BLUE WATER'S Market Perspective

November/December – 2011

Blue Water Capital Advisors, LLC



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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 "The Politics of Debt and Default."** 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 bi-monthly 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: 12 Themes for 2012

By Kevin M. Wilson

Backdrop

The shadows cast by overhanging economic issues, especially in Europe, at the end of a tough year in 2011 have many economists and investors feeling concerned about the prospects for 2012. Long-time readers need no reminders of the nature of European troubles. It probably suffices to say that the economic future of some countries in the Euro-zone (e.g., Italy, Spain, Portugal, Ireland and Greece) contains serious downside risks as a lagged result of the 2000's credit bubble, its collapse in the 2008 financial crisis, and its aftermath of government stimulus followed by deleveraging.[1] Throw in the U.K.'s recent decline, the extreme softness of the U.S. recovery, and the slowing economic activity in China and you have the set-up for a global recession in 2012, although that doesn't mean it will happen.[2] Nevertheless, it is a distinct probability now,[3] and should be the backdrop to investors' views of proper portfolio allocations based on the risk/reward matrix for equities, bonds, and cash as the new year begins.

As is usual at this time of year, predictions for the new year by market observers and economists are widely published as "guides" to investors. Since they collectively predict any outcome one can imagine, investors are free to choose their favorite set of reinforcements to the positions they already believe in, which is of course human nature. Thus anything said here will no doubt make little impression on arguments for or against various investment themes. But we make them anyway in the hopes that at the least we will have helped investors by framing the important questions being debated. By way of full disclosure, here are the major predictions made last year that actually happened in 2011: 1) a major bear market began, but not in 1st Quarter, as was predicted; 2) bond investors did enjoy another good year in spite of the consensus that the bond rally was over; 3) global food, oil and metals prices did soar in the first half, and decline in the second half, as predicted;

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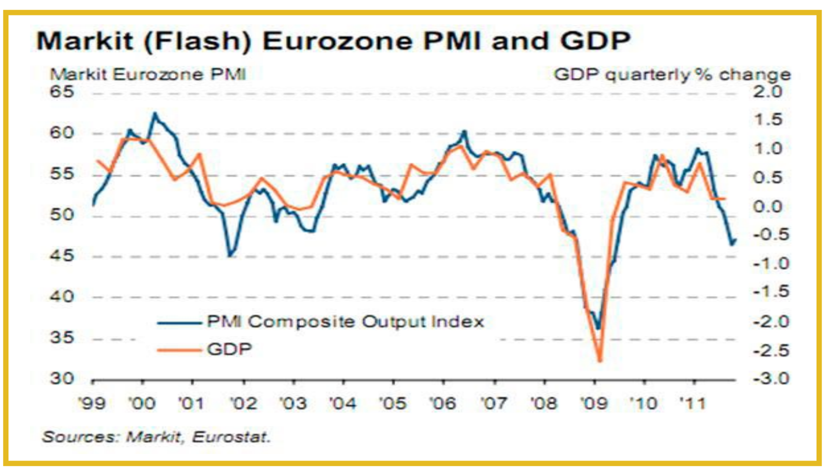
Chart 1: Eurozone in Recession



12 Themes (Continued)

4) European contagion was again contained, but only just barely, and probably not for long; 5) gold did soar to a new high and then substantially correct, as predicted; 6) Dividend-paying high quality stocks did outperform relative to the major indices; and 7) emerging markets under-performed, as expected. So we guessed correctly on about 64% of what we predicted last year.

Twelve Themes for 2012

This year we present "12 Themes for 2012," with this caveat: never have we observed more uncertainty in the workings of global capitalism, and never has the global system been more at risk as a result of a combination of financial sector incompetence, tremendous deleveraging related drags on many developed economies, widespread political dysfunction, and massive government interference in the economy and markets. There is a strong likelihood that any fix for the Euro-zone will continue to involve only temporary solutions involving liquidity, rather than permanent solutions involving solvency.[4] However, when the crisis reaches its peak (perhaps in 1st Quarter 2012), there may be a chance that a permanent solution will be found.[5] The weak nature of financial recovery in the U.S. and many other developed countries will keep the various economies teetering on the edge of recession, with a global recession more likely than not if the EU keeps floundering. On the other hand, in a best case scenario the EU solves their problems, their recession turns out to be mild, the U.S. and China completely avoid recessions, and markets rally in a big way. Here are our guesses at what might be in store:

