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MANAGEMENT
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Elumination Newsletter

"Separating fact from fiction since 1998. The antidote to Wall Street."

Looking Out Into 2012

December 30, 2011

There are a few things that I am confident about for 2012. The first and foremost is that I will celebrate my son's birthday on December 22. The world will not end on December 21 when the Mayan "long calendar" expires.

Given the hype around this fantasy few people seem to realize that Mayan scholars, astronomers, astrologers and priests never predicted the end of the earth on December 21, 2011. If you are at all interested in the mythology about this "prediction" all you have to do is "Google" it and you can read for yourself plenty of information that debunks this urban legend. Without intending to insult or upset anyone, all I can say is that there have been many "faith based" predictions regarding the end of the earth that never came true. This doesn't even fit into that category.

This is the time of year in which money managers love to engage in an annual ritual of trying to predict the future. We have done it in the past too. But it is unlikely that we will do so again anytime soon. The future has simply become too unpredictable in this crazy and complex world.

"Never make predictions, especially about the future." Casey Stengel

I have every newsletter we have ever written in our files and read many of them often. We have done a pretty good job over the years of understanding major trends, but that has not always translated into investment success. We have made it very clear during the last six months, or so, that markets have become more opaque than at any other time we can remember.

For example, if you had told us a year ago that both the U.S. Federal Reserve Bank and the European Central Bank would have record balance sheets at this time, we would have told you to expect rising inflation and record prices in gold. Neither is happening.

The BRIC nations are the emerging economic powerhouses on the planet. They are Brazil, Russia, India and China. For the past several years they have been among the fastest growing economies and their governments have been preoccupied with keeping growth rates in check. Yet their stock markets are down approximately 20%, 23%, 23% and 24% this year (as of December 30). China's Shanghai index seems to make a new low almost every day lately. We would not have predicted that 12 months ago.

These are just two examples, but they are important examples of market realities that were not necessarily reliably predictable.

So rather than trying to predict the level of the S&P 500 on December 31, 2012 we will try to use this newsletter to offer a useful guide to the markets for 2012.

Investments We Like Going Into 2012

As we look to 2012 we are confident that a few things that worked well in 2011 will continue to work. The first and foremost is that high yield stocks have provided solid returns in both 2010 and 2011 and they have provided a significant damper to portfolio volatility through the craziest markets we have ever seen.

Pt. Sur has been our best performing equity model in 2010 and 2011. We don't know if it will repeat in 2012 but we are confident that it is a credible investment choice for an investor seeking rising income over time and who is also willing to tolerate the ups and downs of the stock market.

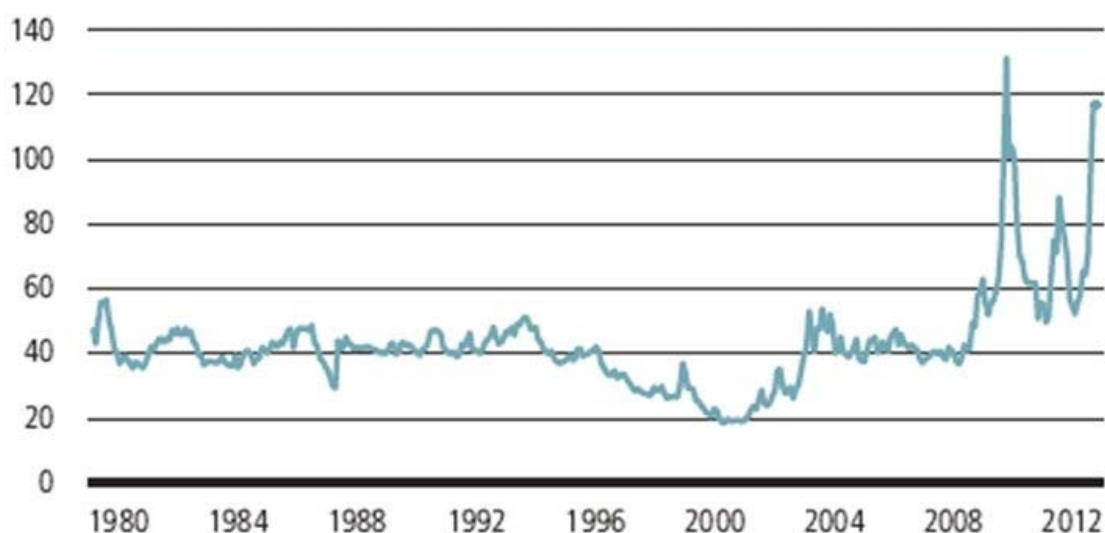
Lee told a client today that if the S&P 500 is down next year Pt. Sur will be down a lot less and if the S&P 500 is up next year Pt. Sur is likely to be up more. That has been the case and seems right to us going forward.

