Altamont Wealth Management

Second Quarter 2012 Performance

The word "crisis" in Chinese is composed of two characters: the first, the symbol of danger, the second, opportunity. Anonymous

Second Quarter 2012 Benchmark Index Returns	Second Quarter	YTD Returns
Large-Cap Benchmarks		
S&P 500 iShares	-2.7%	9.6%
S&P 500 Growth iShares	-2.1%	9.8%
S&P 500 Value iShares	-3.6%	8.8%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	-4.8%	8.1%
S&P 400 Mid Growth iShares	-5.7%	7.6%
S&P 400 Midcap Value iShares	-4.0%	8.3%
Small-Cap Benchmarks		
S&P 600 iShares	-3.6%	8.0%
S&P 600 Growth iShares	-2.0%	9.0%
S&P 600 Value iShares	-4.8%	7.5%
Other Benchmarks		
MSCI EAFE Int'l iShares	-6.8%	3.3%
MSCI EM Int'l iShares	-7.7%	4.4%
Vanguard Total Bond ETF	2.1%	2.3%
DJ-UBS Commodities iPath ETF	-5.1%	-4.9%

The old saying June Swoon was once again true. For the third year in a row the U.S. stock market experienced a mid-year slowdown. In fact, 2012 eerily resembles 2011. Rally early then struggle afterwards including the obligatory application of monetary stimulus program for relief.

Amazing how everything stays the same but is different in the U.S. markets as the parade of monetary stimulus programs flitters by at an accelerating rate. These programs are like crack cocaine for the economy. The high from each successive program is shorter and less effective. QE 1 (2009) was effective about 12months, QE 2 (2010) about 9 months, QE 3 (2011) about 6 months and QE 4 - who knows. Monetary stimulus only buys time for the real economy to right itself or for fiscal policy to normalize. Hopefully, the economy will right itself before the Fed's stimulus programs become wholly ineffective.

In addition to Quantitative Easing programs the Fed has kept interest rates as low as possible (almost zero). The Fed's main impact has been on the stock markets. Investors have been forced to invest in riskier vehicles to earn any return. For instance, 10 year Treasury bond is yielding a negative real return (interest rate less the rate of inflation). Essentially, investors are paying the government to borrow their money. Not such a great deal. So instead of treasuries, investors have been forced back into the stock market in search of sustaining returns. This has given the U.S. stock market a much needed boost. However, these effects are transitory. The concern however is that the Fed may be near the point of having a negative effect. Eventually the economy will turn, but that will likely be when consumers finish deleveraging (paying off debt or defaulting).

It is interesting to note that with fiscal policy running on full tilt and deficits at 8% and monetary policy running on full tilt with zero percent interest rates we should be seeing GDP growth north of 10%. Instead we are closer to 2%. This is akin to a race car driver trying to rev his motor and barely turning over. The U.S. economy is so fragile. It wouldn't take much to throw us back into recession.

Things are precarious in the rest of the world. There is vast turmoil going on in Europe. Add to that the recent deceleration of the Chinese economy and it is not surprising that the markets have become range-bound. These major macro headlines have been dominating investors' behavior over the last three years, with the effect that the market has been unable to establish a direction for longer than a few months.

Europe

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In Europe, markets remain impacted by the inability of Eurozone leaders to develop effective economic policies to deal with their problems. The austerity measures aimed at reducing the burdensome deficits are stifling economic growth and causing a recession. In a recession, businesses contract reducing profits and ultimately taxes collected causing the deficits to grow. It is a vicious circle because without growth the large government deficits will only get worse. Finally officials in Europe are talking about adopting more of a U.S. type dual mandate aimed at tighter fiscal policy and stimulating growth. What form that stimulation will take, however, is unclear.

Greece and the fiscally troubled Eurozone members would benefit from, among other measures, the same types of reforms made by Germany a few years ago, when its economic stagnation earned it the nickname "the sick man of Europe." Changes to labor market regulations, for example, could allow firms greater flexibility in hiring and firing. Reforms of public-sector pensions would reduce government costs.

The emerging-market economies (Brazil, India and China) have slowed their rate of growth partially as a result of weak demand for their goods from Europe. Despite this, the EM growth story is still very much intact, even as the current rate of growth slows. China, in particular, has slowed from a growth rate around 9% to one around 7%. However, given the high personal savings rates in China at close to 40% and the low levels of personal consumption, the long-term China growth story continues, with perhaps the source of growth moving from investment to consumption as some of the pent-up demand for consumer goods begins to get absorbed.

Healthcare

On June 28, the U.S. Supreme Court issued its long-awaited landmark decision on the Patient Protection and Affordable Care Act (PPACA) and its companion law, the Health

Care and Education Reconciliation Act (HCERA). In a 5 to 4 decision of historic proportions, the nation's highest court upheld the law – except for a certain Medicaid provision involving state funding. Key to the Court's approval of President Obama's signature health care law was the finding that the linchpin individual mandate was constitutional. The requirement under the individual mandate that individuals pay a penalty if they fail to carry minimum essential health insurance coverage was declared within the Constitution based upon Congress's power to tax.