1) President Obama will lose the election due to a poor economy, high unemployment, and low consumer confidence, and the failure of his populist message. Markets will rally late in the year in part because of this change in the government, which should be friendlier to business.[6]

2) Europe's slide into a fairly deep recession in 2011 will at some point drag the U.K., the U.S., India, Brazil, Poland, Hungary and other countries into a global recession in 2012; this may occur as early as February, or as late as June. Global data have deteriorated substantially in the last three months, suggesting that Europe is already in a recession.[7] The U.S. recession may be short and mild, assuming there is no European meltdown (probable), or much worse if there is a meltdown (possible).[8]

3) The European recession will combine with government austerity programs, financial sector deleveraging trends, and financial system stress to cause the Euro-zone crisis to peak. However, the proverbial "Minsky Moment" (i.e., when European investors are forced to sell off assets in order to pay off debts, driving all asset prices down in a market crash[9]) will not occur, due to pre-emptive and massive central bank intervention by the ECB and Federal Reserve.[10] This ends the crisis and starts a huge stock rally off the market lows.

4) As a result of the European debt crisis, poor risk management, and falling demand, a major global bank will be nationalized or closed.[11]

5) Nevertheless, at the peak of the European crisis, Greece will default, putting immense pressure on Spain, Portugal and Italy.[12] This will in turn require the central bank interventions (mentioned elsewhere) that will allow markets to breathe again.

6) As part of the global monetary easing, the Fed will greatly expand its purchases of mortgage-backed securities, in a program that will inevitably be called "QE3."[13]

7) The structural imbalances (high debt, dangerous financial sector risk-taking, serial asset price bubbles, low GDP growth, and low productivity growth) that caused the original global financial crisis in 2008, and the high unemployment rates and deleveraging that resulted, will continue to impact the U.S. economy whether there is a recession or not.[14]

8) As a result of the weakened economy and high debt load of governments, small businesses and individuals, deflation and deleveraging will dominate as economic themes in 2012. This means a higher savings rate will transpire, longer term Treasuries will continue to rally in spite of the consensus that they can't,[15] and frugality, income, and safety themes will be useful in selecting stocks.[16]

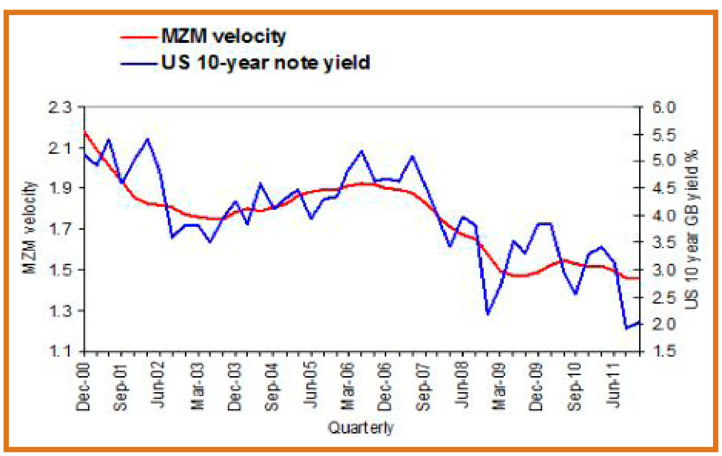
9) As a result of all the above, plus the fact that corporate profit margins will be dropping substantially, the current bear market will continue until it bottoms later in the year, with aggregate losses to the S&P 500 Index of at least 35% from the high made last May to the low in 2012. Tactical allocation will be a key approach for investors, allowing the more nimble to minimize losses on the way down, and then profit handsomely when the market rallies strongly off the low towards the end of the year.[17]