UBS offered this chart in a recent report. Dividend yields are at near record highs relative to the 10 year U.S. Treasury bond rate. Today's level was exceeded only in 2009 as stock prices collapsed. Dividend levels remain near record highs even after the stock market recovery since March 2009.

Many stocks have become "accidental high yielders" over the past two years. That is because valuations of stocks remain low in this uncertain environment. At the same time earnings and cash balances for many companies are very strong. Something has to happen to all that cash and dividends are one use for it.

Fig. 15: Dividend yields are attractive versus interest rates

S&P 500 dividend yield as % of 10-year treasury



Source: Datastream and UBS WMR, as of 5 December 2011

We love high yield master limited partnerships. We know that some of them produce K-1's rather than 1099's and some investors dislike waiting for k-1's. But we love their dividends, and in most cases we also love their investment performance.

The best of the best have been "pipeline" companies that transport oil and gas. We can't predict oil and gas prices, but we know that these fuels are used everywhere, every day, and they need to be transported to where they are needed. That is where the pipelines come in. Why not earn 6% or more from dividends day in and day out, regardless of price fluctuations in the commodity or the stocks?

During 2011 we have refocused several of our models on stocks and exchange traded funds that offer higher yields like this. For example, Halifax has 80% of its assets in high yield stocks. We will be increasing allocations to pipeline stocks and etf's in early 2012.

The U.S. Federal Reserve Bank has made it very clear that they intend to keep interest rates very low through 2012 and into 2013. They are actively buying long term bonds to keep interest rates low on the long end of the yield curve. Therefore it is easy to expect our Pt. Reyes model to provide another safe haven year for extremely conservative investors.

Pt. Reyes has been our "sleep well at night" model for the past three years. We suspect it will be again in 2012.

Mortgage rates are at or near record lows. If you haven't refinanced your house in 2011 think seriously about it in 2012. Talk to us if you have questions about refinancing.

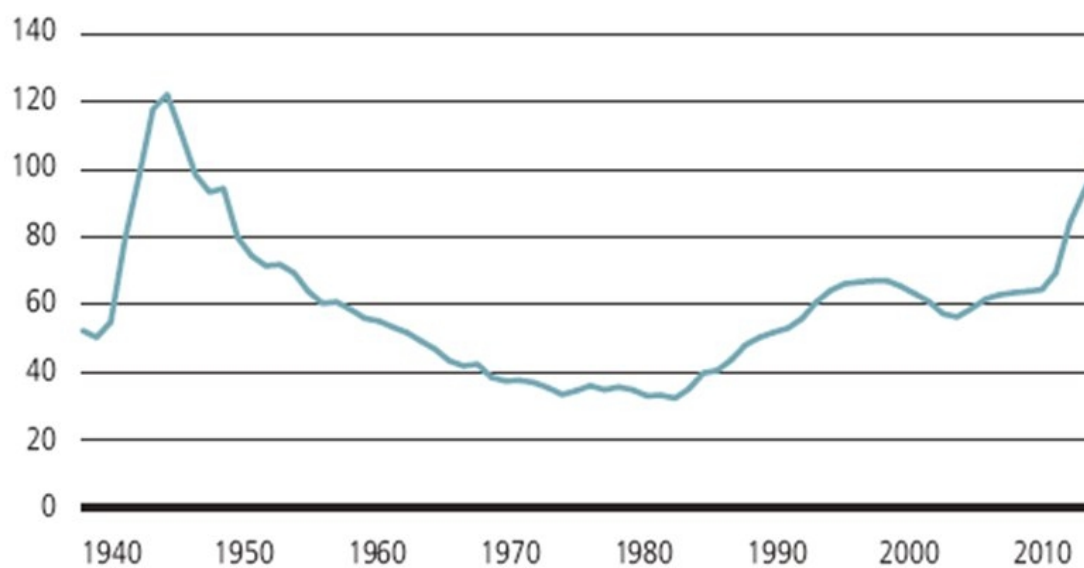
Major Market Themes for 2012

During 2011 we experienced unprecedented volatility in global equity markets. While the U.S. market averages held at nearly unchanged levels most other major stock markets suffered major losses. We suspect that markets will remain volatile during 2012 even if the year-end outcome is quite different.

