

# Quarterly Market Letter



## Year end 2011

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### Highlights:

- 2011: lots of volatility, little return
- Good domestic corporate earnings  
offset by  
Washington stalemate and European crisis
- Interest rates near record lows
- 2012 moderate GDP growth and low inflation

### Introduction

For the S&P 500, 2011 was the year that wasn't. The Index ended the year at 1257.6, almost exactly where it began at 1256.7. Including dividends, the total return was 2.1%. Intra-year, returns ranged from a +10% in the April market run-up, and then touched -10% after the third quarter slump. Returns for smaller and mid-sized stock indices were uniformly negative. So the bottom line was a lot of volatility, with little or no return.

The causes of this stalemate between risk and return were the acrimony in Washington and the European banking crisis, offset by much better than expected domestic earnings. 2010 was an exceptional year, with S&P earnings climbing 47% to \$83.74. For 2011 we had expected earnings of \$92, a more normal high single digit gain of 9%. While 4<sup>th</sup> quarter numbers won't be fully reported for several more weeks, the final 2011 EPS are likely to be close to \$99, a gain of 17-18% versus 2010. U.S. companies continue to keep expenses in check while driving margins higher on fairly modest revenue increases. Unfortunately for foreign investors, the European crisis affected markets negatively without the EPS tailwind felt in the U.S. Almost all non-North American markets were down 10-20%, and continue to be plagued by slowing or no growth outlooks.

The tremendous fundamental earnings performance of domestic companies has been overshadowed by poor politics and policies in Washington and Brussels. Worse yet, neither of these soap operas are likely to come to a conclusion anytime soon. The ECB (European Central Bank) has stubbornly drawn out the crisis, trying desperately to get individual countries and private institutions to pay more for the bailout of European banks, mostly in the peripheral countries. At home, the Washington gridlock will continue until the November 2012 elections, when hopefully some sort of resolution or compromise can set the country on a more stable and predictable course.

Meanwhile, bonds have enjoyed a very good year. Investor disillusionment with or even outright fear of equities and volatility has led to greater demand for fixed income securities and their more stable returns. The broad bond market indices produced total returns of 6-7%

for 2011, with longer-term higher quality bond indices gaining as much as 20%. After a phenomenal performance in 2010, lower quality bonds lagged their higher quality counterparts in 2011. Interest rates ended the year at near record lows over the last 50 years, with 10-year Treasuries below 2% and 30-year maturities below 3%. With the Fed openly stating that they want to keep rates low until at least mid-2013, investors will be hard pressed to find a reasonable yield from fixed income investments for a prolonged period of time.

### Domestic Economy

Last year reinforced our ongoing perspective regarding the U.S. economy. We projected that the recovery from the financially induced severe recession of 2008 – 2009 would be gradual, uneven and subpar when compared to previous recoveries. However, after sputtering along through the year, assaulted by two very disruptive external events, the Japanese earthquake and the European financial crisis, the economy closed out the year on a very strong note. GDP (Gross Domestic Product) growth for 2011 should approximate 2.0%, slightly better than what we had originally forecast. The U.S. economy continues to build momentum as we close out 2011 and enter the new year. Reasons for the economy to have reaccelerated are varied but notable.

First, and perhaps most importantly, unemployment claims have been steadily declining and the four week moving average has fallen to 375,000, the lowest number in three years. The unemployment rate has also fallen to 8.5% from a recession high of over 10%. The labor market is healing ever so slowly, which is essential for the recovery to continue. This will help keep consumer spending steady. Buoyed by the pick-up in job growth over the past few months, it is no surprise that various measures of consumer confidence have increased with the Conference Board's Consumer Confidence Index surging to 64.5 in December from 55.2 the prior month. While this measure is still well below peak levels, it is a good indicator that consumer spending will continue to help propel the economy forward in 2012.

Second, the factory sector has been enjoying some revival after slumping during the summer months. The ISM (Institute of Supply Management) index for factory activity in December rose to a better than expected 53.9 led by inventory rebuilding as vendors strove to meet incremental demand. Also, vehicle sales have bounced back to a 13.6 million annualized pace, the highest reading since the Cash for Clunkers program in the summer of 2009.

