasing homes for rentals instead of for owner occupancy. We conclude that while housing prices may continue to fall a bit, particularly in the most hard-hit markets, the nascent recovery in the housing market signals that it's a good time to buy.
- In terms of our portfolio strategy, we continue to favor U.S and emerging market equities over developed international equities and have recently increased our clients' exposure to U.S. high-yield, commercial real estate, and emerging market debt.



Markets in Review

Global markets posted very strong returns in Q1, with the broad U.S. market gaining almost 12.8% for the second consecutive quarter (Figure 1). Global equity markets also bounced back, with international equities increasing by 11.0%, and emerging markets posting a 14.2% gain in U.S. dollar terms.

Figure 1: Asset Class Performance in Q1 2012 (percentage points)



The principal trigger for the rally was the European Central Bank's decision in late December, and again in February, to provide more than \$1.3 trillion in loans to European banks for three years at low interest rates. There is widespread agreement that the program averted a credit crunch and removed the risk of an imminent banking collapse, thereby restoring investor confidence. The program has also provided politicians with more time to negotiate longer-term solutions to the Eurozone's fiscal problems (which, by no means, have gone away).

The other main impetus for the rally was the continued good news coming out of the U.S., particularly encouraging employment numbers and retail sales figures. There is no longer



any doubt that the U.S. is in recovery, albeit at a pace that suggests that it will be hard to sustain current job growth numbers.

International and emerging market returns were aided by the U.S. dollar depreciating against most currencies during the quarter, except the yen. The resilience of the euro was somewhat surprising but may well be because the Eurozone has a broadly balanced current account, and the currency is still on the other side of the so-called “Bernanke trade” – the Federal Reserve’s printing of trillions of dollars to stimulate the economy. However, as also shown in Figure 1, international and emerging market returns still have been negative over the last 12 months.

Most fixed-income securities posted positive results, although some longer-term government Treasury securities actually had negative returns for the quarter. Yields on Treasury securities across the whole maturity spectrum rose, with long-term securities rising more sharply than shorter-term ones. Spreads between more- and less-risky securities generally narrowed as conditions in global financial markets eased.

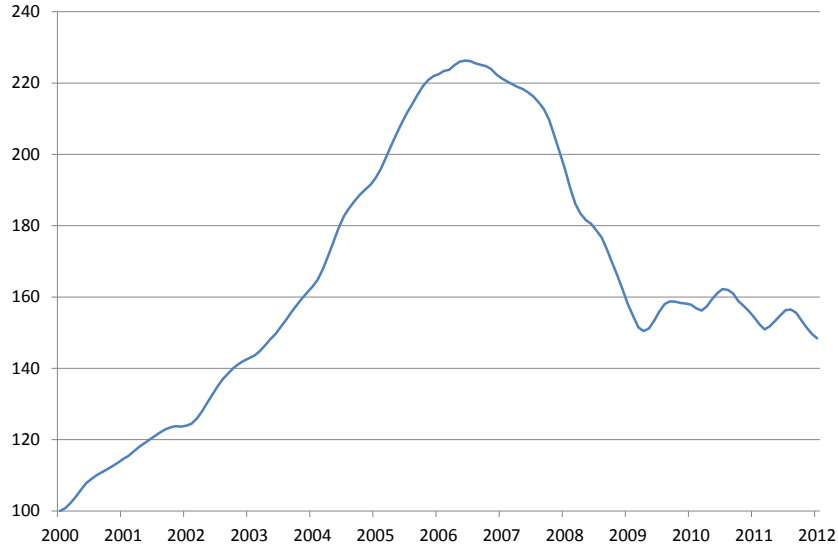
Special Topic: U.S. Housing Market: Is it Time to Buy?

The generally improving U.S. economy has prompted many news reports about the U.S. housing market. In addition, several clients and friends of the firm have recently either purchased a property or expressed interest in doing so and have asked us if the timing is right. These queries prompted us to look more closely at recent statistics and research on the sector.

In our view, the data suggest that there are reasons to believe the worst is over. First, house prices appear to no longer be in a freefall, a huge relief to current and prospective owners (Figure 2).



