

2012 First Quarter Letter: Will 2012 be a road paved with opportunity?

2011 is now in our rear view mirror

2011 MARKET RETURNS

Year to date thru December 30, 2011

S&P 500 Index	-0.003%
Dow Jones Industrials Index	5.53%
NASDAQ	-1.80%
Russell 2000	-5.45%

Looking back at 2011, investors were generally optimistic as the year began, as corporate earnings and balance sheets showed strength and the U.S. economy continued to show improvement. Despite higher oil prices and a tragic tsunami and nuclear accident in Japan, stocks reached a three-year high in April.

However, things began to become unsteady after that, as European leaders grappled with a steadily worsening debt crisis and political squabbling over the U.S. debt ceiling took the nation close to default and put investors in a dark mood. Matters came to a head in August when rating agency Standard & Poor's issued a historic downgrade of the U.S. credit rating and markets gyrated wildly, with the Dow bouncing up and down by 400 points or more for four straight days. The Dow Jones Industrial Index dropped 4.4% in August, its worst decline of the year. Thanks largely to Europe and indecisive dysfunction from Washington, stocks moved inconclusively throughout the balance of 2011, but with a lot of volatility. 2011 saw the S&P 500 move by 1% or more, up or down, 96 days. Nearly three-quarters of those volatile days occurred during the second half of the year.

We look down the road for 2012

We have been studying the technical action of the markets and reading reports from numerous sources outlining where the economy and markets are currently and where they may be headed during 2012. As usual, there are many differing opinions.

Same bumpy, nauseous ride?

Some experts believe that 2012 will offer a continuation from the fourth quarter 2011 and there are many reasons for thinking so. Markets will continue to be focused on U.S. job growth, earnings reports, and Europe's ongoing debt problems. Other factors that could weigh heavily on the minds of investors include the upcoming U.S. elections and uncertainties regarding taxes.

Or possibly we are turning a corner and headed towards smoother roads.

1. **Economic Data continued to be mostly positive during December**, including housing data, manufacturing, retail sales and consumer sentiment. Employment data, while still challenging, has been much more optimistic the past three months also. According to Asset Managers Wilbanks, Smith & Thomas, record U.S. exports are driving a small but significant upturn in manufacturing and service employment after a two-decade decline. Their observation also notes that the U.S. is beginning to "onshore" jobs that had previously moved overseas, an emerging trend that will benefit the employment picture.

4.1% of U.S. citizens with a college degree or higher are currently unemployed.

JP Morgan Weekly Market Recap – January 9th

- 2. Corporate earnings growth has been positive for several quarters now**, but during 2011, especially the second half, the markets largely ignored good corporate news and instead focused on fears surrounding Europe. If the markets decide that Europe being in recession and dealing with their debt issues, which will take years to resolve, is the new normal, they may once again turn the focus to U.S. equities, which by many accounts are very reasonably valued. If this occurs, and so far the market seems to *want* to do this, 2012 may turn out to be a profitable one for equities.
- 3. One issue that caused a lot of angst for the market during the late summer/early fall of 2011, the debt ceiling debate, has been removed from the headlines, at least in the near-term.** The deal struck last August between Republicans and Democrats gives President Obama the authority to raise the debt ceiling in three stages, the third of which has just been requested. At each stage the debt ceiling increases 15 days after the President officially notifies lawmakers that the government is close to the current \$15.2 trillion cap, unless Congress votes to deny the borrowing increase, which is highly unlikely. The House, with Republican majority, voted to reject it, but Senate support for the resolution, with a Democratic majority, is all that is needed for passage ¹.

Although the ‘can’ will be kicked once again down the road a little further, the end of the road is within sight. Our country is running out of time to address these issues and it is very important for Americans to pay attention to these matters and hold their representatives accountable.

- 4. Earnings Growth and Valuations became more attractive during 2011, according to Jeff Saut, Chief Equity Strategist at Raymond James.** While the S&P 500 index went virtually nowhere during 2011, the stocks within it experienced 20% earnings growth accompanied by a 16% valuation decrease, making it very reasonably valued.

Last year, markets paid so much attention to the Greek drama; the potential for a Greek default, policymaker action to supposedly avoid a default and the impact of all of this on other European nations as well as the global impact, that the increasingly attractive valuations of U.S. companies went virtually ignored. Some say this may be our best opportunity to buy equities in years.

“When everyone moves to one side of a ship, the opposite side rises.

Sometimes it is good to be on the high side of the ship”.

This phrase was uttered by a good friend of ours from Oppenheimer. When it comes to investing, usually once everyone has caught on to something to the point where everyone seems to be doing it, it is time to change course (think technology bubble in 2000). This has repeated over and over in market history, and we recently picked up on this data that indicates we may again be at another tipping point.

According to Lipper, since the beginning of June, 2011 investors have pulled \$155 billion out of equity mutual funds. This represents the biggest round of selling since March 2009, which was the end of a

multi-month period when investors pulled \$188 billion out of stock-based funds. March 2009 turned out to be a good time for stocks, with stocks up 40% up over the next year.

It is our job to consider the contrarian viewpoint.

We can't control where the road heads, but we can carefully steer the vehicle and drive at safe speeds

As 2012 begins, we will continue to focus on preserving your wealth first and foremost. Because of the higher risks and volatility, we have been placing a high emphasis on managing risk and seeking income for clients and we will continue to do so, but we do see things that cause us to be hopeful 2012 will offer us some attractive opportunities for growth, particularly within U.S. equities and certain fixed income.

The market turmoil does have a silver lining for younger long-term investors. As we mentioned above, equity valuations are attractive, in fact they are at the low end of their historical range. This means equity returns have better potential in coming years than the last several. For those seeking income, investment grade and high yield corporate bonds offer income investors historically high yields relative to Treasury bonds.

For more insights and commentary on the economy from Raymond James professionals, please see the *2012 Economic Outlook* now available through our website at: www.raymondjames.com/hilliard.

Sincerely,

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¹ *House votes against debt ceiling increase* January 18, 2012 FoxNews.com

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The **NASDAQ Composite Index** is an unmanaged index of securities traded on the NASDAQ system. **Russell 2000**: Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represent approximately 8% of the total market capitalization of the Russell 3000 Index.

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