Last, the housing market has shown some incipient signs of life. Record low mortgage rates, increased credit availability and improving employment pictures are all helping to provide some lift to the long suffering area. Housing starts rose 9.3% to a 658,000 annual pace while pending home sales increased over 7% in November. Residential construction, a hallmark for previous recoveries, appears to finally be providing some modest incremental growth to the overall economy as we move into 2012.

Whether or not the domestic economy can sustain the 4<sup>th</sup> quarter momentum has a lot to do with what happens in Europe, which is likely falling into a recession, the degree of which has yet to be determined. Austerity measures are being implemented and, at the same time, treaties are being rewritten to allow for a more closely integrated fiscal policy with controls and sanctions over free spending, but heavily indebted, Eurozone members. This process will require months, not just weeks, to be put into place. Meanwhile, European output is falling and unemployment is rising with likely consequences for continued social unrest. Ultimately, the ECB will be forced to expand its balance sheet just as our Federal Reserve did during our recession, functioning as a lender of last resort. It is more a question of how much more the financial markets need to suffer and how close the entire Eurozone comes to breaking up before the ECB acts decisively to save the Euro. So we are expecting continued volatility in the 2012 financial markets and maintain a subdued forecast for the U.S. economy.

While much blame can be laid at the doorstep of Europe, there are other headwinds at work as we enter 2012 that will slow the momentum of the most recent quarter. There will undoubtedly be a fiscal drag on the economy this year from ongoing Congressional gridlock ahead of the presidential election in November. The last minute compromise to extend the payroll tax holiday and unemployment benefits illustrates just how acrimonious

the political process has become. Furthermore, this recovery, while resilient, remains vulnerable to any external shock, such as sharply rising commodity prices, especially oil, if tensions were to spill over in the Middle East. If our economy were growing at a healthier 4%, rather than stuck at approximately 2%, our ability to absorb any unforeseen external shocks would be much greater.

One ongoing positive impact from another year of subpar GDP growth is a very benign outlook for inflation. After surging to well over 3% last year, due to rising commodity prices and supply disruptions, the CPI (Consumer Price Index) is expected to decline to around 2% in 2012. This benign inflation outlook should allow the flexibility the Fed needs to keep rates low permitting key sectors of the economy to borrow and finance at historically low interest rates.

The U.S. economic recovery appears to be more and more self-sustaining due to slowly improving employment data, banks extending more credit and inventory rebuilding. As global growth slows, especially in emerging markets such as China and Brazil as well as developed countries such as Japan and Europe, the U.S. economy is looking relatively more stable, providing a refuge for skittish investors worldwide. Assuming that European policy makers will find a way to prevent the ongoing crisis from escalating into a global financial panic, prospects for the continuation of a moderate U.S. economic expansion remain bright. Sustained economic expansion throughout 2012 should considerably enhance the potential for the financial markets and especially for the stock market.

### **Fixed Income**

The last quarter of the year was virtually a repeat of the previous three quarters, with a high level of yield volatility created by the sovereign debt saga, a slowing in global economic growth and improving, albeit mixed, results on the domestic front. As measured by the 10-year Treasury issue, the yield ranged from 1.81% to 2.46%, closing the year at only 1.88%, or a 5bps (basis points) decrease from the 3<sup>rd</sup> quarter level. For the year, the yield for this benchmark Treasury was lower by 144bps.

As we move into 2012, the FOMC's (Federal Open Market Committee) monetary policy is still extremely accommodative, with fiscal policy in total gridlock as Congress and the administration posture for the general elections to be held later in the year. Unfortunately, the outlook remains clouded as growth prospects for the economy and employment are well below the norm at this stage of a recovery. The disturbing part of the current situation is that we aren't meaningfully closer to resolving any of the ongoing global and domestic issues. Given this market backdrop, it is no wonder that Treasury yields remain at historically low levels, while credit spreads are near their widest level of the past 12 months. As measured by the Barclays Credit Index the OAS (Option Adjusted Spread) closed the year at +217bps or 1bp higher than the previous quarter close. The 2011 OAS range was from a low of +127bps seen early in the year, to a high of +232bps.

As a result of the issues outlined above, bonds provided another solid year of performance. As measured by the Barclays Capital Government Intermediate Index, the total return for the quarter was 0.88%, and 5.80% for the year.

