BLUE WATER'S Market Perspective

March/April 2012

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We welcome back all of our long-term readers, and in addition we extend a warm welcome to those who are new readers. We will present our usual review of the economy (authored by Wilson), market trends (authored by Sivalingam and Wilson), and a segment on wealth management (authored by Pavlovich and Wilson), followed once again by a brief discussion of a special topic (authored by Wilson). **This time the special topic for discussion will be "A New Wave of U.S. Export Growth Will Soon Drive The Economy."** We hope that this issue's offering will prove useful to a wide range of investors and will help explain more completely our opinions on what should be done under current market and economic conditions. For new readers, please note that each issue going forward will feature a special topic for more detailed examination, plus a bimonthly economic and market review. There will only be room for a brief discussion of each topic, so even the busiest reader ought to be able to glean something from this report with a minor time commitment. Please feel free to send us an e-mail or call with questions, comments or suggestions.

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Economic Commentary: Springtime for the Federal Reserve

By Kevin M. Wilson

Overview: Operation Twist Will End in June, Inflation Outlook Benign

It's springtime again, and that means that the Federal Reserve is being closely watched for signs that it is willing to print money again, as it did after market drops each spring in 2009, 2010, and 2011. In just two months, the Federal Reserve will probably end its "Operation Twist" program (as scheduled), just like it ended the "QE2" program last June. Under the "Operation Twist" program, the Fed extended the maturity of its bond portfolio by selling $400 billion of shorter term bonds and buying longer term bonds to replace them. During much of the program the Fed has purchased 100% of all longer term bonds offered weekly by the U.S. Treasury, essentially acting to monetize long term public debt issuance. The Fed's stated intent was to lower mortgage rates, which is pretty much what happened temporarily right after the announcement last September. However, yields on the 10-year U.S. Treasury, which serves as the benchmark for mortgage rates, have averaged about 2.00% since November, which is essentially the same as rates were before "Operation Twist" began. Mortgage rates haven't really moved much since early February, when they reached a plateau of around 3.90%.[1] These are very low rates, but ignoring seasonal effects, home sales are still at deep recession levels, and likely to remain depressed as prices continue to fall nationwide.[2]

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Homes Sales (Source: Northern Trust)

Springtime for the Federal Reserve (Continued)

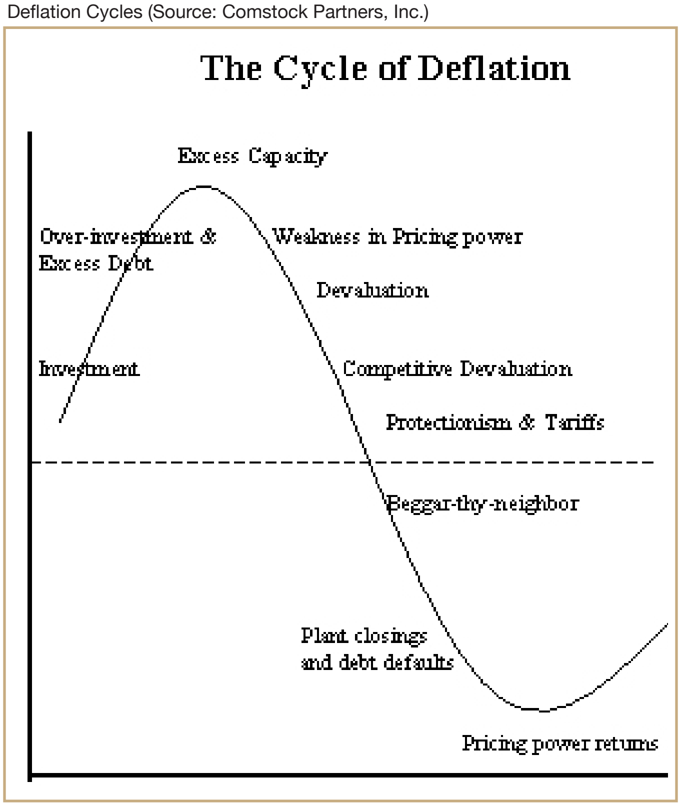
The massive Fed intervention under "Operation Twist" has had at least one other effect, in that it appears to have helped drive a huge rally in risk assets such as stocks and commodities over the last few months. The main driver of the recent rally however was probably the European Central Bank's $1.3 trillion Longer Term Repurchase Operation (LTRO), which began in November and was instituted to provide emergency liquidity to European banks in the midst of Europe's debt crisis. The global risk rally is now faltering, in part because Europe's troubles persist, and in part because the policy efforts behind the LTRO and "Operation Twist" are perceived by the markets to be ending soon. The consensus is again this spring that interest rates will rise, not fall, driving yields higher after the Fed intervention ends. Many large bond market players are actually shorting Treasury bonds in the belief that they will fall in price (rise in yield) in the near term, just as they did last year. Others though, counsel that deflationary pressures remain high, with the housing market in trouble again, unemployment still high, productivity falling, and economic activity apparently slowing down.