The major theme that will dominate markets in 2012 is deleveraging, especially at the government level. Despite all the news and all the talk during 2011 we don't know of a single government that has actually reduced its total debt. We think that Ireland is the only European nation that has actually reduced its annual GDP deficit. Otherwise the only changes in Europe are that old bonds have been retired and papered over by either sovereign bonds that actually have higher interest rates than those that were retired or loans from outside sources, like the ECB, which are intended to be temporary fixes.

Fig. 7: US public debt reaching unsustainable levels

Gross federal debt, in % of nominal GDP



Source: Datastream, US Office of Management and Budget and UBS WMR, as of 5 December 2011

The deleveraging (reduction of debt) that needs to occur to bring long term stability to the region has not happened.

The required deleveraging on both sides of the Atlantic should keep global growth rates subdued for much of 2012.

The U.S. has not even begun to take on its problems. In fact President Obama just expanded the U.S. debt ceiling to above \$16 trillion in hopes that will be enough to get through 2012. U.S debt levels are more elevated than at any time other than World War 2. (See chart above) Unfortunately this chart shows only the official "federal debt" and not the trillions of dollars of unfunded liabilities related to entitlements.

We believe that global growth will remain subdued as nations work their way through these problems.

To the right is a table illustrating that 2012 will be a year for major changes in governments around the world.

Here is a list of countries that will be holding major elections in 2012. These countries represent almost 50% of global GDP. Taiwan, Russia, France, Egypt, Mexico, India, Kazakhstan, South Korea, Venezuela and the USA will be holding Presidential elections.

As we all know leadership at the top has just changed in North Korea.

The 18th National Congress of the Chinese Communist Party will be electing new leadership in October.

There could be many new faces getting used to one another in the second half of 2012 and first half of 2013.

Next year the U.S. consumer will continue to dominate the news and investment themes. If there is one thing that 5T significantly underestimated in 2011 it was the strength of the U.S. consumer to battle back and spend money.

We are a consumption economy after all. U.S. households did a remarkable job in 2011 of continuing to get their own balance sheets in order both by cutting debt and increasing savings. All the while they continued to spend. We expect more of the same in 2012 and that would have to be the main reason for optimism next year. One of our clients recently went to Disneyland. She sent me a text asking, "What recession?"

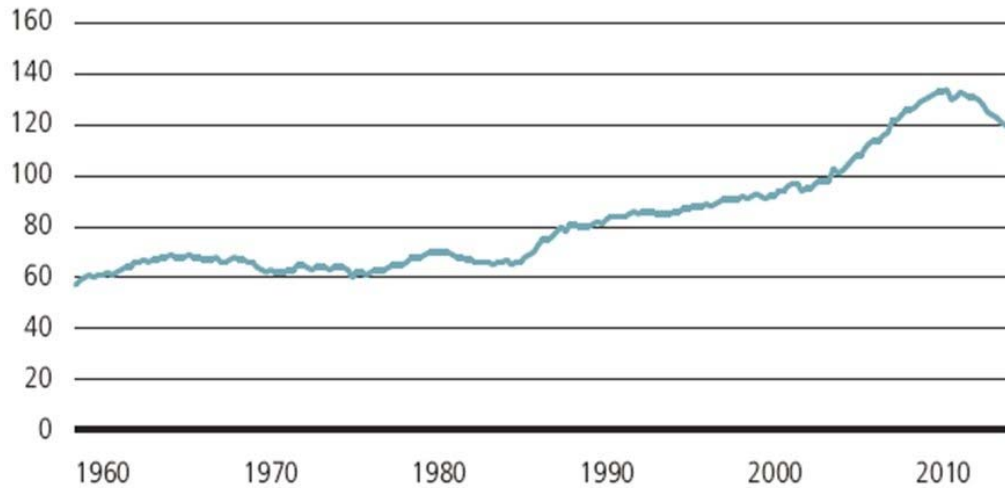
Fig. 8: Key political events around the world in 2012

