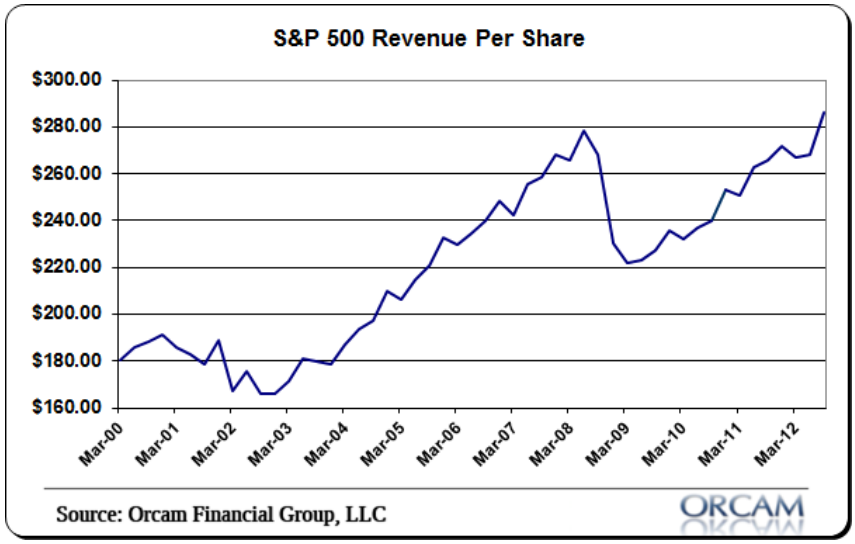
Weekly Round-Up

Cullen O. Roche
Founder
Orcam Financial Group, LLC
cullenroche@orcamgroup.com

Markets finished the week about 0.5% higher as fiscal cliff fears continued to keep markets on edge. At several points during the week the markets experienced sharp downturns on news that the cliff discussions were deteriorating, however, these fears were short-lived as the equity markets remained resilient in the face of what is becoming a repetitive and clearly priced-in event.

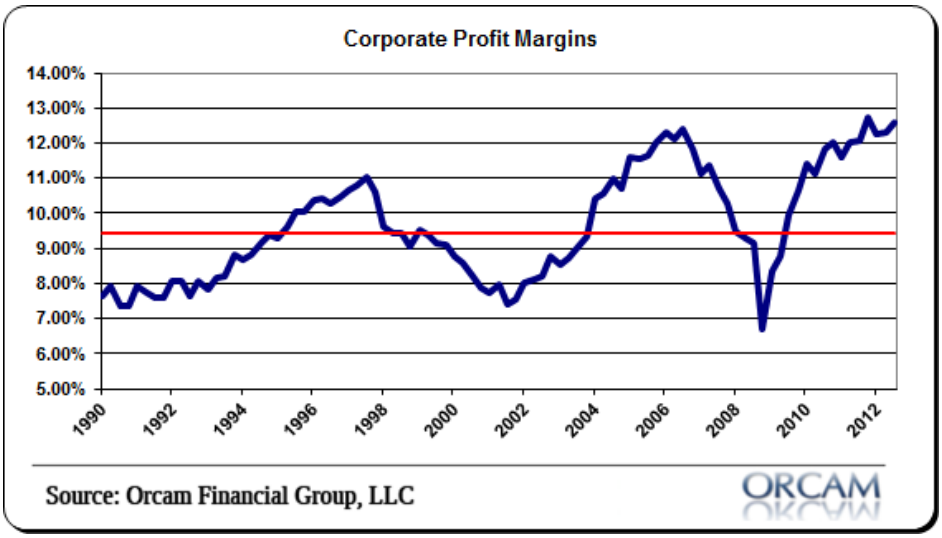
The Big Picture

The Q3 S&P 500 earnings season is almost entirely over (99% of reports are in) and it was a mixed bag. Operating EPS was up 1.1% and as-reported GAAP EPS was up 3.7%. Interestingly, revenue per share is likely to hit an all-time high of $286. This would be the first time during this recovery in which revenue per share has exceeded the pre-crisis levels.



"Failure to prepare is preparing to fail."
-Coach John Wooden

It's equally interesting to note the stability in corporate profit margins. This is primarily due to the continuing strength in revenues and relative stability in unit labor costs. Historically, profit margins have averaged about 9.5%. Given the propensity for reversion to the mean and the volatility of the business cycle it would be highly unusual for this situation to persist for long periods of time.