The set-up is actually technically similar to what it was last May, and the May before that, when in each case longer-term bonds rose in price as yields actually fell in response to the end of the Fed's monetary easing. Whether we observe the same thing this time once again depends on the relative importance of several factors: 1) changes in the expected inflation outlook as expressed in the spread between 5-yr. Treasuries and 5-yr. TIPS (inflation-protected bonds); 2) active trading volumes on long vs. short positions in Treasuries; 3) relative cash flows into or out of bond mutual funds and ETFs; and last but not least, 4) perceptions about the interaction of monetary policy and various economic trends. Taking the last factor first, author and economist Gary Shilling has again this spring argued that the deflationary pressures of the declining housing market, falling wages, high unemployment and depressed capacity utilization will trump any inflationary pressures arising from higher food and energy costs associated with the Fed's and the ECB's monetary easing programs.[3] Economist David Rosenberg has again this year seconded this deflation forecast and suggested the same kinds of market reversals as were seen last year.[4]

Another factor, the inflation outlook, can be captured by observing the 5-yr. TIPS spread to Treasuries. It has been climbing since last October, rising from 1.41% as "Operation Twist" began, to 2.01% in late April of this year.[5] This trend indicates inflation expectations are increasing rapidly but once again are still quite moderate. Yet another factor involves the effect of cash flows into taxable bonds via mutual funds and ETFs. These cash flows into bond funds are still quite strong, reaching $7.2 billion/week over the last four weeks, whereas average outflows from equity funds over the same period reached -$1.9 billion/week.[6] Finally, it is known from the Commitments of Traders reports that huge volumes (130,045 contracts) are now involved in shorting the Treasury market.[7] Similar factors applied last spring, and bonds rallied in a big way over the summer while equities dropped about 20%. In fact, the S & P 500 has essentially gone nowhere (+10 points or +0.73% YOY) since April 29th of last year. Counterbalancing all the recent talk about inflation is the fact that bonds are holding up much better than expected, suggesting that a change in attitudes about inflation risk and/or market risk may be underway.

Deflationary pressures remain high, with the housing market in trouble again.

Deflation Cycles (Source: Comstock Partners, Inc.)



But Will the Recovery Continue?

Several economic factors are putting downward pressure on the global economy right now, and their combined effects may tend to weaken the recovery a bit more than is really comfortable. Rising oil prices, which we discussed at length in the previous issue of this newsletter, continue to subtract from global growth. The risk of a recession caused by higher oil prices seems to be receding for the time being, however, based on adequate short-term supplies and a receding threat posture from the Iranian government, as it tries to capture more gains from appeasement gestures by assorted Western nations. This could change overnight of course, with perhaps the most dangerous likely scenario involving an Iranian naval blockade in the Straits of Hormuz. Supplies relative to global demand are still likely to continue tightening, and a continuation of the global recovery would greatly exacerbate the oil supply shortfall over the next year or two. Perhaps the good news is that oil speculators have also played a significant (but not dominant) role in the price move so far, and therefore demand alone probably does not justify the recent peak in oil prices. Very recent minor declines in oil prices from the peak probably signal the market's awareness of this fact. If demand in the West continues to fall, this could cause a sharp oil market correction at some point, especially if the general stock market also declines, or the

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Springtime for the Federal Reserve (Continued)

dollar rallies.