Date	Country and leadership events	in % of global GDP
1 January	EU: Denmark assumes presidency of the European Council	
January–March	Egypt: Parliamentary elections (3rd round of People's Assembly on 3 January, 1st/2nd/3rd round of Shura Council on 29 January, 14 February and 4 March)	.33
14 January	Taiwan: Parliamentary and presidential elections	.72
22 January	Finland: Presidential elections (2nd round: 5 February)	.39
19 February	Greece: Parliamentary elections (brought forward)	.45
29 March	Iran: Parliamentary elections	.68
4 March	Russia: Presidential elections	2.69
22 April	France: Presidential elections (2nd round: 6 May)	4.01
April	South Korea: Parliamentary elections	1.66
May	Algeria: Parliamentary elections	.26
June	Egypt: Presidential elections	
10 June	France: Parliamentary elections (2nd round: 17 June)	
17/18 June	G20: Summit in Los Cabos (Mexico)	
1 July	EU: Cyprus assumes presidency of the European Council	
1 July	Mexico: Parliamentary and presidential elections	1.69
July	India: Presidential elections	2.63
September	Hong Kong: Parliamentary elections	.35
28 October	Ukraine: Parliamentary elections	.23
October	China: 18th National Congress of Chinese Communist Party	9.97
6 November	US: Congressional and presidential elections	21.50
December	Kazakhstan: Presidential elections	.26
December	South Korea: Presidential elections	
December	Venezuela: Presidential elections	.44
Percentage of global GDP for countries with elections		48

Source: UBS WMR, IMF

Fig. 3: In the early-to-middle innings of consumer deleveraging cycle

Ratio of US household financial liabilities to disposable income, in %



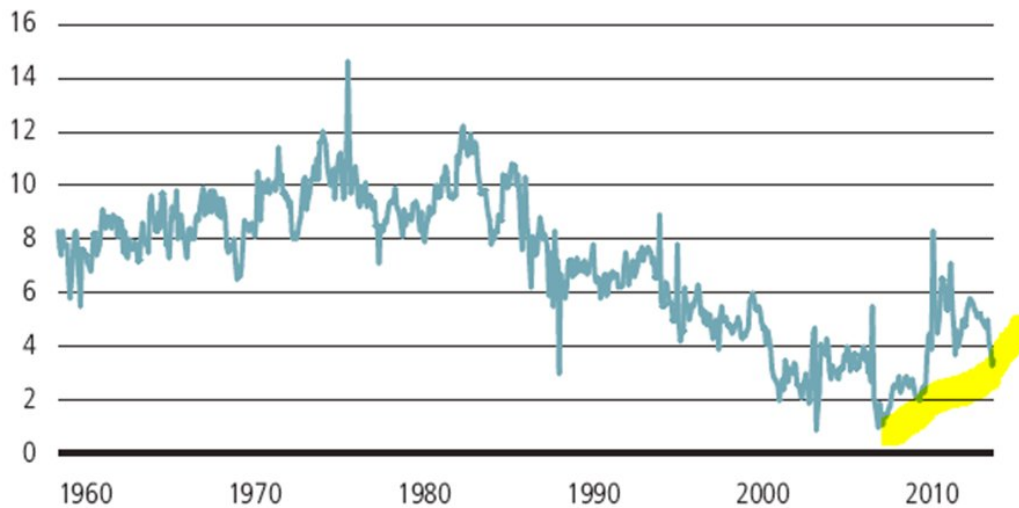
Source: Datastream, U.S. Department of Commerce and UBS WMR, as of 5 December 2011

Americans have a long way to go to get personal balance sheets back to the condition they were in during more sane and responsible times, but the trend has clearly changed.

Personal savings rates are still low but also going in the right direction.

Fig. 2: Personal saving rate higher than during last decade

US personal saving rate as a % of disposable income



Source: Datastream, U.S. Department of Commerce and UBS WMR, as of 5 December 2011

So once more the fate of the nation and the global economy seems to rest on the American propensity to spend. We are good at it!

The Technical Condition of the Market

We have referred many times in the past few months to the fact that U.S. equity markets looked ready to roll over into a new cyclical bear market as recently as September 30, 2011. We are still amazed at their recovery and step back from that brink. For reference see The Message of the Market, dated October 3, 2011 at http://www.5twealth.com/media_ellumination.cfm

But markets have stepped back and technically U.S. equity markets are in relatively good shape as we close 2011. That doesn't mean the situation couldn't change on a dime. But there is not much on charts right now that would lead to an expectation of a dramatic sell off. In fact charts of major U.S. stock market averages seem to have a slight positive bias at the present time. That is particularly true for the S&P 500 and the Dow Jones Industrial Average.



That is not true for many other major markets that are trying to scrape themselves off the bottom. Buying the markets of the BRIC countries, for example, is only for bottom fishers at the present time. The only question is whether or not these markets have reached bottom yet.

European stock markets are cheap, for a reason. We wouldn't recommend touching them right now.

