

As we look back at 2011 and forward into 2012, the most certain observation one might be able to make is the folly of writing definitive prediction essays in January. Few pundits would enjoy a review of their 2011 piece, and yet that is less a reflection on the authors than it is a statement about the volatility and uncertainty of this unique recovery from a deep financial crisis.

Our 2011 was marked by positive results for our emphasis on income yield via dividend paying stocks, master limited partnerships (MLPs), mortgage backed securities, and preferred REIT stocks. Our general defensive mindset helped cushion the blow of the sell-off in international equities, but that exposure still was not helpful when taking a short-term view. On the fixed income side, our recommended managers were a positive contributor to many client portfolios, but the unforeseen dip in Treasury yields led to underperformance relative to benchmarks. The overall flat performance for the S&P 500 hid a very volatile year month to month, and some of our hedge fund managers did not manage that volatility as well as we would like in a period of high correlations between stock prices.

Moving forward into 2012, our first action will be to reduce our exposure to some of the hedge fund managers that we feel have not been handling the monthly volatility and high stock correlations well. We will increase our exposure mostly to dividend paying stocks as a different form of defensive positioning for what we expect to continue to be a slow rising but highly volatile equity market. As we continue to slowly emerge from our massive deleveraging crash we feel it is better to seek yield than growth right now as the markets trade back and forth on macro trends.

Despite the continued risk of crisis in Europe, our relatively defensive equity position overall and defensive European exposure specifically lead us to not reducing that exposure now at the low valuations. As long term investors, we would prefer to ride out the ugliness and benefit from the eventual solutions.

This is a tough market for investors on a risk adjusted basis – ten year Treasury yields are under 2%, thirty year Treasury yields are under 3%, high quality corpo-

rate bonds pay under 4%, and we believe the stock markets might only return 5%-8% annually for the next five years. The low interest rate situation is implicitly encouraging investors to be a gambler and seek higher returns in risk assets (and maybe use a little leverage to gamble even more), but the moment macro shocks like the Euro crisis grab the headlines those same investors are moving their gambling chips back to Treasuries, leading to the volatility and schizophrenic returns seen recently.

We continue to emphasize using alternative yield sources to help overall portfolio returns while the markets bounce up and down. As we begin 2012, here are the top issues we are monitoring that could affect our investment outlook and strategies.

**Employment** – Do not let the recent drop in the unemployment rate fool you, even though it is a good sign to see private sector job growth of any kind. The low participation rate is helping the most visible indicator come down, but the underlying long duration of unemployment and higher underemployment rate are trends we would like to see continue to improve as a stronger signal of a jobs turnaround. That being said, the numbers of the past few months have been more encouraging as the underpinning for continued slow economic growth in 2012.

**Housing** – We have emphasized that when single family housing starts to turn around the impact on our economy will be hugely positive. Unfortunately we do not predict this to change dramatically in 2012, but we do hope to see housing prices start to flatten (instead of dropping further) and mortgage delinquencies continue to decline as signals of an eventual turnaround.

**Consumer Spending vs. Income and Savings Rates** – Savings rates dropped towards the end of 2011 as consumers kept spending despite a continued lack of real disposable income growth excluding government transfer payments such as unemployment benefits. As the programs supporting some of the transfer payments start to slow, will consumers keep the spending going and reducing their savings, or will there be a backlash in the other direction that dampens spending?

**Fiscal Stimulus** – Linked to the above comments, all other things being equal and putting politics aside it would be helpful to see continued fiscal stimulus in the short term to help the economy. The current political climate does not support overt stimulus programs getting approval, but the key issue to watch here is whether Congress approves the extension of the payroll tax cut for the rest of 2012. Failure to pass that extension could be viewed as a negative for sustaining economic growth (whether true in reality or not).

**Corporate Earnings** – Most analysts are still predicting solid growth in earnings this year, and as a result are often more bullish than we are with respect to the S&P 500 index forecast for 2012. We are pleased that corporations appear to continue finding productivity improvements, reductions in financing costs, and other sources of earnings growth in this challenging environment. However, any blip here could change the view of the valuations underlying current pricing and potentially push stocks down for a while until a new balance was perceived to be in place.

**Europe** – Stocks in Europe appear to have already priced in a recession and a little crisis on top of that, but we still have to watch out for a larger crisis that could occur. One key area to monitor will be the roll-over refinancing of government debt by Italy and Spain. Our long term perspective on the Euro common currency is not strong, but that does not mean that the resolution of the situation has to involve a drastic financial crisis. We may see Greece exit from the currency this year, and oddly the chance for that to happen may help strengthen the Euro which then actually hurts remaining countries who might be on the edge and really prefer to see a weaker Euro in the short term. Regardless, we do believe U.S. corporate and bank balance sheets are better prepared to weather another credit crisis relative to 2008 if it does occur.

**China** – The key question for China is whether it can manage a soft landing or if in fact the softness of the landing for their economy turns out to be an illusion. Monitoring Chinese economic conditions is tricky given the questionable data accuracy that can exist, but we will continue to look to other resources to ex-

amine the indicators of the situation in China. A sharp drop in China's economy would have ripple effects on the global economy overall and the commodity markets in particular.

**U.S. Presidential Election Politics** – The results matter most, but the discussion and debate leading up to the election this fall could be just as important. You know our perspective on the U.S. government's need for deleveraging and fiscal balance – whoever wins will face some critical decisions and it will be interesting to see how these issues play out during the general election debates and campaigns. Important decisions regarding tax policy will be coming up late this year, with many issues related to estate and income and payroll taxes all at stake that affect the lives of our clients. We will continue to monitor these developments not only for their impact on investments but also for their impact on our clients in general.

**Iran and other Middle-Eastern Surprises** – We saw this past year that the Middle East region continues to be predictable almost only for its unpredictability and the recent saber ratting by Iran could lead to a surprise in 2012 that could send oil prices skyward and have other positive or negative implications for the financial markets. If we experience a major macro shock then all asset classes could briefly move down together again (maybe except for Treasuries) – but it is important to realize that this would not necessarily imply permanent impairment of value and could even create a brief buying opportunity depending on the situation.

Focusing on the issues to watch does not mean that all of these issues will turn out to have negative implications. Many of these could turn out to be positive trends that help improve the outlook for the U.S. and global economy and markets. As we monitor these and other key issues during 2012, we will evaluate our investment approach and communicate with you regarding potential changes. We know the challenging environment can sometimes create uncertainty, and as always we encourage you to reach out to your team with questions.