The Euro-zone crisis continues this spring, with an ever-increasing risk of at least one more sovereign bailout program being required. The most likely culprits would be Spain or Portugal, based on the strong rises in government bond yields these countries are experiencing right now. The pressure on Spain and Portugal is increasing as some Euro-zone countries such as Germany, France, and the UK deal with voter revolts over footing the bill for bank incompetence, and severe austerity programs imposed in the midst of new recessions. The much-vaunted LTRO liquidity program of the ECB has failed to increase bank lending, but unfortunately did increase risky bets by Spanish banks, who bought massive quantities of their own sovereign debt with their LTRO proceeds. Since the prices for that brand new debt are now dropping, the relative safety of Spanish banks is again gravely in doubt. However, we fully expect the ECB to again ride to the rescue at taxpayer expense. It is likely that the extremely unrealistic policies of the Euro-zone and ECB in dealing with the sovereign debt crisis will again take center stage as they fail yet again to win support from the bond markets. Remember, Euro-zone policy is centered on dealing with liquidity, which is ironically just fine right now. However, the actual problem is insolvency, and there is no easy solution for that, nor has an effective one been proposed.

The actual problem (in the Euro-zone) is insolvency, and there is no easy solution for that.

In the U.S., a slowdown is well under way, as evidenced by falling manufacturing activity, greatly reduced real (inflation-adjusted) retail sales volumes over time, continued consumer deleveraging, falling real wages, higher rates of unwanted part-time employment, falling labor participation rates, falling productivity, falling home prices, higher gasoline and diesel prices, falling gasoline demand, and falling corporate profit margins.[8] At present the consensus is that this is merely a speed bump in the road to recovery. In fact, just to illustrate how wildly irrational things have become, it is remarkable that Wall Street expects BOTH another Fed boost (QE3) due to pervasive economic weakness, and record corporate profit margins and major earnings boosts in the second half of the year! However, I have written a number of times about the building risk of a global recession, driven by already ongoing European recessions, a major Chinese economic slowdown, massive global deleveraging, and high oil prices.[9] Unemployment is already 24% in Spain, over 10% across the rest of Europe, and at least 8.3% (and rising) in the U.S. In addition, the so-called "fiscal cliff" is coming at the end of the year, when federal budget cutbacks and major tax increases are expected to hit consumers simultaneously, shaving 3 - 4% off 2013 GDP (which would make it negative).[10] However, assuming Europe gets no worse, the Chinese pull off a soft landing, and the U.S. also avoids recession, then the recovery will continue as before, with substantial market gains to continue as well.

Market Summary: "Jack Be Nimble..."

By Dheenu V. Sivalingam and Kevin M. Wilson

Notable tactical events in the S&P recently included a continued consolidation in equities, which appear to have stalled below a peak of 1422 points since April 2. In fact, the S&P 500 is only up 18 points (1.31%) through 4/26/2012 in the year since May 2, 2011, the previous market peak. Though there were some up days for this market in the last month, these were in the context of bearish consolidations and so, based on our short term signals, markets are in a short-term down trend. The key action to watch in the next few weeks of trading will be the resolution of these bearish patterns in equities. Probabilities dramatically favor a downside resolution, and a continued selloff, but the possibility of pattern failure deserves some consideration, especially if there are some positive economic surprises. We would be perplexed to see strong buying emerge from current levels, but this would be an extremely strong sign of underlying bullish conviction if it actually occurred. We are seeing enough volatility to suspect that those who are nimble will do a bit better over the next few months than those who are not.

We continue to hold a moderate amount of hedged positions in our two growth portfolios, with varying degrees of confirmation for these positions. We also hold substantial bond positions in the two more conservative (balanced) portfolios. Though we do not expect a dramatic decline in equities in the very near term, we do expect one sometime in the next few weeks to three months. Therefore it is worthwhile to consider the impact of such a selloff on each of our portfolios. Our current hedges would substantially mitigate the draw-downs of each of our portfolios, which are already fairly well positioned for a downside move. One can clearly see the good run most long-only managers have had in Q1 of 2012, but it appears to have come to an end, and as we stated above, times ahead will be challenging for long-only equity players for a period of several months. We are focused on risk management and we are not jumping to buy into weakness, since we expect more of

