Economic & Market Commentary

For a year in which U.S. equities were essentially flat (the S&P 500 starting at 1257.64 and ending at 1257.60), getting from January to December was anything but tranquil. We endured a major earthquake and tsunami event in Japan, serious social unrest in the Middle East, a rancorous debate between the U.S. legislative and executive branches that can't seem to come to grips with federal budgetary and deficit issues, a downgrade to our sovereign debt, a stubborn U.S. economy that grows at a painfully slow pace, and finally a European debt situation that drags on without resolution and that has potentially severe consequences for worldwide growth. The equity market's response to all of this was hope overcoming reality during the first half of the year, and reality taking the upper hand in the second. From its peak in April to its trough in the early fall, the S&P suffered a decline of 20% (a typical bear market decline) as Europe and fears of a U.S. recession took control. Then U.S. economic data began to look better and it appeared that progress would be made in Euroland, which created the makings of a strong fourth quarter rally in equities, bringing us back to almost exactly where we started the year. It was truly a tumultuous ride!

The only place to have made money was with bonds and gold, which outperformed equities. Nor would it have helped if you invested outside the U.S.: 46 of the 49 world indices in the MSCI Index were in negative territory, with 45 of those worse than the S&P 500. In the U.S., large capitalization stocks did better than small and mid, and growth had an edge over value. Macro issues continued to determine market direction, as has been the case for the past few years.

Depending on the data reported and the news of the day, the market would adopt a "risk on/risk off" mode, increasing the volatility from an already high level. There were 96 trading days (38%) that had moves of 1% or more for the S&P 500. This compares to an average number of trading days since 1946 in the mid-teens. On top of this, stock valuations were compressed, and the correlation of movement among stocks was extreme. All of these factors made establishing any strategy in managing a portfolio more difficult than usual. It is therefore not surprising that, according to many press reports, fewer than 25% of money managers outperformed the S&P 500.

A year ago we wrote that we felt the financial markets would be hospitable through the middle of 2011, as many of the policy measures taken in the prior year worked through the system. We felt the economy was on firm enough footing, and there was enough stimulus being injected, to sustain modest growth. The risks we saw had not been clearly addressed and were still lurking, but the U.S. economy was growing and Europe had not yet reached a boil. The markets cooperated until it became evident that political leadership was lacking worldwide, and the risks to our economic progress became more pronounced, which led to the summer swoon. In spite of this reaction, the U.S. economy continues to move forward, albeit at a below trend pace. Most economists project final quarter real GDP at +3%, which would be the best period for the year. Even if this report materializes, the full year would still show growth of less than 2%, well below trend, and the prior year's growth of more than 3%. As it stands on its own, the U.S. economy is performing about as we have expected. We have said for some time that our expectation was that the unraveling of excess leverage and the correcting of the balance sheet recession we experienced would result in a prolonged period of slow, below trend, real growth (in the 2%± area). We have not changed that view.

Consumer spending was the strongest contributor to last year's growth. Despite a weak employment picture and little growth in personal income, spending has been surprising. There has been some deleveraging of consumer debt, but recently the trend has reversed. The savings rate, which peaked in May 2008 at 8.5%, has declined to about 3.5% now. With the employment picture improving, but not yet vibrant,

income growth slow, transfer payments declining, and the savings rate low, it is difficult to make a case for strong consumer spending during the coming year. Corporate spending has been good. Expenditures on productivity enhancement are paying off. Productivity gains picked up in the third quarter, after lagging in the first half. Morgan Stanley points out that the top 1500 companies have $1.4 trillion in cash on their balance sheets. If employment continues to show signs of growth, and demand stays reasonable, capital spending could be a pleasant surprise. Exports have also been a strong point, contributing more than in past cycles. However with a firming dollar, and European banks accounting for about one third of global trade finance, it is difficult to expect anything but modest help from this source. Housing has been a large negative contributor to growth for the past several years. While it's not likely that this area will fill its usual leadership role in a recovery, as long as it stabilizes and begins to show signs of recovery, it can be a significant positive at the margin. Employment is the most crucial element in the economic puzzle for this year. If we see jobs added in the 200,000- 250,000 area for a series of months, we could have the pieces come together in a virtuous circle. With this set of circumstances, we can accept the case for the U.S. economy growing in the 2% area this year.