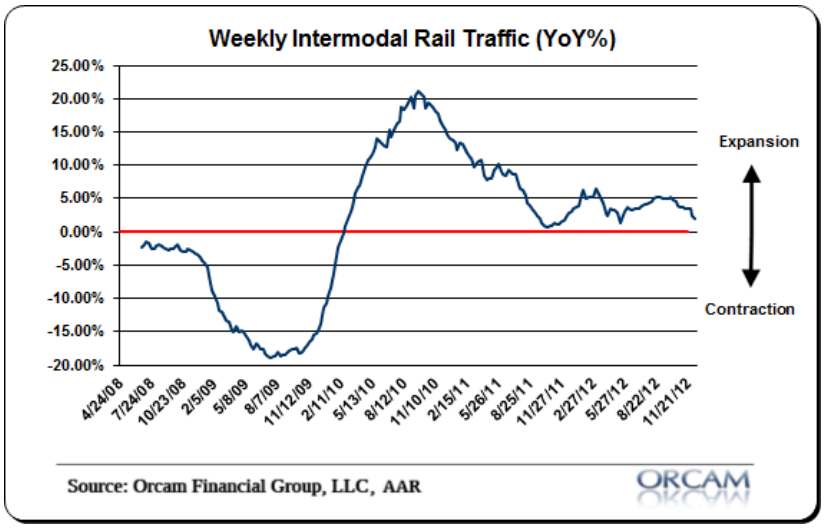
I think a substantial reversal in the government budget situation as a result of the fiscal cliff would be a likely trigger of this sort of event, but we're unlikely to see debilitating cuts in the 2013 deficit. For now, it's still looking like we could see deficits that are 6-8% of GDP depending on the final results of the cliff discussions. That means this environment could persist and corporate profits could continue to move sideways to slightly higher in the coming quarters.

It might seem counterintuitive, but the weak economic environment has been rather good to corporations. This has been primarily due to the massive cost cuts that were implemented and the large government budget deficits. I often try to explain the economy and financial system as a system of "flows". And when the credit markets broke in 2008 households stopped borrowing to spend, corporations saw revenues dry up and private investment sank to a record low. In other words, the primary sources of "flow" in the economy stopped. But the government implemented massive spending programs that served as a source of "flow" when there was none. Much of this has flowed to the bottom line of corporations, but because there has been a weak organic private sector recovery the corporate sector has remained hesitant to hire. The result has been strong corporate profits, decent revenues and high margins.

Warren Buffett's Favorite Economic Indicator

Over the course of his career Warren Buffett has repeatedly referred to rail traffic as his favorite economic indicator. I agree as it has tended to provide a succinct (nearly real-time) perspective of the economy. The latest readings from the AAR provide us with a brief snapshot:

> "The Association of American Railroads (AAR) today reported mixed weekly rail traffic for the week ending November 24, 2012, with U.S. railroads originating 252,931 carloads, down 4.6 percent compared with the same week last year. Intermodal volume for the week totaled 194,538 trailers and containers, up 1.9 percent compared with the same week last year.