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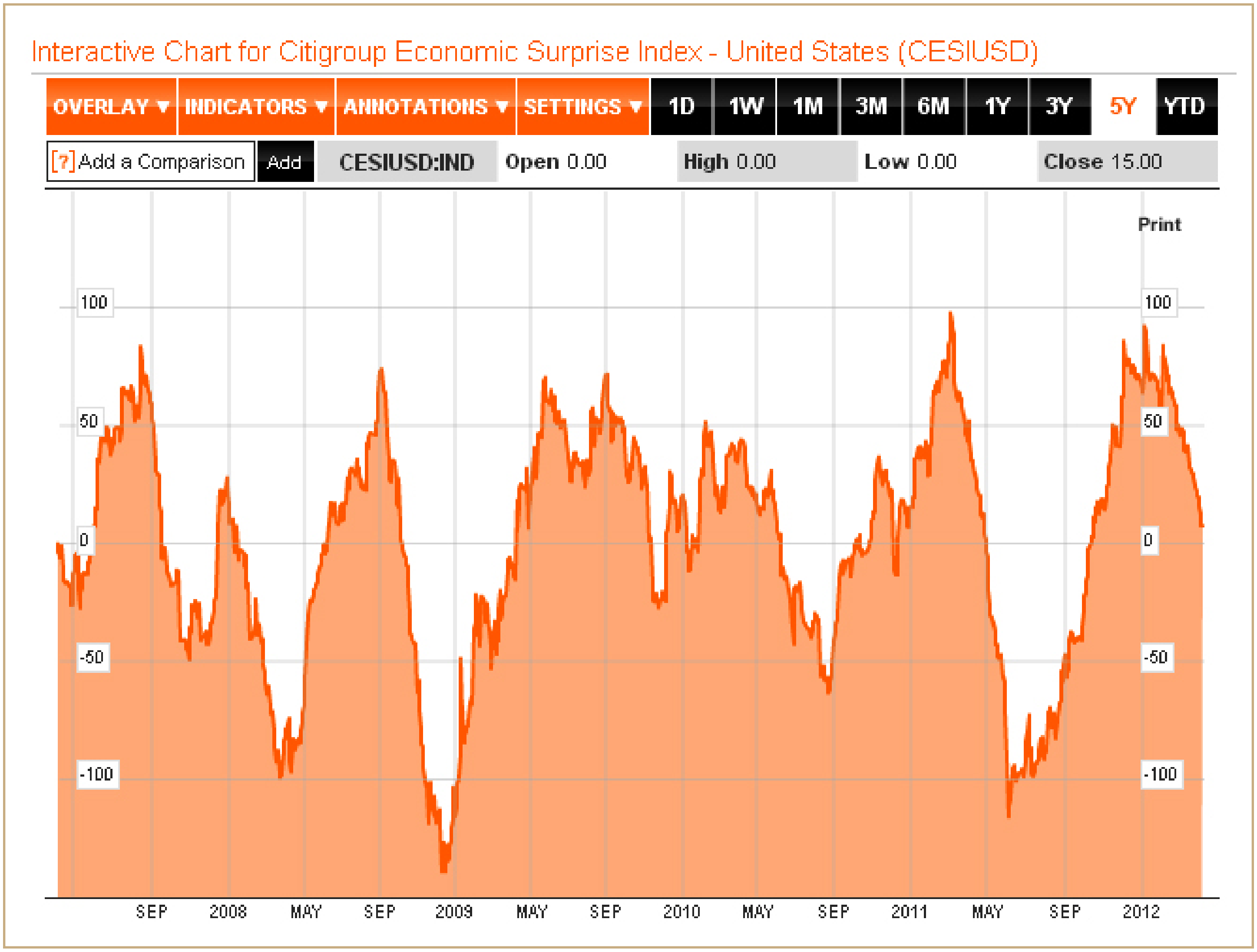
"Jack Be Nimble..." (Continued)

it in the near term. We are instead more or less patiently waiting for the "fat pitch" that Warren Buffett often mentions. This has been coming to us one stock at a time.

It is crucial, however, to put these recent bearish market patterns in context. The bigger picture (patterns on weekly/monthly timeframes) strongly supports the potential for further upside over the intermediate term, with the possibility of a very dramatic rally later in the year if the recovery somehow strengthens or if in the alternative QE3 is announced. The most significant issues in risk management right now come from the current volatility conditions – after many months of contracting volatility, many market participants may be viewing equities with a good deal of complacency. Under these conditions, any large selloff can hit technical selling "stops" and engender panicked institutional selling that leads to an outsized decline.