10) Oil prices will be, contrary to consensus, driven downwards sharply by the European and eventual global recessions, perhaps reaching as low as $70 per barrel (or lower). This will help in the recovery. Nevertheless, oil prices will soar late in the year to over $125 per barrel, due to rising energy demand after the recession bottoms, associated with the monetary easing applied by central banks to further stimulate the economy. Also, China's potential recovery from its slowdown will drive marginal demand later in the year, and troubles in the Middle East will cause high oil price volatility.[18]

11) The leveraged portion of the ETF (Exchange Traded Fund) industry implodes, brought to grief by derivative products (e.g., "double shorts," etc.) that fail to track their benchmarks, and a series of mid-scale "flash crashes."[19] Litigation volume will be huge as a result, and regulators, as usual, will show up after the carnage, but not before.

12) Thematic plays in the equity markets will gain support following the Euro-zone crisis and recession. Examples would include a range of supply and demand-driven themes such as global agriculture, global water resources, global energy exploration and infrastructure, and global mining sector exploration and infrastructure.[20]

Chart 2: Money Velocity Drives Bond Yields Lower" **(Source: P. du Plessis)**



Market Summary: Poor Risk/Reward Trade-off Requires Tactical Allocation Strategies

By Dheenu V. Sivalingam and Kevin M. Wilson

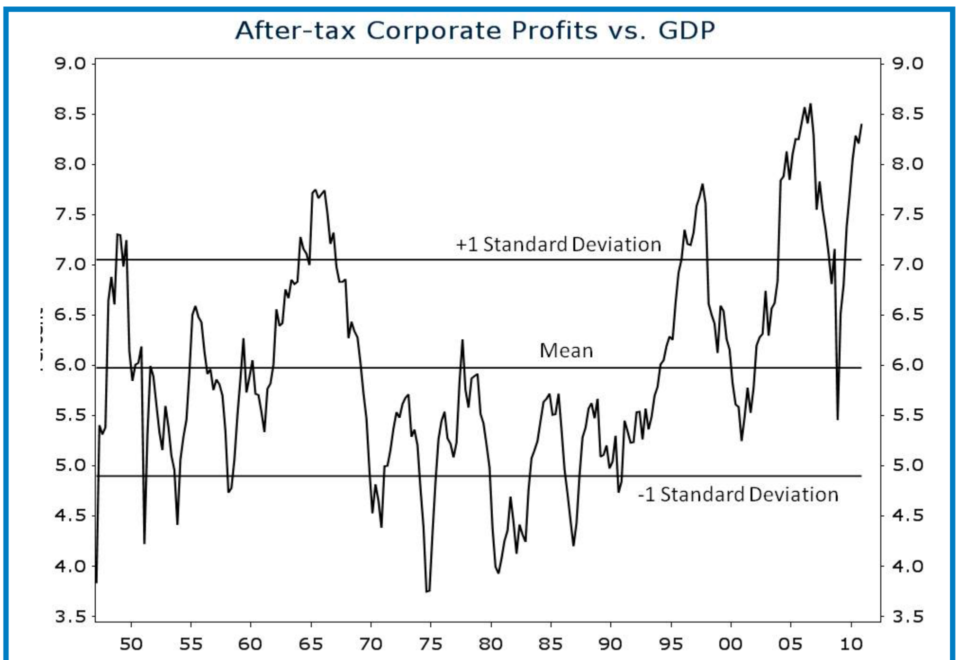
In general markets are in a large-scale consolidation mode, wherein all significant declines have met with ready buyers. On the other hand, there has been no conviction on moves to the upside, and so no upside breakout has occurred, and markets remain locked in these relatively neutral consolidation patterns. This may be setting the stage for a significant move once a breakout from consolidation finally occurs, but it is not obvious whether the move will be up or down. However, time is running out for an up move of any size, since earnings season starts within the first two weeks of 2012, and analysts' estimates have already dropped an average of 10%. Some observers are suggesting that the essentially flat market of 2011 could continue into 2012. However, the many problems in Europe, the advent of a global slowdown or recession, and the probable substantial decline of U.S. profit margins from their all-time highs have tilted the probabilities towards the downside.