Things That Could Significantly Impact Markets in 2012

We are also looking for events and circumstances that could surprise markets either positively or negatively during 2012. We have compiled a list of possible surprises. Bear in mind we are not predicting these things will happen. We are merely on the lookout for them and if they do happen we will try to take advantage for our clients.

Here are our "surprises". We list them in order of confidence that they could happen; number 1 being the most likely to occur.

1. Residential real estate finally makes a bottom in 2012. It already has in some parts of the country. But as measured by the S&P/Case-Shiller index prices have continued to fall nationally in 2011. It would not surprise us to see this index flatten or turn back up by the end of 2012.
2. The bull market in gold may take an extended breather while the price may drop to \$1286 per ounce by the beginning of 2013. That would represent a 38.2% retracement of the entire move from the bottom in 2001. It would not necessarily mean the end of the gold bull market. Gold prices consolidated through all of 2008 and much of 2009 before resuming an upward trajectory. In our opinion the basic case for gold as an alternative currency has not changed. But no asset goes straight up in price forever.



3. Google (GOOG) is one of the best performing stocks of 2012. After a multi-year price consolidation GOOG finally breaks out to challenge its 2007 high of \$747.24. It seems to be breaking out of a very long consolidation this month. See the red arrow on the chart below. There are pundits that are concerned that GOOG is diversifying into too many businesses. There are others that recognize GOOG as a technologically brilliant company rivaled only by Apple. The chart below supports the latter case. GOOG breaks out in 2012.



- Wal-Mart breaks out of a 13 year trading range and enters a new bull market in price, just as Sears declares bankruptcy. It is the end of Sears and the beginning of a new era for WalMart around the world.



5. Equity markets around the world swoon in Q1 2012 related to geopolitical events/risk, or an apparent worsening of the debt crisis in Europe, or both. The government in Iraq, which has been supported by the U.S. for years, may not last six months following the recent withdrawal of our combat troops. The last combat troops have been gone for two weeks and violence is already escalating in Iraq.
6. The Greeks, Spaniards and Italians must roll over huge amounts of debt in the first half of 2012. If they are not successful politicians on both sides of the Atlantic have to finally get serious about solving long term taxation and debt problems. Real crisis will lead to real solutions.

The European Central Bank (ECB) will finally intervene forcefully with full blown quantitative easing (QE). How is this possible? The Germans will eventually figure out that they are fighting deflation, not inflation. It is quite possible a German will take over the reins of the ECB. If this happens it will be a sign to buy gold, no matter what its price at the time. QE3 will be on-big time.

In the USA former President's Clinton and Bush will put together a coalition to solve the U.S. debt crisis and solve long term tax policy issues.

We confess candidly that we lifted this "surprise" directly from Doug Kass, of Seabreeze Partners, who suggests the following policy solution:

Former Presidents Bill Clinton and George Bush form a bipartisan coalition that persuades both parties to unite in addressing our fiscal imbalances. The Clinton-Bush initiative, also known as "Simpson-Bowles on steroids," gains overwhelming popular support, and despite strenuous initial opposition, it forces the Democrats and Republicans (months before the November elections) to move toward a grand compromise on fiscal discipline and pro-growth fiscal policy. Interest rates remain subdued, growth prospects become elevated and a feel-good atmosphere begins to permeate our economy in a return of confidence and in our capital markets engendered by the Clinton-Bush initiative.

The Clinton-Bush initiative includes seven basic core policies that are accepted by both political parties.

- A broad infrastructure program focused on a massive build-out and improvement of the U.S. infrastructure base -- the restoration of our country's highways, bridges and buildings and an extensive internet bandwidth expansion are embarked upon.
 - The annual increase in government spending is limited to the change in the CPI.
 - A comprehensive jobs plan includes new training programs -- all veterans are made eligible to tuition subsidies to vocational schools and colleges.
 - A Marshall Plan for housing is introduced, highlighted by a nationwide refinancing proposal adopted for all mortgagees (regardless of loan-to-values).
 - A series of new tax increases, including a plan to raise taxes on the families with an income in excess of \$500,000 a year (a two-year income tax surcharge of 5%-10%) and some other more imaginative, outside-the-box proposals (e.g., a tax on sugar products) are introduced.
 - Mean test entitlements, freeze entitlement payouts and gradually increase the Social Security retirement age to 70 years old.
 - A comprehensive plan is designed to rapidly develop all our energy resources.
7. The U.S. Dollar rallies as a result of the comprehensive plan reversing a multi-year downward trend.