Recent macro drivers are focused squarely on European politics and "Euro Crisis 2.0." The recent French election results have revealed a deeply divided electorate that is unhappy with the Euro-zone austerity program. Pressure is now on President Nicolas Sarkozy to engage the discontented hard-right (led by Marine Le Pin) in coming weeks to close the gap on Socialist candidate Francois Hollande, but it seems unlikely that this will work. It is notable that both candidates have espoused protectionist and anti-business policies during the heat of the election. Meanwhile Dutch Prime Minister Mark Rutte's resignation in late April over failed austerity negotiations demonstrated the problems that the Euro-skeptic right wing is now able to cause there as well. Euro-zone flash April PMI data registered weaker manufacturing levels than consensus forecasts had predicted, with the headline index contracting further to 46 versus 47.7 last month. Finally, Banco de España's initial Q1 GDP release registered a contraction of 0.4% QOQ, providing further confirmation of the deep recession in Spain; data released the same day by the British government also confirmed a double-dip recession for the U.K. The perception of risk in European economies has been driven, in large part, by concerns over the stability and political will of the leadership there as they face many difficult decisions. In our opinion recent news underscores those fears, but provides few clues as to their resolution.

Economic Surprise Index (Source: Citigroup)



Wealth Management Commentary:
Off Into the Sunset

By Ted A. Pavlovich and Kevin M. Wilson

The Jobs and Growth Tax Relief Reconciliation Act of 2003 was signed into law by President Bush. This 2003 tax law lowered dividend and capital gains rates for all investors. Under the 2003 Act, the maximum net capital gains tax for assets held for more than one year was lowered from 20% to 15%. The reduced tax rate on capital gains, previously scheduled to expire in 2008, was extended once in 2005 and again in 2010 and is now scheduled to "sunset" at the end of this year (2012).[11] The sunset is a time phase-in provision, which means that without further Congressional action, the previous law, including the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), will go back into effect. Therefore, the top 15% capital gains rate will revert to its former pre-May 6, 2003 level of 20%, an effective 33% increase! The chart below shows the changes in the short-term capital gains tax rate and the long-term capital gains tax rate from 2003 thru 2012. The chart also projects the new rates after the sundown law hypothetically takes effect in 2013.

The chart shows that someone that in a 10% ordinary income tax bracket in 2012 and paying 10% short-term capital gains and 0% long-term capital gains would jump up in 2013 to a 15% ordinary income tax bracket and be subject to a 15% short-term capital gains tax and a 10% long-term capital gains tax. This would amount to a 50% increase in ordinary income tax and a 50% increase in short-term capital gains tax adding to a whopping 1,000% increase in long-term capital gains tax! Now let's take a look at how this affects the top end of the income range. The high-end taxpayer this year (2012) would see his ordinary income tax rate increase from 35% to 39.60% in 2013 and his short-term capital gains rate go from 35% to 39.60% in 2013, followed by his long-term capital tax moving from 15% to 20%. This would calculate out to an approximate 15% increase in this taxpayer's ordinary income tax and short-term capital gains tax rates, followed by a 50% increase in long-term capital gains tax rates. For the purposes of this article, we are addressing the tax law as it relates to stocks and bonds. The cost basis of stocks and bonds is normally the purchase price of the security plus any costs or fees associated with the purchase, such as management fees. If you acquire capital assets such as stocks or bonds by any other means, such as a gift or inheritance, then your cost basis is usually the fair market value or the previous owner's adjusted basis. In addition, if an individual realizes both a capital gain and a capital loss in the same year, then the loss can be used to offset the gain. This is one of the reasons taxpayers often sell investments that have lost value at year's end. The realized capital loss will help to offset capital gains on other investments. Finally, due to the many complexities of the current and possible new tax law changes, we recommend that you consult with a tax accountant or tax attorney well in advance of the end of this year, before the sun goes down on our current tax law.

2003–2012				
	2003–2007		2008–2012	
Ordinary Income Tax Rate	Short-term Capital Gains Tax Rate	Long-term Capital Gains Tax Rate	Short-term Capital Gains Tax Rate	Long-term Capital Gains Tax Rate
10%	10%	5%	10%	0%
15%	15%	5%	15%	0%
25%	25%	15%	25%	15%
28%	28%	15%	28%	15%
33%	33%	15%	33%	15%
35%	35%	15%	35%	15%

2013–		
Ordinary Income Tax Rate	Short-term Capital Gains Tax Rate	Long-term Capital Gains Tax Rate
15%	15%	10%
28%	28%	20%
31%	31%	20%
36%	36%	20%
39.60%	39.60%	20%