For those who are feeling more bullish, it is still likely that volatility will remain high in 2012. It is important to note, as we have learned over the last few years, large irrevocable losses can accrue to investors/traders who attempt to position in these pre-breakout zones before a clear pattern emerges. We believe that these are complex and difficult times to make large directional trades in the absence of technical support and momentum. Ideally one should be prepared either to aggressively manage positions with tight stops, or to sit through large adverse moves with smaller positions. Having a plan and sticking to the plan is the only way investors will come out of this market turmoil with capital left to invest. After a tough year, we have settled upon the use of larger scale technical indicators, which we believe will let us tactically adjust on major moves while ignoring smaller moves. We have back-tested this approach and see plenty of evidence that it should work. Trading less, but trading with conviction, should lead to reasonable results even in a sideways market. We believe that the risk/reward characteristics currently observed do not permit a substantial commitment to equities until the overbought, overbullish, and over-valued syndrome now present is displaced by downward price action.

In terms of sectors, we also continue to believe that the best potential for short-term earnings outperformance and relative market leadership lies in Energy, Technology and possibly Industrials stocks. In the case where defensives are needed, say in the event of more European troubles, we expect Consumer Staples, Health Care and Utilities stocks to continue to do well. While we see attractive opportunities in many individual names in a variety of sectors, we are cautious now due to the elevated levels of implied correlation (all stocks tracking an index closely), and the relatively high levels of volatility. The estimated risk to reward ratio associated with owning individual names does not look attractive in the intermediate term. We do not believe that Materials or Consumer Discretionary stocks offer attractive broad sector plays at this time, although they will again be in play after the head line risk from Europe is reduced. Speaking of Europe, we believe that there is real value to be found in European stocks, especially in Germany, France and the United Kingdom; however, this is best played once resolution of the current crisis is a bit more evident.

The European debt crisis is still driving the day to day market action and appears to be driving many of the short term swings in trend lines. In short, although the December European summit brought progress, there is no decisive conclusion to the crisis in sight. As the world waits for greater details and an ECB response, the facts suggest that while the measures adopted may ultimately prove sufficient to avoid a deepening crisis, the intermediate-term looks bleak for the European economies as a new age of austere budgets and high taxes takes hold. EU underperformance for the foreseeable future is almost certain. The ECB's move to inject liquidity into banks, thus making up for the funding shortfall experienced as U.S.

Chart 3: Profits to Fall



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Poor Risk/Reward Trade-off (Continued)

money market funds withdrew from Europe, dominated market narratives in the last weeks of 2011. The initial purchases by banks were at a level of EUR 489 billion in this three-year ECB loan tranche. The ECB operation is larger than anticipated, with 523 banks participating. With a second lending facility scheduled for late February, the short-term funding crisis for European financials has now been decisively addressed, but only from the point of view of liquidity. Although European banks face significant debt rollovers in 1H 2012 and the process of stabilizing capital ratios continues, expectations are clearly developing that the liquidity provided from ECB coffers will now trickle through to peripheral sovereign debt as a back door quantitative easing mechanism. This is almost certainly an overly optimistic presumption, as there is no assurance that the security provided by a lender of last resort will embolden banks to buy Italian or Spanish debt, especially since they are under the gun to deleverage. For now we are noting two major factors which may influence markets: 1) short-term liquidity does nothing to address the underlying economic issues facing Europe; and 2) crisis aversion in Europe is actually bullish for U.S. market sentiment. For now, if the market were to take an upside bias direction at some point, we would continue to see support for our U.S. relative outperformance thesis.

Wealth Management Commentary:
The Meaning of Wisdom and Experience

By Ted A Pavlovich and Kevin M. Wilson

Now more than ever there are very high levels of wisdom and experience needed for managing money. With the S&P 500 at 1,244 points right now, markets have made essentially no returns since 1998. If you indexed over that time, as many say you should do, you just wasted 20% of your investment lifetime going nowhere. Even if you stayed invested 100% in stocks since the low of March 2009, you are still well below the balance you would have had in such a portfolio four years ago. Many are aware of this failure to make progress and have withdrawn from the markets. You may even have stopped opening your 401k statement, since it is now probably more like a “201k,” or at best a “301k.” To top it all off, your home, cabin, or condo properties are probably down substantially in value but you are nevertheless paying higher real estate taxes! The atmosphere of continual crisis over the last four years has worn down many investors, and the ongoing problems in Europe and the U.S. are somewhat discouraging.