The Supreme Court's decision preserves all of the far-reaching tax provisions and health insurance reforms that were part of the overall health care reform legislation as passed in 2010. In coming months, lawmakers and legal scholars will examine all of the nuances of the Court's highly complex decision.

More immediately, individuals and businesses are concerned about what steps they need to take next. So here are some issues I would like to highlight. Generally the plan requires most individuals to have at least a minimum level of healthcare coverage called minimum essential coverage.

Under the new law each state will create a healthcare exchange through which uninsured individuals can buy coverage. California is one of the few states that is close to having its exchange established. In addition, the new Healthcare Act imposes a penalty tax on individuals who fail to carry minimum essential coverage. It also allows personal or employer provided health benefit coverage existing at the time of enactment (2010) to stay in place under a "grandfather" provision.

The Act does not require an employer to provide health care to employees but strongly encourages them to by offering tax credits and penalties. Employers that provide health insurance will have to disclose the benefit's cost on each employee's annual Form W-2. Though the benefit is shown on the W-2 it is not included in taxable income.

The new law's provisions go into effect between 2010 through 2018. In 2013 you can look forward to the following changes:

- Automatic enrollment of employees in large employer plans (Over 200 full time employees).
- Additional 0.9% Medicare tax on wages and self-employment income of high earners (Individuals earning over $200,000).
- 3.8% Medicare surtax on investment income of higher income taxpayers.

- $2,500 limit on annual health FSA salary reduction contributions under a cafeteria plan (Flexible Spending Arrangements).
- A tougher 10% floor on itemized medical expense deduction. However a 7.5% Adjusted Gross Income floor will continue to apply through 2016 if either the taxpayer or taxpayer's spouse is age 65 or over.

The 3.8% Medicare surtax is a concern and could impact how your investment assets should be managed. This tax applies to investment income for higher income individuals, estates and trusts. For individuals the tax is 3.8% of the lesser of net investment income for the year or the amount by which modified adjusted gross income (AGI) exceeds $200,000 a year and $250,000 for married couples. This tax does not apply to qualified retirement plans (like 401(k) plans) and IRAs. Net investment income includes gross income from interest, dividends, annuities, royalties, rents, net capital gain and income earned from passive trade or business activities.

I always think it helps to see examples. Let's say that Maryanne is single and has a modified AGI of $220,000. AGI is the figure at the bottom of the first page of your tax return. Of the $220,000 AGI, $100,000 is net investment income. So her liability for the unearned income Medicare contribution is 3.8% of $20,000 (220,000 – 200,000) which is $760.

It gets more complicated when the limit is hit so here is another example. Sylvia, who is a single taxpayer, has modified AGI of $310,000, of which $100,000 is net investment income. But Sylvia's investment income ($100,000) is less than the difference between her modified AGI and the $200,000 limit (310,000 – 200,000 = 110,000). So the Medicare contribution tax of 3.8% applies to $100,000 and not the $110,000 for a tax of $3,800 (.038 x 100,000).

Congress could change this part of the health care bill before 2013. But if it is still in play by year end we may need to take gains in 2012 and change some of the investments strategies held in your taxable portfolios depending on your tax situation.

It is important to consider how this Act will affect your situation. We can help. If you are worried about the new health care law please let us know if we can help.

Fiscal Cliff

Fiscal Cliff refers to a confluence of fiscal events timed to happen in the fourth quarter and includes yet another battle over the debt ceiling, the expiration of the Bush tax cuts, and a lot of automatic cuts. Coupled with all the political fighting and a Presidential election, you have yourself a perfect storm. They call it a Fiscal Cliff because fiscal policy refers to government use of taxation and spending (through the Budget) to influence the economy (as opposed to monetary policy, which uses interest rates and the supply of money) to influence the economy.

With the expiration of the Bush tax cuts and the across-the-board budget cuts anticipated in January 2013, this "Fiscal Cliff" could remove $500 billion from the economy. But it is doubtful that Congress is going to drive off this Fiscal Cliff and allow the automatic budget cuts from the 2011 debt ceiling agreement to kick in or let the Bush tax cuts expire. Though we won't fall off the proverbial cliff, the road to compromise is going to be bumpy. It won't happen on schedule. Expect Congress to kick the can down the road, implementing extensions rather than making a decision for the future. Damage to the economy may occur businesses hold off hiring or making large expenditures until the final compromise is cobbled together.

In addition, this combination of extending the Bush tax cuts and raising the debt would allow Moody's to justify a ratings downgrade. It warned that a downgrade was likely if Congress failed to act. A rating reduction could happen by January 2013. And this time, the impact of a downgrade could be more severe.

This is just another hurdle that the economy must surmount. As we pass the midpoint of 2012, the U.S. economy will continue to muddle through with modest growth. The markets will remain volatile. Close attention will be paid to potential debt solutions in Europe and more meaningful stimulus policy from China. Everyone's investment portfolios are structured for a range of outcomes and will be adjusted as the evidence presents itself. Hopefully, global leaders are up to the challenges pressuring economic growth, and the markets continue to improve.