### **Looking Forward**

We continue to believe that this recovery will see below average growth in new jobs as an unintended consequence of an extremely accommodative monetary policy. However, this past quarter did bring a little more sunshine to the employment picture as the net jobs lost during the past 46 months have been reduced from over 7 million at the end of the previous quarter to now less than 6.2 million. Also encouraging is that the last eight weekly initial jobless claims reports have been under 400,000, the required level for economic growth to be sustainable. While these statistics cannot yet confirm we have turned the corner, it is a sign that things are slowly improving and less people are being laid-off.

Rising pressures on governments to establish austerity policies increase the likelihood of reduced near term GDP growth both domestically and globally. While weaker economic growth is largely already factored into present bond yields, if growth exceeds expectations, governments might respond by postponing the austerity measures. Also, central banks are likely to further ease monetary policy going forward. These actions have the potential to

add to the already elevated inflation measures and could place modest upward pressure on interest rate levels across the maturity spectrum during the upcoming year.

### **Taxable Strategy**

We believe that interest rate volatility will remain elevated with the market vacillating between the potential for sustained domestic recovery and the continuing European banking crisis. Therefore, we intend to use this volatility to opportunistically manage portfolio duration for our various fixed income styles. This will be accomplished primarily by adjusting the maturity of our Treasuries. However, absent any meaningful changes in the market environment, rates will likely remain near historically low levels.

We will maintain an overweight position in the corporate sector for a variety of reasons. First is a diminished primary supply of corporate debt. The decline in new issuance during 2011 was approximately 18% and is expected to drop another 6% in 2012. Second is the strong balance sheet position for most corporations, as there has been sufficient deleveraging to withstand further weak economic growth and potentially lower profit margins. Non-financial leverage peaked at around 5x, pre the 2008 crisis, and is now half that level at 2.5x. Finally, there is investor desire for more yield. In combination, these three themes should place a near-term cap on corporate yields. If the European Union membership can reach even a short-term resolution to their debt problems, corporate bonds should enjoy a material rally.

In addition, we think that corporate yield spreads have already priced in a modest recession. With the financial crisis of 2008 still fresh in everyone's mind, yield spread widening in 2011 has been swift. However, we feel there has been an overreaction for selective credits. In general, shorter maturity corporate securities with solid fundamentals offer very attractive yields over Treasury securities, and we look to add to our holdings. Unfortunately, the level of yield spread compression will probably be limited given the risk premium offset required to compensate for the increasing level of stock buybacks and rising M&A (Merger and Acquisition) activity. These almost invariably hurt corporate balance sheets. While the timeline for our forecasted credit spread tightening may extend beyond the next quarter, we feel

investors are being well-compensated to hold their positions through the potential turbulence.

While we have scaled back our TIPS (Treasury Inflation Protected Securities) exposure, we will maintain a modestly overweight posture since the statistics driving the CPI headline rate should remain at a fairly elevated level. On the other hand, we are maintaining an underweight exposure to government agencies given the narrow yield spreads available coupled with the associated headline risk. Finally, we will stay neutral on Treasury securities from a contribution to duration basis. They will be held for liquidity purposes and as a hedge against future uncertainty from global events.

### **Municipal Summary**

Last year at this time, a certain market pundit predicted hundreds of billions in forthcoming municipal defaults in a total market of over \$3.7 trillion. Coupled with a rising expectation for economic growth and an increase in supply from the expiration of the BABs program, these comments led to yields ratcheting significantly higher at the end of 2010. However, the Armageddon did not occur and in reality there were only approximately \$2.1 billion in defaults for 2011, which was actually down from \$2.8 billion in 2010. As a result, municipal securities managed to reward investors with strong positive returns in 2011 despite the negative headlines. As measured by the broad based and longer maturity focused Barclays Capital Municipal Index, the total return was double-digits at 10.70%. At the shorter end of the maturity spectrum, returns were still very favorable at 3.46% for the Barclays Capital Municipal 3-Year Index.

In hindsight, we would suggest that this so-called market maven picked the wrong "D" word; opting for "default" instead of the reality of rating "downgrades." State and local governments continue to struggle with budget issues, unfunded pension and OPEB (Other Post-Employment Benefits) liabilities and tepid, albeit improving, revenue figures. While this has contributed to more downgrades than upgrades this past year, it has not led to a market meltdown. More importantly, there are some positive fiscal events occurring at the state and local levels reinforcing the positive returns already achieved.