There are real reasons to fear the unknown, but we believe that the answer is not to retreat from your dreams or financial goals. Instead, you should proceed cautiously, with full awareness that this too shall pass. Indeed, we have been through long periods of market decline before this (e.g., the bear market of 1966-1982) and have eventually experienced equally long periods (e.g., the bull market of 1982-2000) of sustained growth. A prepared investor should be able to minimize losses when fear prevails, and obtain reasonable gains when the inevitable optimism of the markets returns. Since markets are so volatile and complex nowadays, we suggest that you hire a registered investment advisor you can trust, one who has the experience and wisdom in handling risks to navigate this environment. We humbly submit that Blue Water Capital Advisors, LLC is such an advisor. Remember that registered investment advisors are legally and by regulation held to a fiduciary standard, much like a trust company. That means that they must always put each client’s needs first, ahead of those of the firm or its employees. We have between us here at Blue Water an accumulation of over 52 years’ experience and market wisdom. Our mission is to use that experience and wisdom to fulfill our fiduciary obligations to our investors. Many of our clients already know from long experience with members of our team, that we can be trusted with helping you achieve your dreams and financial goals.

More and more people seem to believe that the current political environment reflects the lack of integrity and total breakdown of ethics and accountability in our country. The recent appearance of the Tea Party in many cities, or the many local Occupy Wall Street groups, represent opposite political approaches but surprisingly similar complaints. People in each group appear to be responding to the fear, anger, and distrust that they are experiencing due to: 1) huge transfers of wealth (bailouts) from the public sector to the private sector essentially designed to socialize the losses at Fannie, Freddie, AIG, GM, certain hedge funds and Wall Street’s big banks; and 2) the constant interference of the federal government in various sectors of the economy, while simultaneously failing to hold accountable the management and bondholders of all these same entities as they failed their clients, their employees, and ultimately U.S. taxpayers. Although history shows that this kind of failure is common (e.g., just look at what’s happening in Europe), people are as concerned as we have ever seen them about how the financial system is affecting their lives.

We can readily understand the public’s anger and sense of helplessness at the government’s many ad hoc decisions over the last four years to “print money” and run up huge deficits, greatly expanding our collective long term risk while achieving little in the way of lasting economic progress. Many retail investors have pulled out of the markets over the last year and gone to cash, often because they no longer feel comfortable with how the markets are working. We would argue that for most investors this is a mistake. Really, what many investors need is someone to help them navigate (with a degree of relative safety) the

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The Meaning of Wisdom and Experience (Continued)

formidable market environment we now face. We believe that that is what good advisors should do for their clients. Long term there is no alternative to investing in the markets if one hopes to achieve one's goals, but there are ways to mitigate the risk through active, tactical asset allocation.

Our outlook for the New Year is one of caution. When one of us, Ted, started out in 1983, the S&P 500 Index was at approximately 150 and the DOW was at about 940. The "experts" training me thought that after 190 years, that was top of the market! Obviously our system is resilient and over the long term investing in American companies has been a good idea. We submit that in spite of today's complexity, it still is a good idea over the long term.

Clearly our political leadership must present a unified plan that would give the citizens and businesses of our country a road map as to how we will get out of our current situation. We know that this will involve reducing our debt over time. Our government must also hold accountable those institutions and individuals (in both the public and private sectors) that have enabled and perpetuated this financial debacle. Our leadership must also act to remove the moral hazard that now prevails in the financial industry as a result of government interference in the markets.

We believe that the market's problems are manmade; therefore, they can be solved by man. An old sage once said to me, "Never bet on the end of the world, it only happens once in an eternity." So we reject the fear that sometimes drives people out of the markets permanently. Certainly, however, we must be cautious and realistic about the current economic and political environments and their effects on our markets. We offer our clients hope with respect to their dreams, and action with respect to the control of portfolio risk in these turbulent times.

