December 22, 2011

Given the New Year just around the corner, it is time for every stock analyst/advisor to give their annual 'outlook.' Not sure why the calendar year matters as it seems more like a hypothetical line in the sand then a resetting of the clock, but tradition is tradition I suppose. Nonetheless, here are my thoughts looking into 2012.

1.) *The U.S. stock market looks attractive.* Earnings growth has continued to beat expectations and the economy is still slowly chugging ahead. Without getting too technical, the price to earnings multiple on the S&P 500 is trading below longer term averages, and with a dividend yield near, or higher in many cases, that of a long dated U.S. Treasuries. If history serves as a guide, this has led to positive equity performance looking forward. Broadly speaking, investors are able to purchase the finest publicly traded companies the world at prices that famed investor Jeremy Segal recently called "the cheapest since the 1950's."

2.) *Volatility is here to stay.* With the U.S. equity markets up and down materially at different points this year, we all now know what is meant by term volatility. Certainly not pleasurable and definitely unappealing, but the future seems to hold more of the same.

Side note on volatility: What really seems to be driving the markets of late has been an increased sense of another 2008 credit crisis type of event coming from Europe. Clearly should such an event occur, the markets would most likely trade sharply lower for a period of time. However, what made the credit crisis of 2008 so alarming was that it was not widely expected or understood. With respect to Europe, it seems that they have done a reasonable job of ensuring the likelihood of this is a low probability event by being transparent and diligent in getting ahead of it. The U.S. has also done its part by lowering rates to international banks in need of U.S. dollar financing which should allow the credit markets and international trade to continue functioning normally.

3.) *Probability of a recession in the U.S. is less than 50% in 2012.* Of the three forecasting models I follow (and have been reliable enough to continue to follow), only one currently suggests a recession and even that model has bounced back and forth throughout the year. Should 4th quarter 2011 GDP (Gross Domestic Product) come in stronger than anticipated, which I think is likely, the odds of a recession go down further.

Europe accounts for roughly 20% of our dollar based output, so while definitely material, higher domestic growth should provide sufficient cushion from the U.S. importing what is mostly likely a severe recession, potential depression, in Europe. To be sure, we are not immune from international economic problems, but worldwide growth for 2012 is forecasted around 3.5% according to various economic

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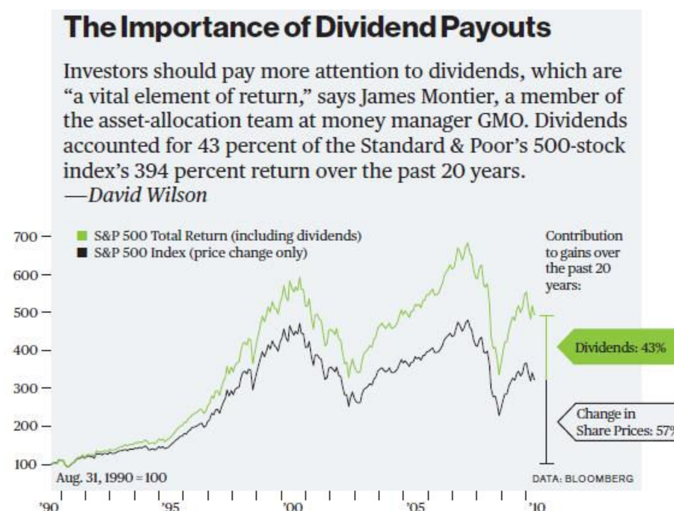
outfits such as The World Bank and Morgan Stanley. This provides additional support for the thesis of higher GDP growth in the U.S. via exports, and not a recession in 2012.

4.) *Dividends are still the straightest arrow in the quiver.* Never forget that dividends account for a significant portion of total return; 43% over the last 20 years (see source below). Dividends may also provide a consistent cash flow for those in need of income. With bond yields and interest rates as low as they are, dividend oriented equities seem like a natural substitute for fixed income investments to the extent of your risk tolerance, comfort with the volatility of stocks, and your asset allocation. We have seen an increasing desire on the part of clients to own individual equities in lieu of mutual fund and index funds. Generally, we are comfortable with this approach as long as investors understand that risks associated with this style of investing.



5.) *Interest rates to remain low, but I can see rate hikes in the forecast.* The Federal Reserve has reiterated its position of no interest rate increases in 2012. The market, not the Fed, has the ultimate say in this, but we expect little change in interest rates. Stronger growth domestically and/or another downgrade of U.S. debt could provide a catalyst for higher rates, but even then only marginally. We still have a preference for short duration bonds given that at some point in the not too distant future higher rate hikes are inevitable. Additionally, while government reported inflation is low, expenses such as fuel, education, health care, and food suggest inflation is more prevalent than we are led to believe. This may make the 'real' return on fixed income/bond investments negligible or negative.

Here is a recent comment from the fixed income analysts at Goldman Sachs:

Despite a deeper recession in the Eurozone, slowdown in the US, and below-trend growth in China, we believe 10-year Treasury rates will not fall below 2.00%, other than temporarily, over this cycle. We believe the 10-year Treasury will gradually rise to 2.50% and 3.25% in 2012 and 2013, respectively.

Source: Goldman Sachs Market Pulse- First half of 2012

As such it would seem prudent to us that investors be ever aware of the duration of their bond investments as the most fruitful bull market in bonds ever seems to be coming to a close.

6.) *Holding Period & Patience.* Do you remember who first introduced investing to you? Was it an uncle, your grandfather, maybe your mom or dad? When sharing the wisdom of the benefits of investing, I would venture to say that it was their intent to hold an investment until they had a reason not to. Today, for reasons behavior psychologists could probably explain, most view investments as short term financial transactions, not long-term wealth management opportunities. Making change to your portfolio for no other reason than your emotions are poking at you only puts money in the hands of people other than yourself, and increases cost. During times of dislocation, do your best to remember that investing is a life-long commitment, not a get rich proposition.

We truly appreciate your patience and continued trust, especially during trying years such as 2011. The toughest part of investing is ensuring that our emotions do not take control of the proverbial wheel and steer the vehicle off course. Recognizing and prudently directing fear and frustration, more than anything else, is the key to successful long term investing. We hope that our ongoing dialogue and relationship provides value in this regard.

Best wishes to you and your family for a Merry Christmas and a New Year of health, happiness, and financial security.

Gratefully Yours,

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