The flies in the ointment however are the handful of risks that are part of the equation. As we turn the calendar most of the risks we're faced with are not new. In fact most have been enumerated in our past quarterly outlooks. None have been successfully dealt with yet, and therefore continue to weigh heavily in our thinking. They are all complicated by world politics. Over the next 2 years, countries accounting for close to 50% of world GDP will be holding elections. This, of course, makes judging policy moves almost impossible. With a Presidential and Congressional election in the U.S. less than 11 months away, it is unlikely that any of our pressing issues will be confronted this year. Any meaningful discussion and decisions on the budget, deficit, entitlement spending, or tax reform will likely not be made until 2013 and beyond. That will coincide with the expiration of the Bush tax cuts, and the beginning of budgetary sequestration. These are anti-simulative actions which will cloud the outlook for the year, with any additional austerity measures taken adding more fog.

The most pressing problem, as it has been for some time, is the resolution of the European debt crisis. Little progress has been made in ensuring the solvency and providing the needed liquidity to ailing countries, and in recapitalizing the banking system. The capital necessary to meet the needs has been estimated at €2T-€4T. Accessing that capital is not palatable to the important constituents of the European Central Bank (ECB). Germany (19%), France (14%), Italy (12%), and Spain (8%) contribute 53% of the bank's capital. Germany, with its fear of inflation stemming from its Weimar experience, is particularly adamant. In place of a capital raise or euro-bond issuance, the ECB has initiated Longer Term Refinancing Operations (LTRO), which allows it to extend collateralized credit to European banks, for a three year term. It, in effect, is a form of quantitative easing (QE), which we are familiar with in the U.S. This allows banks to borrow from the ECB for 3 years using assets on their balance sheets as collateral, thereby reducing their capital requirements, and easing some of the banking system's strain. The hope is that banks would then purchase sovereign debt of ailing countries thereby reducing solvency risk. So far this has not happened as the lending to date remains held in reserves (why should a bank take on debt it has no confidence in, and increase its capital requirement at the same time?). In the meantime, the balance sheet of the ECB has expanded at a faster rate than that of the U.S. Federal Reserve under two rounds of QE. While this may seem like a fruitless exercise, it may have a valid point. Opening the loan window and extending terms may serve the purpose of buying time so that the peripheral countries can implement coordinated fiscal policies to promote growth and bring budgets under better control. In a typical debt crisis there are generally 3 ways out: growth, inflating (currency devaluation) or default. A broad ranging series of defaults leading to bank runs and dissolution of the Euro, would have devastating effects on the world economy. Buying time

through the LTRO, a little inflation, and a hope for growth oriented policies may not be as fruitless as it appears.

However even if some of the monetary and debt issues are addressed, it has been pointed out by many that they are not at the root cause of the European Union's problems. Differences in labor costs, productivity and competitiveness are more reflective of the issues that need focus and reform. This is a problem that is cultural in nature and can't be solved in a short period of time, but a window of calm is at least a step in the right direction. As the Bank Credit Analyst wrote "a monetary union without a fiscal union is always a strange animal."

