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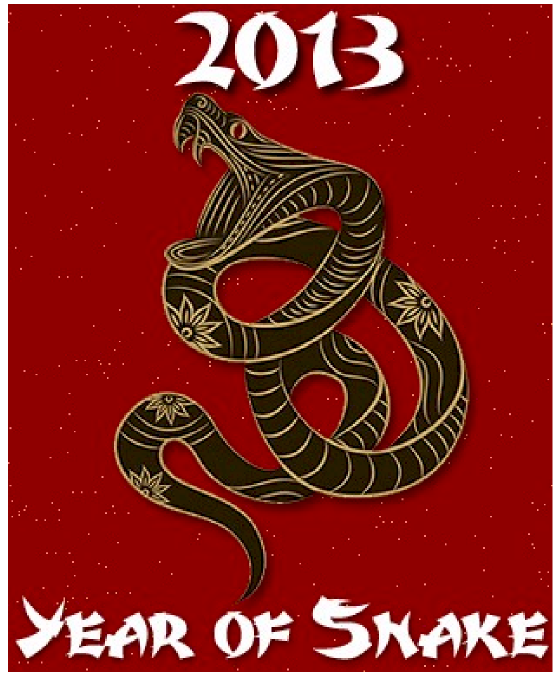
FEBRUARY 5, 2013

02/04/2013	Value	YTD %
Dow Jones Industrial Avg	13880	6.75 %
Vanguard 500 Index	137.9	5.01 %
Vanguard Total Bond Index	11	-.81 %



Snakes in the Grass

Every year, Andresen & Associates sends our clients an Asian New Year gift of token money in a red envelope to represent our wish for their continuing health and prosperity. We always try to make it interesting. This year's money is FASCINATING! We got these from our international currency contact Joel Anderson, who has a website at www.joelscoins.com.

This tiny little bill was issued following the post-World War I collapse of the Austro-Hungarian Empire. After the empire collapsed, the currency and imperial debt became largely worthless, and the economy crashed. To provide something to keep from lapsing into a barter system, different regions and principalities each issued their own currencies.

This tiny little 50 Heller note was issued by the city of Vienna and is dated December 3, 1920. It was good only until December 31, 1921. It is a tiny example of how unexpected gigantic changes can take place very quickly, and how life goes on anyway.

In 2013, Europe and the global economy are again facing very daunting challenges. Big changes could happen at any time, very unexpectedly. This historic little scrap of paper reminds us all that we'll get through whatever happens, and that we should all remain somewhat prepared for the unexpected.

Money continues to pour into stock market mutual funds and exchange traded funds. This is a negative indicator.

Some financial writers are saying that "Indexing beats EVERYTHING!" Certainly the Vanguard Index 500 fund beat most actively managed funds in 2012, although almost all of that was due to the unexpected great performances of technology, financial, and large cap stocks. This is another indicator that there hasn't been any bad news recently, and short-term traders have already forgotten 2008. In other words, this is also a negative indicator for the stock market.

Finally, I am reading in the February 1st Value Line that their estimated median appreciation potential statistic (VL-MAP) is now 50%. Historically such a statistic suggests mediocre returns for the next 3 to 5 years in the stock market. In other words, this statistic suggests that a "normal" correction is overdue.