Figure 2: U.S. Single Family House Prices (Jan 2000 = 100)

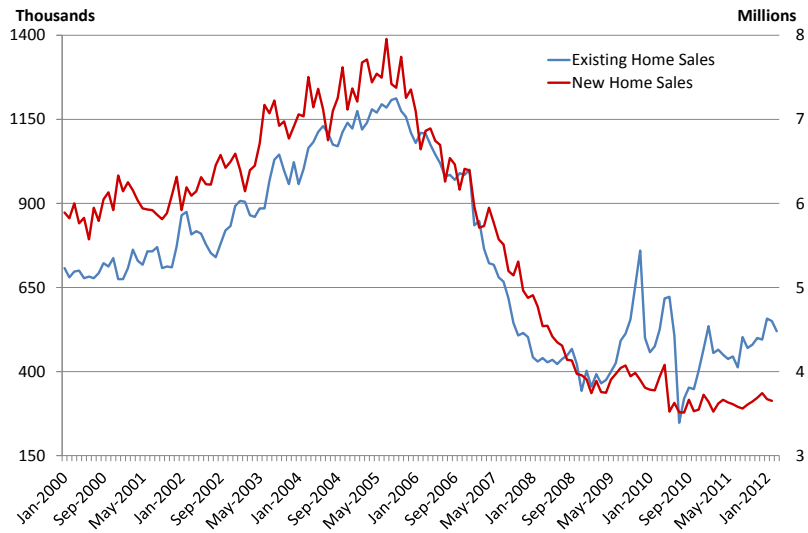


Source: Project America

When the housing bubble burst beginning in late 2006, house prices fell almost 40%, making it one of the worst bear markets in U.S. history. However, housing prices have been stable for about three years at those lower levels.

More importantly, sales of both new and existing homes seem to be stabilizing (Figure 3).

Figure 3: Existing Home Sales vs. New Home Sales

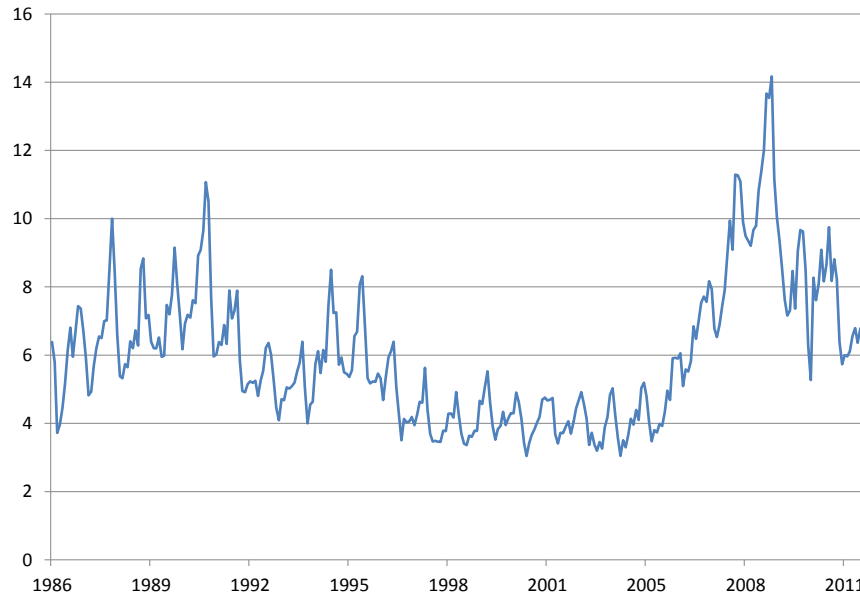


Source: Haver Analytics



In addition, as shown in Figure 4, the inventory of unsold homes has dwindled to about six months of supply (considered ideal for a healthy housing market by experts), and the inventory of unsold new homes is now at its lowest level since the 1950s (the likely reason why homebuilders' stocks have been soaring lately).