A structured or managed Greek default is probably already discounted in financial markets, and that event can probably be absorbed without great difficulty. Of course this circumstance is not new to Greece which, according to Reinhart & Rogoff, has been in default or restructuring 50% of the time since 1830. An unstructured or chaotic default would cause risks to increase exponentially. A cascading of the debt crisis to the point where it engulfs other of the peripheral states is not in the financial markets. In addition, it is likely that Europe is in a recession now, or soon will be. Austerity policies almost assure that will be the case. As we have pointed out before, direct exposure of the U.S. to Europe is quite small. Exports to the E.U. account for less than 2% of U.S. GDP, and cross border exposure of U.S. banks is minimal. Of course there is the area of derivative securities that could be a huge problem. Clearly if contagion spreads and defaults look imminent, the U.S. economy is vulnerable, and our assumption of modest growth becomes suspect. All of these risks demand watching as any of them could significantly alter the path of growth. Although the most likely scenario is modest growth at least through the first half of the year, the numerous risks discussed above make the most likely deviation to this benign outcome to the downside. The risks are several and their severity high.

For the past year earnings growth was the story for equities. Corporations turned in another stellar year, turning nominal GDP growth of less than 5% into earnings growth of close to 17% (18% including share repurchase). UBS provides an analysis of the source of earnings growth for the S&P 500 as follows:

- Base Revenues	+5.0%
- Margin	+2.4%
- Commodities, weak dollar, Non U.S. Growth	+9.4%
	+16.8%

Clearly some of these tailwinds of 2011 will be the headwinds of 2012:

- Non U.S. growth will slow – recession in Europe (50% of S&P revenues are from abroad with 14% from Europe)
- Dollar has been strong and will continue to be in all probability
- A strong dollar and weak global demand will not be good for commodities
- Margins could begin to revert to the mean from their all-time high levels currently

Therefore, while S&P earnings were strong in the past year, there is a good chance they will not measure up to expectations in 2012. The consensus forecast for the year is about $108, up 11% from the $97 expected for 2011. Analysts/strategists are typically wrong at inflection points, and we expect this will be true this year as well. Three months ago we wrote that that we could see 2012 earnings in the range of $85-$100 for the S&P 500; we see no reason at alter that view. According to Barron's, 96 S&P 500 companies have lowered 4th quarter guidance (the most in 10 years). So the earnings reporting season, which is now starting, should be instructive.

Over the past year it is obvious, with the S&P flat, yet earnings up 17%, that P/E multiples contracted. With the world situation confused and unclear, the equity risk premium (ERP) increased. We expect it to remain high for some time, until greater clarity returns and risks are diminished. A look at history, and in particular Japan, shows that under prolonged clouded circumstances, P/E's in the 11-13 range are commonplace. Put all this together and stirring vigorously, it seems to us that the equity market closed the year at about fair value. This judgment makes middle of the road assumptions. If we look at the dark side and the bright side we could see an S&P 500 range in the area of 1100-1350. While this prospect is nothing to jump up and down about, there are always opportunities to make money. The good news is that multiples are highly compressed, and correlation of movement is high. This means that there is little discrimination being shown among businesses and business performance. We spend most of our time examining the performance of a business, and trying to understand the economics behind it. This is where the potential rewards are and we expect to add value to our clients' portfolios.

Fixed Income Review and Outlook

Fixed Income produced another year of good returns. In fact bonds outdistanced stocks not only for the year, but also annually for 5,10 and 15 year periods. It paid to be nimble, as investors were rewarded for holding corporate debt and mortgages for the first half of the year and Treasuries in the second half. For the fourth quarter, the Barclays Aggregate returned 1.12% and 7.84% for the whole year. A breakdown of the sector returns follows.

After returning 6.48% in the third quarter, Treasuries offered only 0.89% in the fourth quarter. Treasuries outperformed the broader market with an annual return of 9.81%. The yield curve flattened dramatically in 2011, as long rates (ten and thirty years) fell more than shorter term rates. Ten year yields, which began the year at 3.37% and hit a high of 3.74% in February, finished at 1.8%. The yield of the 10 year note reached a low of 1.72% in September. The two year note which finished 2011 with a yield of 0.25% moved in a 70 basis point range with a high of 0.85% in February and a low of nearly 0.15% also in September.

We believe Treasury rates have hit their lows for the cycle and are poised to rise moderately. We do not expect a significant increase in rates. Given the uncertainty prevalent in the markets, especially with respect to Europe, we believe it is prudent to hold more Treasuries in the portfolio. However, the low yield of Treasury bonds and wide spreads of mortgages and corporate bonds relative to Treasuries discourages us from taking a large position in the asset class.