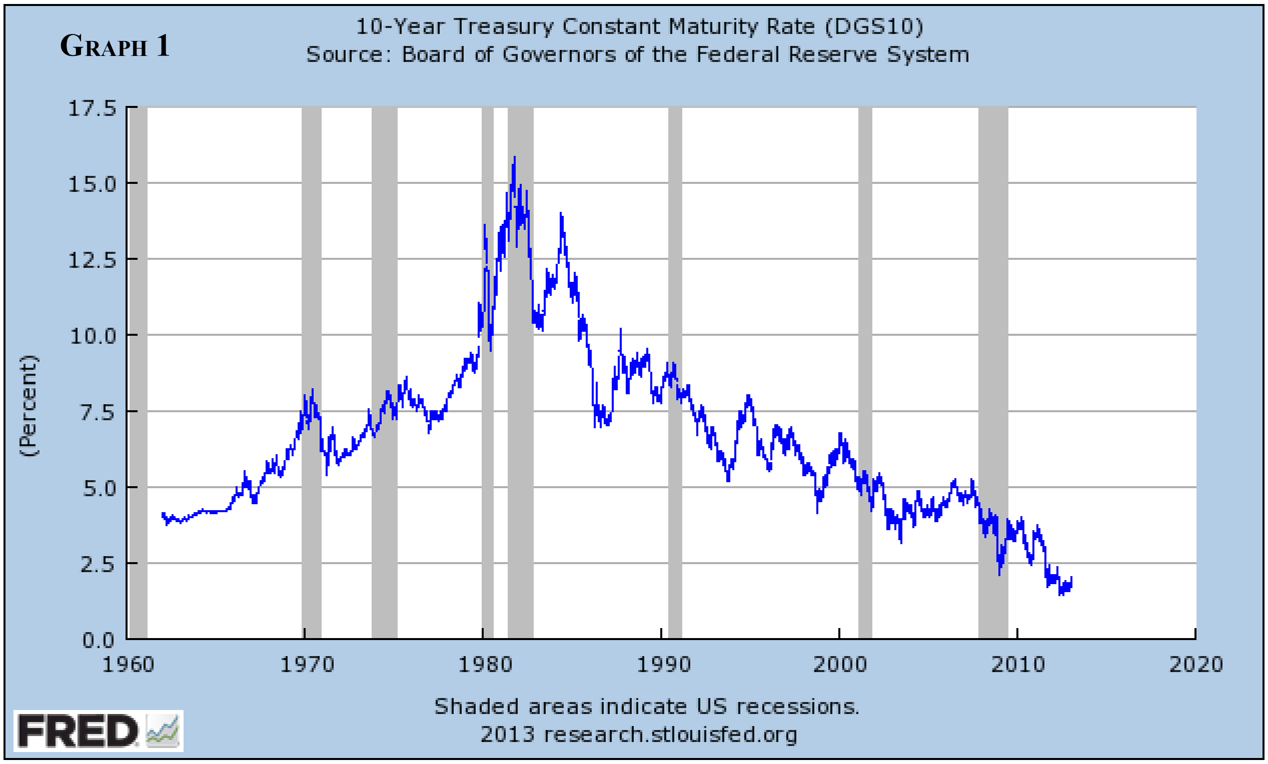
The average price earnings ratio is 15.8, which is fairly valued.

The estimated yield for the stock market is 2.2%, which compares favorably to the 2.03% yield on a 10-year Treasury bond.

Even given all this, we can't forecast when or even if a stock market correction will occur. Historically this sort of VL-MAP reading has sometimes lingered for months, even years, before the awaited correction arrived. In hindsight, I can't find a time when a cautious VL-MAP statistic was erroneous. This STRONGLY suggests that we should remain patient. It could be days, weeks, months, or even years, but our caution will likely be rewarded.