There will no doubt be a debate in Congress about whether the existing tax rates should be extended again rather than being allowed to sunset. There will be much noise produced but little light shed on the subject because it is an election year. It is possible that a lame-duck Congress will meet after the election and pass an extension in order to avoid taking the blame for crashing the economy in 2013. This outcome is not certain of course, hence the debate, but by raising taxes in the midst of the weakest economic recovery ever seen, Congress and the President are playing with fire. There is no evidence that such a move actually helps anything economically except for possibly reducing the deficit and ameliorating the

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Off Into the Sunset (Continued)

long term debt situation; however, these are also serious concerns. Adding to the drama and risk are the facts that a "fiscal cliff" will arrive at the same time, when the $1.3 trillion spending cuts agreed to last summer finally kick in, and that the debt ceiling may need to be voted on again before year-end. This dangerous combination of factors could cut GDP in 2013 by well over 3%, directly causing a recession, as was alluded to in our remarks on the economy.

Will Congress have the sense to pass something before we are forced into another test of our stamina? We shall see, but even if the tax law is extended, it is important to note that the downside to such a decision is that our huge annual deficits and growing total government indebtedness will be made that much worse. We are facing very tough decisions, much like the Europeans, and it is clear that there aren't any answers that don't involve pain. It is very important to get this one right, both for the short term benefit of the recovery, and for the long term health of our economy. It can't be that we have made all the cuts in federal spending that could possibly be made, nor is it likely that government efficiency is at peak levels. So there are some things to be done that would help our long term outlook on debt, without resorting to higher taxes. But neither are we over-taxed on income at the federal level; instead, we are taxed at so many levels of government, and in so many different ways, that in aggregate the taxes are pretty onerous for the 50% of us who still pay taxes (and have middle class incomes). Federal tax rates in 1982 went as high as 70% for the top earners, compared to 35% now. But state and local taxes and fees were much lower in 1982 than they are now for many taxpayers.

Worst of all, healthcare spending has more than doubled as a percentage of GDP since 1965, acting as a sort of "stealth" tax on the middle class that makes many people more sensitive to tax issues than they used to be. Much of that cost increase is being reflected in the huge spending growth of federal programs like Medicare and Medicaid. Since 40 cents of every federal dollar spent is now being borrowed, the current situation is unsustainable. Yet Congress and the President have refused to do anything serious about reconciling our spending habits, tax revenue needs, and fiscal imbalances. After the election, they are going to have to do something about these major problems. If they don't, and if we continue to print money, punish thrift, reward spending, and foolishly waste much of what we spend, the ever-powerful bond market will eventually do to us what they have done to Europe. Thus we continue to avoid making the tough decisions at our own risk. Indeed, it is time to stop trying to contain the problem and actually find a solution.

Special Topic:

A New Wave of U.S. Export Growth Will Soon Drive The Economy

By Kevin M. Wilson

The Shale Gas Revolution Will Lower Manufacturing Costs

The exciting boom in natural gas production from shale formations in the U.S. has astonished even the optimists. Total recoverable shale reserves exceed 482 trillion cubic feet (TCF), which, when added to the 273 TCF of existing conventional gas reserves, will provide enough energy to last 200 years at current rates of consumption.[12] This stupendous leap upwards in what had been a declining resource story has already caused some major changes. The glut in new production has over-supplied the U.S. market. In consequence, natural gas prices in the U.S. have fallen to a ten-year low under $2.00 per thousand cubic feet (MCF) of gas; these prices were more than 7-fold higher in 2005 in the aftermath of Hurricane Katrina. This has caused a reversal in the outlook for the import or export of liquefied natural gas (LNG). As little as three years ago plans were under way to import natural gas due to falling supplies. Now a leading firm has reversed course and received federal approval to convert their LNG facility in Louisiana from an import function to an export function. They will thus be able to take advantage of the arbitrage between cheap natural gas prices in the U.S., and expensive prices in Europe and Asia. The recently dormant big idea of entrepreneur T. Boone Pickens, to convert the U.S. trucking fleet to natural gas, has suddenly been given new life by the prospect of sustainably cheap natural gas prices. The fact that prices may stay under tight constraints for some time almost guarantees that many new ideas such as this eventually gain momentum in the marketplace.