Figure 4: Months of Supply of All New and Existing Homes

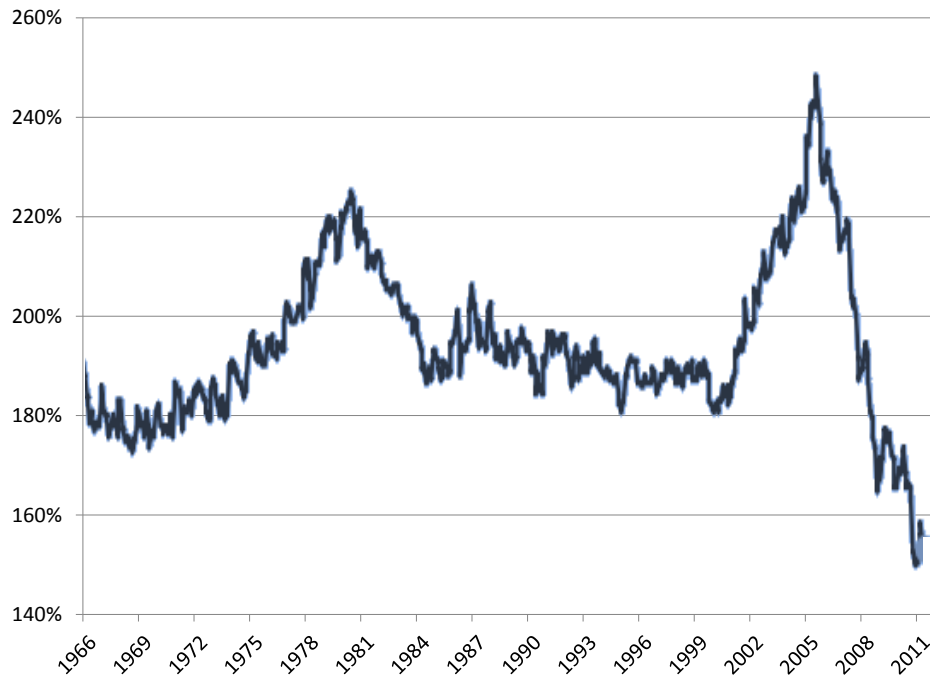


Source: EconoMagic

Moreover, housing affordability appears to be both underpinning this stabilization and supportive of continued market improvement. One of the simplest measures is to look at home prices relative to average household income. Figure 5 shows the relationship between average, per-household personal income and home prices over the years. Since 1966, the median price of an existing single family home in the U.S. has varied between 150% and 251% of personal income per household. Roughly 75% of the time, it has been between 185% and 230%. By the fall of 2011, the ratio was just 153%, the low end of the 45-year average. This leaves ample room for rising home prices even to get back into the middle of the historic range.



Figure 5: Median home price of existing single-family home as a percentage of personal income per household



Source: Advisor Perspectives, J.P. Morgan Asset Management

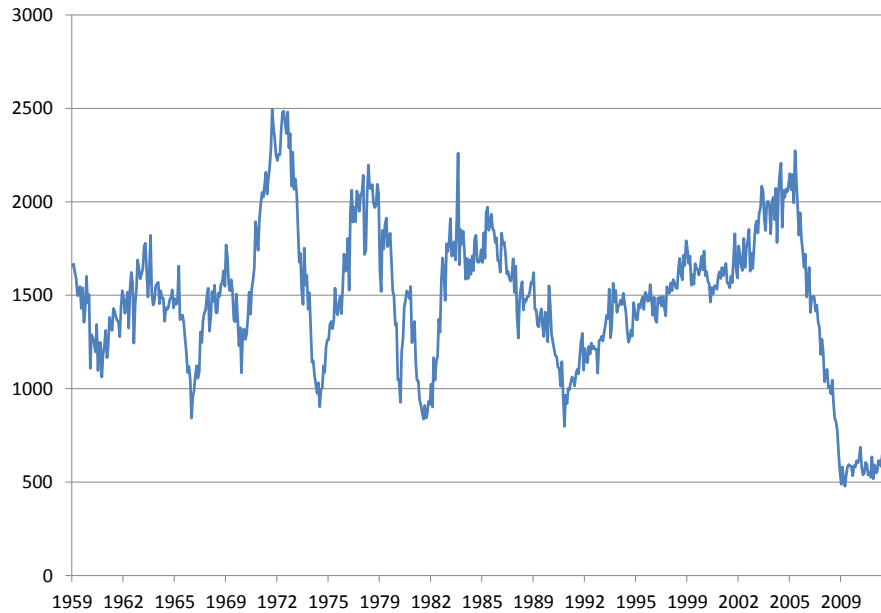
Current mortgage rates represent another measure of affordability. According to J.P. Morgan, at current rates and assuming a fixed-rate mortgage with 20% down, the median mortgage payment on a single family existing home is just 6.9% of per-household personal income, compared with an average of 14.4% since 1966.