8. Global stock markets rally on the resolution of U.S. and European fiscal problems after Q2 or Q3 of 2012. The Dow Jones Industrial Average could touch 9000 (first half of year) and 13500 (second half of year) in the same year.
9. Oil prices drop below \$80 per barrel in the second half of 2012 as new supply comes on line from various sources around the world, including rising domestic (U.S.) production. The rising U.S. dollar also tempers oil prices as they are primarily denominated in dollars. The U.S. becomes a major exporter of oil after the Clinton-Bush plan resolves environmental issues related to extracting huge oil and gas deposits from shale. The U.S. and Canada suddenly boast the biggest proven, extractable oil and gas reserves in the world.
10. Hilary Clinton does not quit the Obama administration in 2012. Instead she joins Obama on the ticket for the Presidential election as the Vice Presidential candidate.
11. China has a soft landing as its economy decelerates, but does not collapse. The BRIC country stock markets significantly rebound in late 2012.
12. As goes China, so goes Australia. Their stock market was down 15% in 2011. Look for a rebound in 2012.

We wish you the best and a prosperous 2012!

Paul

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5T WEALTH MANAGEMENT manages accounts with various histories and investment objectives. Various accounts may be managed differently from time to time.

Krsek makes frequent reference to the model portfolios called Hatteras, Mendocino, Halifax, Fresnel, Point Reyes, Key West, Cape Lookout and Point Sur. During 2005 Paul Krsek was appointed Chief Investment Officer of 5T WEALTH MANAGEMENT, and as such is responsible to make all trading and management decisions for all client accounts which are being managed according to a specific portfolio model. A description of each of our models can be found on our website at http://www.5twealth.com/prd_port_signup.cfm.

Not all accounts managed by 5T WEALTH MANAGEMENT are "modeled" accounts. We strongly urge our clients to understand which model, if any, are being used to manage their accounts.

As of July 3, 2007 Lee O'Dwyer joined 5T WEALTH MANAGEMENT as a portfolio manager. Paul Krsek and Lee O'Dwyer frequently discuss investment ideas, model portfolio strategies and the investment policies of 5T WEALTH MANAGEMENT. But when it comes to the implementation of those policies Krsek is primarily responsible to manage the accounts that fit into each model portfolio description. He generally makes all final investment and trading decisions relative to those accounts that are considered to be "modeled." However, in Krsek's absence O'Dwyer does have the authority to trade all client accounts. He has been actively trading accounts in the various models since joining 5T WEALTH MANAGEMENT.

From time to time 5T WEALTH MANAGEMENT receives requests from clients to purchase securities that are not included in the model portfolio to which they are assigned. Effective May 24, 2006, 5T WEALTH MANAGEMENT has encouraged clients to hold such securities in a separate account for the client. Because 5T WEALTH MANAGEMENT is a "fee only" registered investment advisor" it charges its normal management fee for monitoring such securities in the separate accounts in which they are held.

5T WEALTH MANAGEMENT makes every effort to exclude securities that are 'requested by the client' from the modeled portfolio accounts.

The investment objectives of various accounts and models may be substantially different from one another. Therefore topics or investments mentioned in E-ellumination may or may not apply to specific managed accounts and/or models.

Trades or adjustments to accounts mentioned in ELLUMINATION may or may not happen in every account managed by portfolio managers at 5T WEALTH MANAGEMENT.

If you are not satisfied with the investment results in your account it is your responsibility to inform Krsek or O'Dwyer and to discuss possible changes that can be made to the account to accommodate and satisfy your needs.

The assets held in managed accounts at 5T WEALTH MANAGEMENT may include stocks, bonds, cash, commodities, foreign exchange or mutual funds or exchange traded funds (ETF's), money market accounts or limited partnerships that represent the same. They are subject to market fluctuation and the potential for losses. The assets are not insured. The value and income produced by these investment products may fluctuate, so that an investor may get back less than they initially invested.

The portfolio managers at 5T WEALTH MANAGEMENT do not guarantee results.

Past performance should not be considered an indicator of potential future performance. If you do not consider yourself suitable, either emotionally or financially, to experience volatility and/or losses in financial markets, you should not invest.

From time to time Krsek lists the simple annual returns of the six model accounts in this newsletter. These accounts are "models" and do not represent the actual results accruing to individual accounts. Simple annual return does not represent "time weighted return" as reported individually to clients in their quarterly reports prepared using Centerpiece.

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