Another impact has been resource-switching by utility companies, many of whom have the ability to stop burning coal and initiate burning natural gas whenever prices permit it. This is no doubt better for the environment, and has the additional benefit of lowering household energy costs across the country, both with respect to electricity use, and also with respect to the direct burning of natural gas used for cooking and heating in homes. The money saved last winter due to cheaper natural gas was used to boost consumer spending, which has helped to sustain the recovery. Yet another change is the increase in the competitiveness of U.S. manufacturers relative to those in Europe, China and Japan.[13] Recent estimates suggest a huge cost advantage will be obtained from using cheap natural gas

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A New Wave of U. S. Export Growth (Continued)

in manufacturing. This in turn could usher in a new era of increased U.S. exports and more high-paying manufacturing jobs, extending over many years. This would potentially raise U.S. economic growth by an aggregate of over 1% of GDP annually, for at least a decade. This is comparable in scale to the boost in productivity that drove GDP and corporate profits in the 1990s. The impact on markets from this would be very positive, as one might expect.

The competitive advantage enjoyed by the U.S. manufacturing sector will be sustained by four things, according to Philip Verleger[14] of the Peterson Institute for International Economics: 1) the U.S. knows how to exploit gas-producing shale formations very efficiently, and the revolution has been led by smaller companies (rather than the majors), so competition has been fierce and production costs have as a result come down sharply relative to other countries; 2) the cost advantage for U.S. manufacturers is tremendous, reaching perhaps as high as 60% or more relative to competitors such as China; 3) U.S. financial markets allow producers to lock-in prices using futures trades, permitting continued drilling in spite of low current prices; and 4) a multitude of independent pipeline networks throughout the country permit access to cheap gas by virtually all manufacturing firms, and there is no dominant player who could deny the benefits of cheap gas to any region or locality. In recognition of these factors, major foreign firms are already moving operations to the U.S.

The money saved last winter due to cheaper natural gas was used to boost consumer spending, which has helped to sustain the recovery.

Huge new reserves of natural gas in shale formations have also been found in Canada (388 TCF), South Africa (485 TCF), Mexico (681 TCF), Argentina (774 TCF), and China (1,275 TCF). However, as already mentioned, these countries (excluding Canada) lack the infrastructure and expertise needed to fully exploit their newfound resources for use in manufacturing. U.S. experts in shale drilling and production are in extremely high demand worldwide, which has already led to several substantial joint venture agreements. Major shale resources are also being acquired by foreign firms, many of which are backed by government ownership of their shares (e.g., China). Still other countries with large shale gas reserves, such as France, have decided on extremely doubtful evidence that the hydraulic fracturing ("fracking") of shale wells is dangerous to water resources, and they have completely outlawed it. But a recent MIT study noted that over 20,000 U.S. shale wells have already been fracked without significant damage to water resources quality. I know from industry experience that over 500,000 conventional wells have been fracked since the 1940s with little or no damage, except when improper engineering procedures were used. I have personally fracked over 100 wells without incident, and I believe the fears over this procedure are ridiculous. Of course environmental regulations and proper procedures need to be employed, but they already have been for decades.

In short, the natural gas production boom will continue, manufacturing costs in the U.S. will continue to drop relative to most other countries, and the resurgence in export activity will boost U.S. GDP over the next ten years. Investors would do well to keep an eye on this promising trend.

The author and geologist John Fowler at a horizontal drilling rig in Michigan, 2011.
(Source: Robin Raley)

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We encourage you to share our newsletter with business associates, friends and family. Let them know what we have done for you to preserve and grow your wealth. We would be glad to help your contacts benefit as well. We are not a "stay the course" or a "do nothing" type of firm. We are actively researching, analyzing, and managing risk every day. We do not take our fiduciary responsibilities lightly. We work hard on your behalf to anticipate economic trends and take action accordingly based on our assessment of risk and potential returns. We have made significant investments in our business to make sure we have the best information and people that are capable and intellectually equipped to make important and timely decisions managing your wealth. Also, please visit our website at www.bluewatercapitaladvisors.com, and our weekly blog at http://bluewatercapital.wordpress.com.

Please attend our next "Monthly Market Review" if you can; we'd love to see you, your relatives and your friends there. Scheduled meetings will be held at 5 pm - 6:30 pm on May 17, 2012 at WITC in Superior; and on June 21, 2012 at a location TBD. We don't run the meetings in July or August due to vacations, but will start up again on September 20. If you can attend in May, June or some later time, please RSVP to Blue Water. Business casual attire suggested.

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