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Market Review & Update

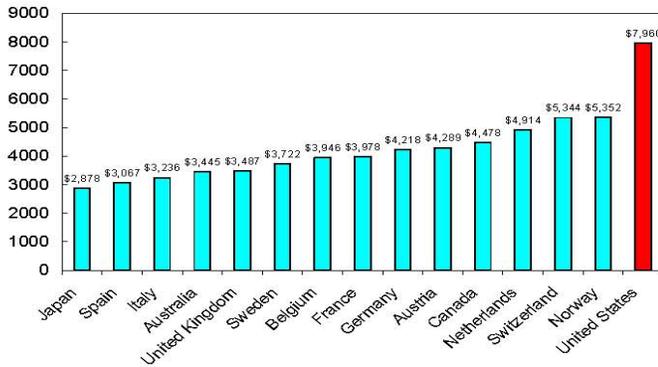
WINTER 2012

In the space surrounding Thanksgiving, Christmas and the New Year it is not a surprise to catch yourself being thankful for what one has lost, albeit a bit after the fact. Too often we fail to truly appreciate something until it has gone. Poignant, over the last few years, has been the vacuum left by significant individuals we have lost as a nation, as a community and on a very personal level as well. Mostly, these have been members of what Tom Brokaw penned as “The Greatest Generation”. They were my elders growing up. They returned home from World War II embodied with a staunch ethos that manifested in the feeling that all they were ever entitled to was an opportunity to work hard. Their driving force was to care for their families. If one job didn’t suffice, they took two and I knew more than a few that had three. They built communities and businesses. They weren’t always fun to be around, but that intractable ethos was a solid foundation. I, for one, will miss them with gratitude for who they were.

Funny, or not so, that aforementioned word “entitled” is one that has been at the forefront of much political discussion over the past few years as well. It should be of little surprise to anyone that Alan Simpson is a member of that Generation. And, given that, should it be any wonder that his lengthy tome for righting the domestic economic trajectory, co-authored by Bowles, should have the concise core message that we should all “expect a little less and work a little more”. Simple, but it ain’t easy. And that brings us to another icon on life support, Hostess. Wonder Bread, Twinkies, Sno-Balls, Cupcakes, even Drake’s Cakes were the stuff we were raised on (maybe that explains a lot!?). The recent, well publicized bankruptcy was occasioned by a labor negotiation failure. 18,500 jobs go the way of history. This plays to so many of the issues manifest in the current political dialogues. From entitlements to immigration to globalization, they are all resident in this unfortunate occurrence. Did no one in the US really want these jobs? As I recall, the Statue of Liberty is emblazoned with a sign welcoming to our shores those dying, quite literally, for that opportunity to simply work hard. Prosperity can too often result in a morphing of the word “earned” to “entitled”. My elders would have sharply reminded me that hard work “helps build strong bodies 12 ways”...

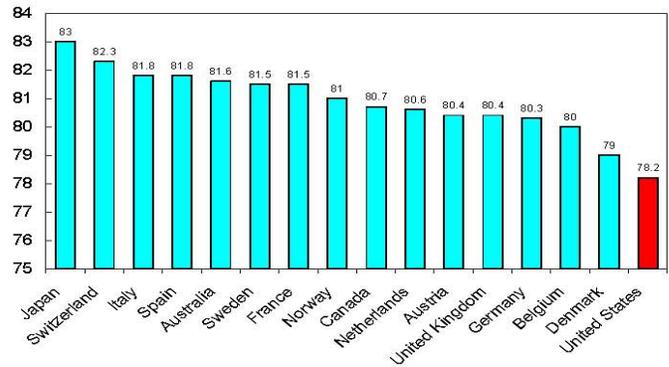
Entitlements are also one of the centerpieces of the current discussions now underway to ameliorate the momentums inherent in the Fiscal Cliff. It’s so understandable that in any relationship, this one political, that giving is always easier than taking away. Human nature. But we seem to have reached a point at which Europe could well be the “spirit of Christmas future” if we, like Scrooge, fail to mend our ways. That prosperity thing can also manifest as an understandable attitude that money can be the easy solution to most problems. This has come home to roost in the discussions about entitlement programs, now this nation’s greatest budget items. There will be much discussion about Medicare and sadly, much of that discussion will be limited to the internal structure of Medicare, which is simply the checkbook that pays for the product. We recognize that the checkbook is broken, as the average Medicare participant pays a bit over \$150,000 into the system, withdrawing between \$250,000 and \$300,000. Even the average congressperson can recognize that as very bad math. But underlying that math is the greater root problem. Each of us has a checkbook, and we realize that when it empties too fast the problem is not the payment system, but what the payments are directed at. That “money is no object” trajectory has made the actual delivery of healthcare in the US perhaps the real core of the problem (fig 1). As the charts clearly show, we throw more money at the healthcare product per capita than any other developed nation, but get far less return for that investment. Yes, the payment system is broken, but underlying that is a delivery system in dire need of reevaluation. I have been told by those who should know that a core flaw is that the US mistakenly incents procedures in lieu of outcomes. That seems grounded in logic. We won’t spend time on it here, but we would simply insert the word ‘education’ into the above and the dialogue would be the same, we’re spending