Municipal entities have been proactive in dealing with their budgetary problems by introducing austerity measures, renegotiating excess benefit packages with public employee unions and raising taxes and fees where possible. Many have curbed their borrowing plans in order to prevent the acceleration of the percentage requirement of annual debt service on their respective budgets. This latter fact led to a rather light year in overall primary supply, a positive for performance. For 2011, tax exempt new issue supply was only \$295 billion, down almost 32% from the \$431 billion of primary municipal issuance in 2010. However, tax-exempt supply was only down 5% after adjusting for the taxable BABs financing from last year. We expect new issuance to increase to the range of \$325-\$350 billion in 2012, led by the potential for more refundings given the lower interest rate environment. Furthermore, light primary supply is expected in the beginning of the year. This fact should bode well for a modest positive January effect, looking for reinvestment of the normal heavy cash flow from coupon interest and maturities.

Earlier this year, there was a proposal from the Administration to cap the tax-exempt benefit of municipals at 28%. The result would be that the ratio between tax-exempt munis and taxable Treasuries would remain elevated and well above historic norms. No matter how high the marginal tax bracket, the ratio would be floored at the 72% breakeven level. At the present time these ratios remain elevated and attractive, with a range from a low of 96.5% at 7-years to a high of 165.6% at 3-years. The 30-year ratio is 131.1%. Of course, the inaction by the Congressional super-committee places this proposed cap on the backburner for now. But we expect some type of similar legislation to be introduced in Congress in the near future.

Unfortunately the Congressional budget inaction means that state and local entities will be subject to automatic cuts in aid triggered in January 2013. There is little time for state and local entities to address this potential for reduced levels of aid for mandated programs. Although we believe there will be challenges, the potential budget impact most likely will be offset through further austerity measures.

Another factor to consider for reducing the volatility and limiting the upside on interest rates for tax-exempt municipal securities will be the sunset provision on the Bush-era tax cuts that were extended. These cuts, which affected the level of the various federal marginal tax brackets, are presently set to expire at the end of 2012. If they are allowed to expire, there will be an increase in the top federal marginal tax bracket from 35% to 39.6%. This possible change in tax rates will start to be priced into the market around mid-year, bringing lower relative yields and ratios.

### Municipal Strategy

As we enter the new year, municipal yields still offer good relative value across the maturity spectrum. With tax-exempt / taxable ratios almost all well-above 100%, this has led both traditional and crossover buyers to participate thereby buoying the municipal marketplace. We expect ratios to remain elevated during the year but trending down towards 100%. Money flow into municipal bond funds has turned positive, which also bodes well for the market going forward.

Headline risk will continue to be a factor, although we believe its effect will be muted. Municipal investors are accepting the reality that unlike corporations, the state and local governments are not going to implode or choose the bankruptcy route to solve their many problems.

However, due diligence and attention to the details is still of utmost importance in this event-laden environment. Our emphasis remains on essential service revenue issues, both state and local GOs (General Obligations) with good underlying demographics, and well-documented pre-refunded bonds. The yield curve remains somewhat steep and we feel the 7 to 12-year area is relatively attractive at this time. We will be targeting this area for extension swaps and in structuring new client portfolios. Our duration target remains the same at around 4 years for the intermediate product. Once we experience some increase in the visible supply, it is likely to increase pressure on yields to rise moderately. This should provide us with more opportunities to pick up income for our clients by selectively extending out the curve, while maintaining a conservative duration posture.

### Equity Outlook and Strategy

The recent impressive performance of the U.S. economy has led us to raise our 2012 forecast a bit. We still see headwinds to growth, but feel that recent data confirm that the economy is healing and is a little ahead of our prior conservative forecast. We do not see strong growth in any particular area, with the possible exception of energy, where oil prices continue to rise, and which should fuel double-digit EPS increases for the sector throughout 2012. On the other hand, several sectors continue to lag. Utility, housing and consumer discretionary companies all should struggle to find any growth. Utilities in particular stand out because they are selling at lofty P/Es due to their higher yields. But this is probably the whole story. With new construction of houses or industrial plants at very low levels these companies have almost no new customers. They continue to lose customer volumes to energy efficiency (try buying a conventional incandescent 100-watt light bulb), conservation and alternative sources such as solar panels. So the yield of 3-5% may be the entire return, and it could be less if the high current relative valuation does not hold.