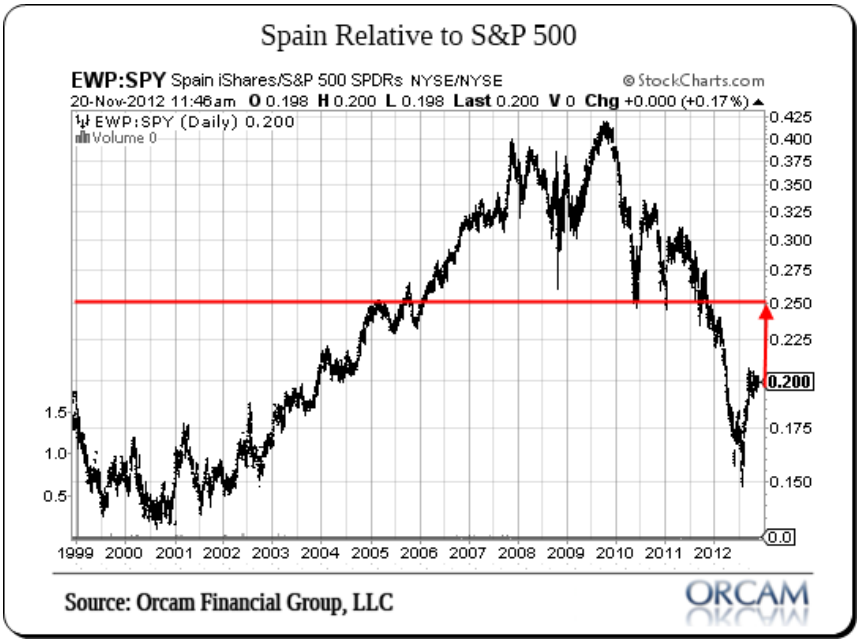


> Twelve of the 20 carload commodity groups posted increases compared with the same week in 2011, with petroleum products, up 63.6 percent; farm products excluding grain, up 24.8 percent, and lumber and wood products, up 17.1 percent. The groups showing a decrease in weekly traffic included metallic ores, down 24.7 percent; grain, down 16.7 percent, and coal, down 12.2 percent."

This brings the quarterly moving average down to 2%. Intermodal traffic has weakened substantially in the last few months from mid-single digits to low single digits. This very clearly remains a weak economy in the USA. I don't see a recession in the coming quarters, but it's hard to celebrate this environment.

The ECRI reiterated their call for recession this week. Although their call is now a bit long in the tooth (they first said the USA was in recession last September, 2011) it's increasingly plausible that the NBER could call this environment a technical recession.

Asset Class Deviations—Long China?

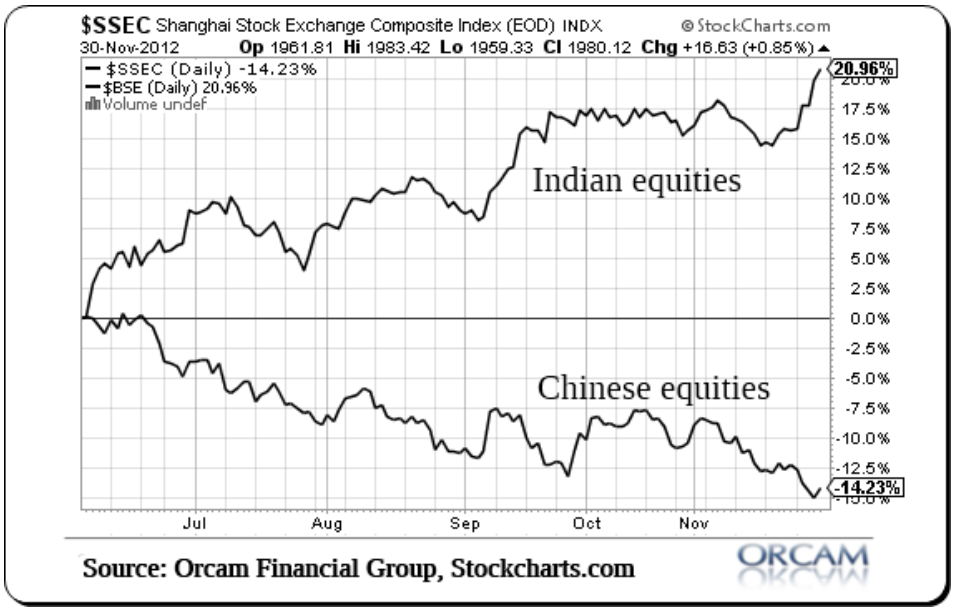


A few weeks ago in our cross asset class correlations note I highlighted Spain relative to the S&P 500.

One similar idea that has started to look increasingly attractive is Chinese equities.

If you look at the chart below you can see the Bombay Stock Exchange relative to the Shanghai Composite. These two BRIC emerging markets have substantially diverged in the last 6 months.

Like the Spanish equities idea, this is not for the faint of heart as Chinese equities can be extremely volatile. But given the recent recovery in Chinese PMI and overall economic data I have to wonder if the 18 month 27% slide in the Shanghai Composite isn't a bit overdone? It's something to ponder.



ORCAM

If you ever have questions or concerns regarding research or other services provided by Orcam Financial Group please don't ever hesitate to reach out to us at info@orcamgroup.com.

Orcam Financial Group, LLC

Orcam Financial Group, LLC is a fee only financial services firm offering macro research, personal advisory, institutional consulting and educational services.

Important Disclaimer

Nothing contained herein should be construed as an offer to buy any security or a recommendation as to the advisability of investing in, purchasing or selling any security. Some of the statements contained herein are statements of future expectations and other forward-looking statements. These expectations are based on Orcam's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those in such statements due to, among other things, general economic conditions, performance of financial markets, Orcam Financial Group, LLC assumes no obligation to update any forward-looking information contained in this document.

ORCAM