For 2011, Agencies returned 4.86%, 0.48% of which came in the fourth quarter. We prefer to use callable agencies with final maturities of 2016 and earlier as a yield enhancing strategy. In general, we think high-rated corporate bonds offer better return opportunities than agency bullets.

Investment Grade corporate bonds put in a strong last quarter of the year, returning 1.93%. For the year, corporates returned 8.15%. While the returns were good, corporates underperformed Treasuries for the first time since 2008. Most of the underperformance of the sector came in the third quarter when economic indicators pointed to the possibility that the U.S. was about to enter another recession and the European debt crisis started to spiral out of control.

Fundamentally, corporates could hardly be in a better place. Earnings are at record levels, as are profit margins. After the financial crisis of 2008 and 2009, companies implemented balance sheet repair programs that included reducing their debt burden, holding more cash on the balance sheet and extending the maturities of the debt they did hold. Those companies that want to access the debt market are doing so

at close to all time low yields.

These repair programs have mostly come to an end. In fact we are seeing a reversal of the deleveraging trend by some companies. For example, in November Amgen announced plans to pursue a $5 billion share buyback funded with a bond offering. Intel pursued a similar exercise in September. Until there is evidence of a stronger economic expansion than we are seeing now, we expect these programs to be limited in scope.

We expect to remain overweight corporate bonds for the coming quarter. As mentioned above, fundamentals remain strong and the additional yield offered by corporates relative to Treasuries is elevated. We favor bonds with final maturities of six to ten years.

Mortgages returned 0.88% for the quarter and 6.23% for the year. We believe that mortgages should continue to be a good source of yield for investors. Concerns that the federal government will successfully launch a massive refinancing program pushed spreads wider to Treasuries and offer better value than Agency bonds. We favor higher coupon mortgages that have little interest rate sensitivity and are focusing on bonds with low loan balances that have a reduced chance of refinancing risk should the government be successful in implementing the program.

One such refinancing program is the changes to the HARP or Home Affordable Refinance Program announced in November. This HARP 2.0 eased the conditions by which lenders could offer refinancing to homeowners and extended the end date of the program from June 2012 until December 2013. Since the targeted homeowners' mortgages must be owned or guaranteed by Freddie Mac or Fannie Mae and must have been sold to Fannie or Freddie on or before May 31, 2009, we are targeting mortgages originated in late 2009 and 2010 in order to mitigate prepayment risk.

Municipal returns almost doubled those of the Barclays Aggregate this past quarter, returning 2.00%. Despite some well publicized predictions of "hundreds of billions of dollars" of municipal defaults, investors were drawn to the market as yields, both absolute and tax-adjusted, reached very attractive levels and long maturity municipals returned 10.70% in 2011.

While the actual number of municipal bankruptcies was far less than some predicted, there were several high-profile bankruptcies in 2011. In October, Harrisburg, the capital of Pennsylvania, filed Chapter 9 and in November, Jefferson County, Alabama filed the largest municipal bankruptcy in history. As both events had been expected, neither caused a large disruption in the orderly flow of the market.

In instances where they offer better value than mortgages or corporates, we favor municipals backed by revenues such as tolls to those dependent on tax receipts as we believe municipalities' ability to increase taxes is limited.

High yield posted a 6.06% return in the fourth quarter reversing the 6% loss of the third and bringing YTD performance to 4.3%. For 2011, high yield mutual funds received inflows of $14 billion.

Going forward, we expect to reduce the interest rate sensitivity of the portfolios by holding fewer Treasuries and those we do own will have shorter final maturities. Before adopting that posture, we'll look for some signs of a real solution to the sovereign debt crisis to come out of Europe. We'll look to add mortgage pools in anticipation of further Federal Reserve easing and will keep an overweight in corporate bonds.