Special Topic:

The Politics of Debt and Default

By Kevin M. Wilson

The Problem is Debt

A surprising amount of media coverage and market worry about the European financial crisis has been focused on various bailout schemes, rather than on the much more fundamental topic of how to deal with the underlying structural economic imbalances in Europe. But of course before these structural balances can be cured, the survival of the Eurozone for the near term must first be addressed. Bailouts might work very briefly to allay market fears, but long term solutions will have to involve some sort of support for the credible funding of sovereign debt over time. Michael Lewitt (www.thecreditstrategist.com) has noted that European banks currently need to generate $800 billion per month to fund the maturing portions of their massive $55 trillion of debt (4 times the U.S. amount). This is clearly unsustainable, implying that around $2.0 trillion of bank recapitalization will be needed in the European banking sector. This is far more than is contemplated by the currently authorized levels in the European Financial Stability (bailout) Fund, or EFSF.

The story of how Europe came to be in this fix is a long one, but can be summarized here as three basic problems that were never resolved: 1) the relatively high unit labor costs and generally uncompetitive nature of the Southern European economies relative to Northern European economies; 2) the promise of government social benefits (such as pensions) in Europe far exceeding the ability to pay for them; and 3) the use of sovereign debt to paper over the other two problems at ever increasing levels throughout Europe. For some time now many governments in Europe have persisted in the vain hope that truly impossible levels of GDP growth would someday appear to save the day with respect to servicing all of that debt. Now that a new European recession is beginning, these hopes are shockingly out of sync with reality. What will happen when markets accept the fact that growth is on hold for at least a year is anyone's guess, but I don't think we will like it.

In the meantime, various austerity regimes have been proposed or put in place in most of the EU periphery, essentially precluding the possibility of even temporary Keynesian GDP growth to offset the new recession. This government austerity will probably have the contrary effect of actually making the debt load worse, since tax revenues will fall as a result of the recession. Yet, the costs of automatic stabilizers like unemployment insurance will simultaneously soar. Plus, the potential cost of new debt may continue to rise, given the lack of any solution to the underlying structural imbalances. This means that some form of coordinated action by the IMF, the European Central Bank (ECB) and the Federal Reserve will soon be necessary if sovereign debt rollovers are to be funded and markets are to avoid a collapse in the near term. The reason the term "collapse" is appropriate here is that most large European banks are insolvent, as are a number of governments if their banking systems go.

The Need for Action

The ECB, the Fed and four other central banks announced at the end of November a new, coordinated effort to provided liquidity to the European banking system. Wall Street rumors suggest that a major European bank was about to implode due to illiquidity, and that may have driven the decision. Be that as it may, this action is strongly reminiscent of the fall of 2008, a time we would all like to

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The Politics of Debt and Default (Continued)

forget, and certainly never repeat. There are differences this time, the most prominent one being that the central banks are more prepared. Another difference is that European governments are in general agreement that the Euro must survive, even if major changes are required. But a really scary difference this time is that the population (especially the middle class) is now fully aware that they will be stuck with the bill (again) to save those who caused the crisis, i.e. incompetent bankers and irresponsible governments. This may prove to be a wild card in the game of politics; certainly the approaches favored by the Germans (austerity and no money printing) have been strongly influenced by this aspect of the problem.

However, there are also a number of parallels with the financial crisis of 2008: 1) the problem again involves highly leveraged banks, but linked to sovereign rather than subprime debt this time; 2) off-balance-sheet assets (such as Greek, Spanish, Portuguese and Italian sovereign bonds) of Too-Big-To-Fail (TBTF) banks are again giving regulators and the public a false impression of bank solvency; 3) various governments again favor highly destructive bailouts over actually solving the underlying problems; 4) unregulated banking system credit derivatives (credit default swaps, or CDS) are again a real but indeterminate threat to the entire financial system; and 5) central bank policy errors (such as tightening earlier this year by the ECB) are exacerbating the problem. Failure of governments and central banks to reach at least an interim solution using a so-called monetary "bazooka" (now transformed into a "howitzer" in the media), will very soon cause a financial collapse, according to many observers. Signs of stress in the global banking system are manifest; indeed, we monitor these daily now ourselves. The overhanging threat from losses not yet taken is causing the entire Eurozone banking system to freeze up, much like it did in 2008. However, much depends on market sentiment, and markets are completely agnostic as to the mechanisms used to "save" the system – they simply want something to happen that removes uncertainty and offers a chance at profitable new trades.