Greater affordability comes with the improving economy and continued improvement in job growth as backdrops, which will increase the rate of household formation and the demand for housing. Also, it should slow the number of foreclosed properties coming onto the market.

Longer-term factors also favor recovery of the housing market. Housing starts have declined from an annual rate of 1.8 million in 2006 to under 700,000 by the end of last year (Figure 6).



Figure 6: Total Housing Starts (thousands, seasonally-adjusted)



Source: EconoMagic

Most economists estimate that, given U.S. population growth, household formation rates, replacement needs, and other variables, builders likely need to be building closer to 1.5 million houses annually to satisfy the “natural” demand for housing. This supply-demand imbalance bodes well for prices at some point.

But there are some equally good reasons to believe that we are not yet completely out of the woods. One big concern is the so-called “shadow inventory” of houses. These are houses destined for market, but not yet counted as inventory. Shadow inventory includes homes that owners would like to sell but have not yet placed on the market due to current low prices. It also includes homes somewhere in the foreclosure process but, again, not yet on the market. It is tough to gauge the size of the shadow inventory, but conservative estimates suggest the combined shadow and revealed stock of unsold homes might stand at over an 18-months’ supply. This supply overhang may well explain why housing prices have remained weak despite the recent sales pickup, and why they may continue to decline somewhat for a while longer.

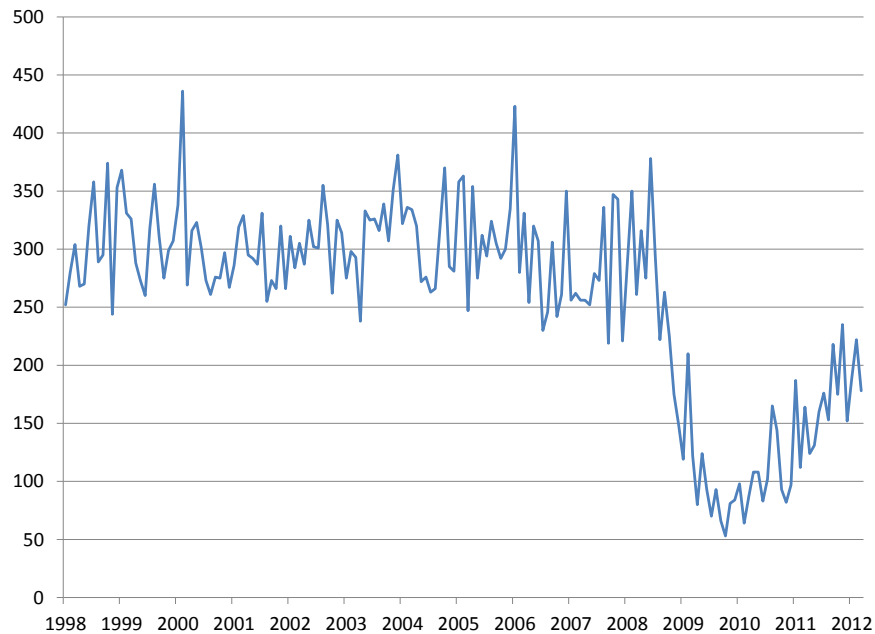
Another headwind is tight credit standards. According to an interesting new paper by the Federal Reserve, mortgage credit conditions have tightened severely from their pre-recession levels and are limiting or preventing lending to even creditworthy borrowers. While some tightening is definitely warranted, given the lax standards that prevailed in the



years before the house price peak, very recent surveys by the Fed indicate persistent net tightening, even for prime mortgages for which lenders do not bear the credit risk.¹

In the meantime, people have to live somewhere, so it's not surprising to learn that rents have risen rapidly, fostering a mini-boom in multi-family housing starts (Figure 7).

