

December 2011

YEAR END REVIEW AND OUTLOOK

For most investors, closing the books on 2011 will be a welcome relief. In a year marked by a calamitous Japanese earthquake and tsunami, numerous uprisings in the Middle East, China growth concerns, U.S. fiscal battles and a credit rating downgrade, and a series of European debt crises, it is not surprising that world security markets experienced unprecedented periods of volatility and directional changes in prices.

While the economic impacts of the foregoing events have been either transitory or uneven amongst countries, the net effects have been a prevailing sense of unease and a broadly-based reduction in confidence – not the strongest foundation for the year ahead. We are entering 2012 with potential downside risks in the forms of a likely recession in Europe accompanied by possible sovereign defaults, continued political gridlock in the U.S., and slowing or disparate growth in the emerging economies.

In assessing the risks, we fully acknowledge the seeming intractability of the European debt dilemma and the U.S. political morass. Nevertheless, we think it is important to note the steps taken by the European Central Bank to meaningfully enhance liquidity availability for European banks and to recognize the common grounds of policy agreement and necessity between the two U.S. political parties.

While it has been easy for many to be critical of the progress in addressing, much less resolving, the European situation, it was never likely to be a one-step solution; but, rather a sequence of events involving governments, bankers, and regulators. At the risk of appearing as a Pollyanna, it is reasonable to assume that recent moves by the ECB, agreement among the Eurozone members that fiscal unity is necessary and achievable, and policies undertaken by new leaders in Italy and Spain may have established a road map to stabilization in debt markets. But time, consistency of action, and patience will be required.

For the U.S., it is unlikely that there will be a substantive resolution of the underlying philosophical differences as to the political priorities; and, the failure of the congressional “Super Committee” to deliver a plan of deficit reduction was a disappointment, but not a total surprise. Despite this polarization, congressional leaders and a growing majority of members are feeling the urgency of dealing with the structural aspects of our budget deficit and national debt. While the pressures of an election year may provide complications, they also instill incentives for responsible and timely actions to ensure re-election.

China is the largest factor and the key variable in the developing economy sector, and its stringent monetary policies during the past two years have had a restraining impact on certain parts of its economy and have dampened trade volumes with a number of other emerging nations which had earlier imposed their own tighter monetary conditions. Conditions are now changing and we are seeing moves to ease monetary policies and regulations in a number of key countries such as China, India, Brazil, and Australia. These steps, with others likely to follow, should aid in spurring or supporting growth in the emerging economies in the next year as inflation pressures recede.

Lest we become overly fixated on the risks and uncertainties, we should identify and examine some important positive factors and areas of fundamental strength. The good news encompasses the recently improving trends in U.S. economic data, the strength of corporate balance sheets and liquidity, the recovery in the financial health of the U.S. banking industry, the resilience in corporate earnings, cash flow, and dividends, and the demonstrated ability of various central banks to coordinate policies to prevent systemic financial disruptions.

The U.S. economic outlook has brightened since late summer. Employment conditions have improved moderately, consumer spending has rebounded, small business confidence measures related to hiring, capital expansion, and credit availability have registered upticks, industrial output remains healthy, and exports have grown. Importantly, support for this encouraging data comes from the combined strengths now present in the corporate and banking sectors and which should be key bulwarks in the year ahead for keeping our economy moving forward on a self-sustaining basis as pent-up demand for inventories, business investment, and consumption is facilitated. While the recent sharp gains in corporate earnings will likely moderate or even flatten for a period, we believe the incentive and capability to increase dividends, buy back stock, and make strategic acquisitions will continue.

Since it is generally agreed that the biggest threat to global economic expansion and world credit and securities markets is an implosion of the European banking sector with widespread financial impact, the coordinated action by our Federal Reserve and five other key central banks in late November to enable greater access to U.S. dollar funds for European banks is instructive and reassuring. More such actions may be required in the next year, and such decisive multilateral moves indicate confirmed commitment by powerful entities.

While it is apparent that we are acutely aware of the increased risks to economic growth globally and the serious uncertainties attendant to the persistent issues of the European financial and sovereign sectors, we have concluded that the proper strategy is to maintain our basic portfolio structures, but with a somewhat larger cash component. The long-term conviction in the prospects for our holdings remains firm bolstered by the ongoing positive comments, with few exceptions, from the managements of our major holdings regarding their operating conditions and outlooks.

We do, however, recognize the inherent cyclicity of many of these sectors, and the sensitivity of their earnings progress to macroeconomic forces cannot be ignored. The likelihood of a moderate decline in European economic activity coupled with continued muted growth in the U.S. argues for a somewhat more defensive posture over the next few quarters until there is greater clarity on the direction of fiscal policies in the U.S. and Europe and the effectiveness of monetary policies in the U.S., Europe, and China. During this period, we will closely monitor individual firm's balance sheet segments, revenue and operating profit margin trends, and actions to support or enhance competitive advantages in order to ensure that our portfolios are comprised of the financially strongest entities with the soundest prospects and to identify reinvestment opportunities.

We continue to feel that equities are at attractive valuation levels based on earnings and discounted cash flow projections, particularly in the areas of capital equipment, technology, strong global consumer franchises, and specialty health care companies. In addition, our interest and conviction in the attractive potential in global emerging nations continues. The progress that has been made in these areas regarding their financial stability, global competitiveness, and infrastructure priorities is undiminished. Our preferred way of tapping this potential at this point is through U.S.-based multinational corporations.

Our views of the fixed-income sectors have changed very little. U.S. Treasury issues have a "desired nation" status in today's strained world credit markets, but do not offer market yield returns in excess of current and expected inflation rates. U.S. corporate and agency issues have held up relatively well during recent turbulent periods. Growing demand for these issues have pushed down current yields, so that attractive returns are only available on longer dated maturities. The tax exempt sector has experienced a decline in new issuance during a time of uncertainty around possible changes in tax rates and a cap on tax exemption. We would continue to favor issues of shorter maturity that have specific dedicated tax revenue linkages. Overall, we expect a continued investor desire for the perceived relative safety of fixed-income securities. But, if confidence and clarity increase regarding the discussed uncertainties, a major shift to equities could ensue.