The Politics of Debt and Default

If we assume for starters that Greece, Portugal and Spain will soon default (in that order), we will merely be acknowledging what markets already believe. If we further assume that Italian debt is unsustainable at current high bond yields, and that failure to provide a means of rolling over maturing Italian and Spanish debt could take down the entire European financial system, we would again merely be reflecting what markets already think. Given the massive (40:1) average leverage within the European banking system, and the rising cost of financing European government spending, it is unrealistic to talk of "solving" these problems without write-offs and defaults. However, no one in government is even considering recognizing the actual losses; rather, naïve attempts are made to convince markets that much smaller "haircuts" are required than are already being priced. European banks are deleveraging rapidly in an attempt to beat the clock on new reserve requirements, with the ECB buying major portions of the bad debt that is sold each week. Banks are booking substantial losses on the rest.

The overhanging threat from losses not yet taken is causing the entire Eurozone banking system to freeze up, much like it did in 2008.

The Eurozone bailout schemes now contemplated, involving debt purchases by the IMF or debt monetization (money printing) by the ECB, amount to little more than transfers of the private sector (bank) debt back to the public sector where these instruments originated, with a net increase in total debt. But only a major reduction in overall debt will solve the problem. This debt burden transfer is so huge it will probably take at least two generations to pay off, assuming that tax rates are sustained at very high levels. So the real problem is convincing the public that they should shoulder this burden for the greater good, rather than let the banks take their losses or fail. As Keynes pointed out in 1922, resolving this kind of crisis is always a political question – it's about which group will end up paying the cost of rebalancing the system. Will it be the investors who gambled all and lost? Will it be the middle class who received little benefit but will pay the cost via taxes? Or will it be the working classes paying the major part of the cost through currency devaluation or hyperinflation?

In 2008, it was decided by the Fed and the U.S. Treasury (on an ad hoc basis) that the public should underwrite essentially the full cost of all rescues and bailouts. This had the disturbing result that, almost without exception, no major group of bondholders ever paid the price for blowing up, or assuming cynically that they would be bailed out if anything went wrong. They were made whole by the public purse, violating one of the major tenets of capitalism. Thus "creative destruction" has not occurred and the weak and incompetent have been rewarded. The public in the U.S. is permanently irritated by this action, and will be hard to deal with when the inevitable next crisis arrives. In the present European crisis, Germany has insisted on austerity budgets and no debt monetization by the ECB because of concerns about who will pay for the profligacy of Southern Europe. They are not wrong to think it is the German people who will pay the most, because in fact no one else has any money. The French people and those of several other fairly healthy countries will also pay a great deal over time.

The political question of the hour is how bad it would be for Germany if they don't push for a bailout for the rest of Europe, versus the cost of actually doing so. There is room for serious disagreement here, but many Germans feel like they are being taken for a ride. Ultimately they must decide whether the European experiment is worth it, and whether changes in the EU charter will actually stop the outrageous spending habits of many European governments. They will also have to decide if TBTF banks should continue to get away with risking the whole system for private gain. Perhaps they will get something worthwhile out of this after all is said and done, but it will involve considerable pain in the short term.

Please Share Our Newsletter or Refer Others to Blue Water to Help Them Preserve and Grow Their Wealth

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.bluewater-capitaladvisors.com, and our weekly blog at http://bluewatercapital.wordpress.com.

Please attend our next "Monthly Market Forum" if you can; we'd love to see you, your relatives, and your friends there. Scheduled meetings will be held at 5:00 p.m. - 6:30 p.m. on January 19 and February 16, 2012 at The Kitchi Gammi Club, Duluth; and on March 15 at a Location TBD. If you can attend in January, February or some later time, please RSVP to Blue Water. Business casual attire suggested.

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