Figure 7: Multi-Unit Housing Starts (thousands)



Source: EconoMagic

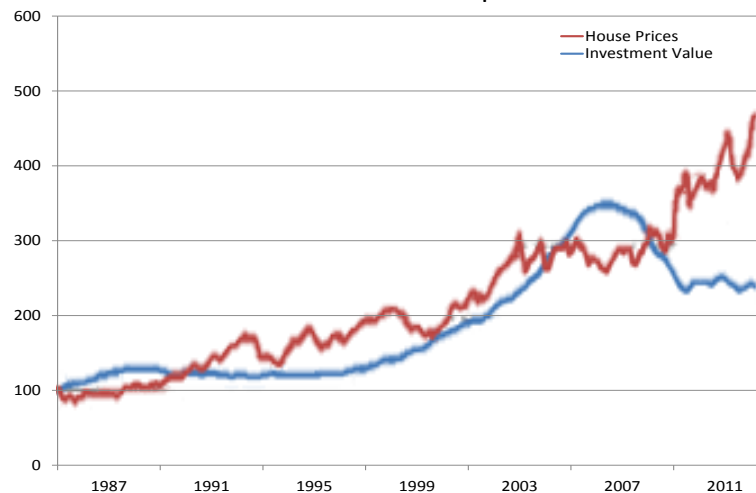
One paper we looked at calculates the investment value (monthly cash flow value) of housing based upon rents and interest rates.² This measurement treats a house as an investment, similar to a bond, which rises in value if interest rates fall. But it also rises when rents rise. A comparison of investment value with home purchase prices is shown in Figure 8.

¹ Federal Reserve Board of Governors, "The U.S. Housing Market: Current Conditions and Policy Considerations", January 4, 2012.

² GR-NEAM, "American Housing: Falling Prices, But Rising Value", *Reflections*, February 2012



Figure 8: House Prices and Investment Value Based Upon Rents



Source: GR-NEAM

The result suggests that the market is crying out for more rental supply, higher house prices, or both, as there hasn't been a gap approaching the current level for at least the last 25 years. The other implication is that the return to ownership for rental income rather than for occupancy suggested by this relationship is attractive. Indeed, the aforementioned paper by the Federal Reserve draws the same conclusion and goes so far as to float the idea of establishment of a new government program to encourage large-scale conversions of foreclosed properties to rental units. Several private companies have already jumped into action this year in California.

Bottom line:

Based on all this new data, our view is that the housing market is in a nascent recovery. Prices are likely to continue to fall, particularly in hard-hit markets, but the worst appears to be behind us in most regions. While it may be too early to call an absolute bottom to home prices today, as one pundit put it, "it's a very low risk conclusion at current valuations."

Artemis Portfolio Strategy

We are sticking with the game plan we set out in our letter last quarter, namely to favor U.S. and emerging market equities over developed international equities. We have not fully eliminated our underweight position in emerging market equities, as we remain concerned about slowing growth in some of the largest emerging market economies, especially China.



Artemis

FINANCIAL ADVISORS LLC

Indeed, China has recently displayed broad-based weakness across exports, industrial production, real estate, and autos. Authorities have eased some monetary policy measures, but lending and money supply growth remain tepid, underscoring continued risks to the outlook. For us, the key signal to start to overweight emerging stocks is when Chinese shares begin to take off.

The continued uncertain global macro backdrop and low yield to maturity on high-quality bonds also reinforce our strategy to diversify our clients' fixed-income holdings. We favor U.S. high-yield bonds, emerging market debt, and, increasingly, U.S. commercial real estate fixed income, and we have recently modestly increased our clients' exposure in these areas.

Finally, the uncertain global environment reminds us to remain cautious overall, and so we have no plans to increase risk at this time.