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As we start the New Year, our partner William "Ledge" Mitchell looks back at 2012 with the following observations and comments:

The Year in Review

"Twenty-twelve" had its share of good and bad days, but the tragedies of Hurricane Sandy and the Newtown massacre will rightly be remembered long after folks have forgotten that the Bush tax cuts were made permanent for most Americans and that the stock markets climbed for the 4th year in a row. Granted, 2011 was barely positive but on a total return basis, equities have finished higher every year since 2009. In fact, the 16% advance for the Standard & Poor's 500 Index last year was its best since 2009, when it was up almost 27%.

Delving deeper, it appears that once again Wall Street's rotation game was alive and well. Strategies for rotating in and out of stocks, industries or different types of assets can be based on computer models, trading patterns, business cycles or other variables. The best performing asset class last year was S*mall Cap Value* stocks, which was the second worst performing class two years ago. *Bonds*, which bested all stock categories in 2011, dropped to the rear last year with a total return a little better than 4%.

The S&P 500 also saw rotation among its individual sectors. Two years ago, *Utilities* led the markets while *Financials* were last. Just the opposite occurred in 2012 with *Financials* up front and *Utilities* at the back of the pack.

Leaving aside Wall Street's questionable trading tactics, fourth-quarter earnings for companies are just starting to come in. While momentum may have slowed a bit, the final tally for S&P 500 earnings per share could top $100 for the first time ever. For 2013, the consensus has preliminary estimates of earnings expanding to $108 or so, although some "perma-bears" are forecasting $80 -- a substantial drop below 2012's earnings.

Typically, consensus earnings start high and end up being shaved as the year progresses. It appears that the Street's current estimates are being influenced by "Fiscal Cliff" hang-overs -- as one wag recently put it, "hope is turning to cope" for many families living paycheck to paycheck. Also, at least half a dozen euro zone countries remain in recession and China's economy is throwing off mixed signals. Of course, it is always difficult to know what is really going on in Beijing with the government's well-known standard operating procedure of manipulating data.

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Here at home, with the election behind us Washington remains in gridlock. There was a time when Wall Street was quite content with this state of affairs, but not so much now with the national debt above $16 trillion and expanding at a rate of $4 billion a day.

The prospect of a U.S. default is being bandied about again but is not being taken seriously, yet. The credit rating agencies have already hinted that another downgrade is possible but the last had little impact on Treasury yields. In fact, some yields are virtually unchanged on a year-over-year basis. For example, the 30-year Treasury bond yielded 2.89% at the end of 2011 compared to 2.87% at the end of 2012.

With an inflation rate currently below 2% and the Federal Reserve signaling that easy money policies will remain in place until certain conditions are met (inflation above 2.5% or unemployment below 6.5%), traders will continue to use Treasuries as a "safe port" in a stormy world. This risk-on/risk-off trade has been in place for a number of years and there is no reason to think it will stop anytime soon. There is, quite simply, no viable alternative to the U.S. Treasury market.

Down the road however, central bank money printing eventually should lead to inflation and currency devaluation. The Fed's quantitative easing program of buying $85 billion worth of Treasuries and mortgages each month (known as "QE-infinity") is aimed at keeping the sluggish economy moving forward. For the third quarter, the final figure for Gross Domestic Production came in at just over 3% but estimates for the fourth quarter are being pared back. In 2013, economic growth will likely be around 2% -- steady, but not high enough to get unemployment down to the 6.5% target.

Against this backdrop, stocks have gotten off to a quick start this month even with these barriers to progress. In some economic sectors, there are very encouraging signs.

Real estate prices are bottoming out and, according to the Case-Shiller Index, home values have started moving up. This welcome news has, in turn, produced a sharp upturn in the building industry. Auto sales have rebounded and manufacturing activity has held up reasonably well.

So even with "twenty-twelve's" nerve-wracking days and weeks, last year was actually a triumph for investors who stayed the course. There will always be those on Wall Street who are smitten with speculation -- jumping in and out of markets or rotating back and forth among sectors. But instead of trying to guess which will be the next "hot" area, we think it makes more sense to focus on vibrant companies with exceptional fundamental characteristics. It is these top-notch companies that grew their earnings and dividends last year and will continue to grow them this year and in the years ahead, in spite of Wall Street's never-ending merry-go-round.

William H.L. Mitchell