Figure 1: Total Health Expenditure per Capita, U.S. and Selected Countries, 2009



Note: All data are 2009 except the following: Italy, Canada, and Switzerland 2010; Australia and Japan 2008.
Source: OECD

Life Expectancy of Total Population at Birth (Years), U.S. and Selected Countries, 2009



Note: All data are 2009 except the following: Sweden and France 2010; Italy 2008; Canada 2007.
Source: OECD

so much more and not getting the results. Leading CEOs cite this as a major issue to solve for our economic future. Are the immiscible forces in Washington up to the task? Experience in the kitchen has taught me that if you agitate oil and water enough, an emulsification you will get...agitate away.

I often get told I am overly optimistic, so by now I feel I am about to let some people down. Well, since Kool-Aid has NOT filed for bankruptcy, let's toast the holidays in a style to which we are apparently accustomed...

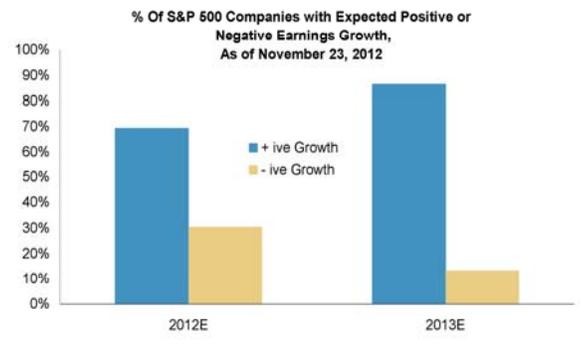
Notwithstanding the importance of the political dialogues that have been underway for the last few years, there has been a global earnings recovery since 2009 that has witnessed a near doubling of the equity markets. Questions arose as to whether certain emerging patterns could weaken this recovery. China's temporary slowing seems to be just that as the recent data indicates a rebound. Shockingly to me, the consumer in the US, perhaps buoyed by, as the McKinsey reports have detailed, their much deleveraged balance sheets have bolstered numbers in both retail and housing. Could this also be the beginning of a capex trend for those now overflowing corporate coffers?? And energy. Who would have guessed a few years back that we would be discussing an overabundance of available domestic energy, both oil and natural gas, and that energy independence would be a discussion point that has an inherent component of significant job growth opportunities? In the recent election campaigns, job growth in Ohio and Pennsylvania was touted as a credit to saving the auto industry, but not so. Nearly all of the jobs created, almost 200k combined were in new energy related jobs. This trend seems to be just beginning. So, can we be comfortable that this ongoing earnings recovery is indeed ongoing? Seems to be a safe bet at this juncture. As the example shows (fig 2) it is estimated that over 90% of S&P 500 constituents will experience an earnings gain in 2013. Yes, you're right, this would take earnings to an historic all time high. And yes, markets ultimately do ultimately follow fundamentals. Several experts have postulated that the housing, and especially the energy opportunities before us, if managed properly, could create a long term momentum that we have not witnessed in some time.

We wish you all the best for the coming New Year.

We'll talk to you soon...

Figure 2:

90% of the Companies in the S&P500 Are Forecasted to Grow Their EPS in 2013



Source: Factset, Morgan Stanley Research