Our dividend thesis is playing out very successfully. Once the Fed made it known that they expected to keep rates low until mid-2013, the search for yield has been on. Investors had been waiting for interest rates to go back up. Now they know that to improve their cash flow they must move out of their bank CDs yielding 1%. Conservative higher yielding stocks have benefitted enormously in the last six months, with utilities, a traditional place to find yield, being a prime example. But now their valuations are stretched. So we have shied away from this sector and looked for yield in consumer staples, technology and healthcare companies. These areas offer dividends of 3-4%, almost as high as utilities, but also offer some growth and in most cases are selling at lower P/Es.

In the kind of dramatic market rebound we had during the fourth quarter of 2011, dividend oriented stocks would normally be expected to lag materially, as they are conservative, better capitalized, slower growth and lower beta. This time they moved up right in line with the market. In a more moderate market rise such as we expect in 2012, we think these stocks can still outperform, providing both capital appreciation and substantial spendable current income. So we remain heavily committed to this area.

On the other hand, we had been favorably disposed to foreign earnings, expecting the U.S. dollar to decline. We have softened this stance, and now expect the dollar to rise over the short term. The Euro cannot help but decline until a solution is found for the undercapitalization of their banks. We will continue to orient our foreign exposure to the Far East and BRIC (Brazil, Russia, India and China) countries where growth may be slow or slowing, but which is better than the recession we expect will grip Europe in 2012.

While the Christmas season got off to a strong start right after Thanksgiving, sales subsequently slowed considerably and even a last minute surge did not bring joy to many retail stocks. Consumers continue to retrench. They will spend when things go on sale, but retailers will face a difficult trade-off of volume versus margin in 2012. We have reduced our holdings in this area and now have just one or two positions, somewhat less than our benchmark in all our strategies.

The financial sector has continued to underperform, but not badly. Even the unexpected bankruptcy of MF Global, a large derivatives broker, did not cause a significant decline. U.S. banks now have more than enough capital to withstand further large losses. But looking forward, we see very modest growth coupled with low returns on equity stemming from a much larger regulatory burden. So unless the P/E is quite low or the dividends are increased materially, we do not expect to increase our holdings.

The fourth quarter rally spurred us to make some shifts towards stocks that are more market and economically sensitive. Any pickup in growth, even just the modest revision from 1.5% to 2.0% that we have made, can have a substantial impact on stock prices that are cyclically depressed such as they were last summer. Now with continued earnings growth, the market is selling at a P/E of only 12.5x. This is well below the long-term average of around 15x, and seems even more of an opportunity when compared to fixed income investments that are yielding an historically low 2-3%. So in balanced accounts we have shifted the mix to emphasize equities. We expect that 2012 will be a year of slow improvement, but with continuing volatility until Europe can get clear of its current malaise.

### Conclusion

Despite the volatility of 2011, we see things pretty much “steady as she goes.” The ship is making progress; and while we might like to be going faster, headwinds have forced us to make some adjustments. We look for a smaller economic contribution from exports, especially from Europe, being more than offset by a domestic consumer who is slowly coming out of the bunker from 2008-2010. With low inflation and rising EPS, equities look particularly attractive. Bonds are likely to only earn their coupon in 2012 and may be under pressure once the recovery gathers a little momentum.

The U.S. will have major decisions to make in 2012. The current legislative paralysis in Washington will hopefully be resolved in the November elections. Almost any outcome would be better than the current situation where businesses have no idea what tax and regulatory policies to expect over the next 4-5 years. This makes it impossible to effectively plan any expansion or significant commitment of capital. Consumers will continue to retrench, but in a more balanced way, with moderate spending yet continuing to build savings. Fears of a double dip recession are all but gone, layoffs have slowed substantially and housing prices are bottoming. Barring a dramatic event such as a Mideast implosion, which unfortunately is possible, we expect the U.S. to make substantial progress on its deficits and for the economy to improve slowly but surely. For global markets that had a poor year in 2011, the steadying influence of the U.S. should provide good support for better markets in 2012 and beyond.

We believe that although growth will be slow, U.S. stock prices in 2012 should at least be able to track mid to high single digit earnings growth plus an attractive dividend. Combined with the possibility for some very modest P/E expansion, equities should provide a 10 – 12% total return for the year. The ride will continue to be turbulent but should be a little smoother than the last several years as the storm clouds continue to clear.