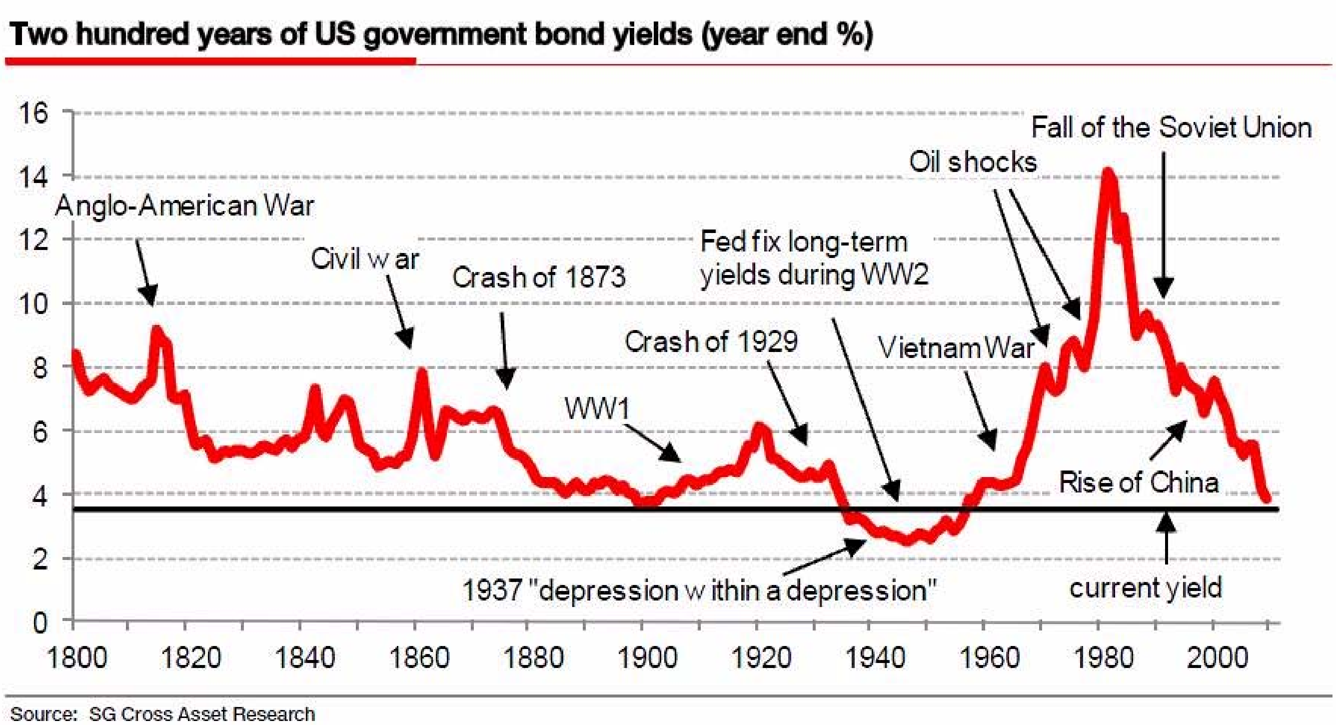
The bigger issue in my mind seems to be the bond market. In fact the bond market may be the biggest global financial issue during 2013.

As the 2.03% yield on the 10-year Treasury bond indicates, and the 3.19% yield on the 30-year Treasury bond confirms, interest rates are at artificially-created historic lows. **Graph 1**



This is saying that Treasury investors expect a TOTAL global economic performance of about 1% a year plus 2% inflation for the next 30 years. That's wildly pessimistic, in my opinion. In other words, the bond market appears to be in the midst of a gigantic government-induced bubble. Here's another look at history: **Graph 2**

Graph 2



This strongly implies that our current low interest rates are artificially supported. We can also posit that while it is impossible to keep interest rates this low, the adjustable rate mortgage market and the fragile economy provide strong governmental incentives to keep global rates from rising rapidly.

On the other hand, global governmental debt creation has reached an overwhelming large level.

We are left with four expectations:

1. At some point in coming years, interest rates will irresistibly begin to move up. They already began this move in 2012, although whether or not rate rises will continue depends upon continued economic recoveries.

2. We can expect "debt ceiling" battles to play out over the next years as we come to grips with the true magnitude of debt supply. This will possibly create continued tremendous social and political angst.

3. Economic growth will probably remain lackluster for the coming decade, but not permanently so.

4. The bond markets are very likely to UNDERPERFORM the stock market and LAG their performance histories of the last few decades. Expect less going forward.

For us, this means that we will move some of our bond allocations gradually to dividend-paying stocks, especially during buying opportunities. We will continue to shorten average bond maturities, and we will continue to direct most bond money to quality.

Given these expectations, our tiny little Viennese Heller notes are especially timely reminders. The unexpected CAN happen. We should invest with such a reality in mind.

Beware the snake in the grass, and may you continue to be prosperous. *Gung Hay Fat Choy*! ■