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2012 Outlook

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Highlights:

Months of slippage in fundamental data have left investors concerned about the outlook. Although Europe's troubles grabbed the headlines, the process of household balance sheet repair continued in 2011 and remains the single most important thematic as we head into the new year.

- ✓ *Balance Sheet Repair Advanced in 2011:* Reduced debts and rising income puts household balance sheets in a better position. Despite the slow economy, debts are on the decline as income continues to rise.
- ✓ *Higher Savings Rates Provide Cushion / Catalyst:* Today's higher savings rate may mean less spending now but a larger pool of investment capital to drive growth down the line.
- ✓ *Fundamental Conditions Set to Improve:* We now anticipate an improvement in fundamental conditions in the first half of 2012 and expect the U.S. to avert double-dip recession.

Asset Allocation Summary

Asset Class	Current Outlook	Tactical Posture
Allocation	Fundamentals not yet turned positive, but should soon	Bonds over Stocks
Equities		
Global	Foreign fundamentals / manufacturing still weak	U.S. over Foreign
Stage of Development	Weak commodity markets / stronger dollar favor developed	Developed over Emerging
Market cap	Better performance recently, but weak fundamentals create risk	Large over Small
Style	Focus on balance sheet quality until fundamentals improve	Growth over Value
Fixed Income		
Quality	Spreads somewhat better, but continue to focus on quality	High Grade over High Yield
Region	No QEIII and stronger dollar favors United States	Domestic vs. Foreign
Duration	Rally in long-end of curve leaves real long-term yields less attractive	
Commodities & Other		
Commodities	Stronger dollar keeps lid on commodities, for now	Neutral
REITS	Decent yield spread over Treasuries	Neutral

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We believe the central economic issue remains the fact that the world's supply of money and credit has been growing slowly and contributing to a recovery that is sub-par. This is, however, a cyclical process rather than a structural one, as the process of balance sheet repair eventually runs its course. In the meantime, lower returns, slow growth, and lower levels of inflation are to be expected.

Economists Have Seen This Before

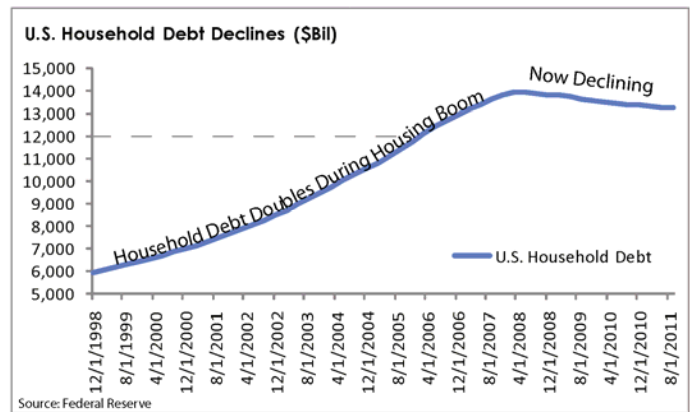
Nobel prize-winning economist Milton Friedman, along with co-author Anna Jacobsen Schwartz, detailed the historic relationship between changes in money supply and economic growth in their 1960s study, "A Monetary History of the United States." In tracing the history of money, banking, and economic cycles over the preceding hundred years in the United States, Friedman and Schwartz found a well-established relationship between changes in the quantity of money and the business cycle. They also found that it was changes in the money supply that drove economic cycles and not the other way around. Importantly, they insisted that an unstable supply of money will produce the kind of financial and economic instability we see today.

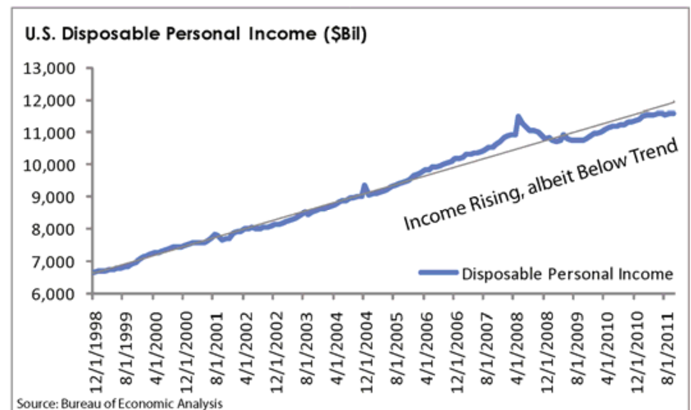
A scarcity of bank credit and an excess of debts are nothing new, and are one of the recurring themes running throughout the financial crisis that began in 2007. The inability and/or unwillingness of private individuals and lenders to engage in additional borrowing and lending following a boom period have many precedents in history. This lack of new borrowing has the side-effect of restricting the flow of new credit into the financial system and produces slow growth in output, high unemployment, and price weakness — all common symptoms of monetary instability as chronicled by Friedman and Schwartz.

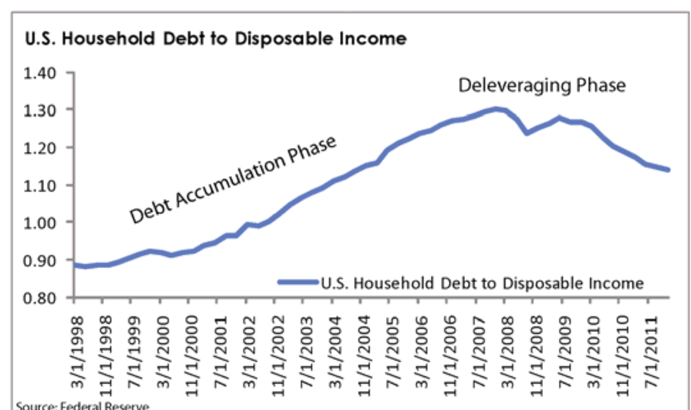
The taproot issue is the lack of new borrowing, and hence money and credit, into the financial system. So what is happening with borrowing? Recent data from the Federal Reserve clearly reveal the size of the collapse in net new borrowing. The report shows that households continue to pay down debt and that overall U.S. borrowing increased by just 1.6% from a year ago. The average growth in net borrowing over the past 30 years had been closer to 8.5% per year. Today's sharp falloff in credit growth, therefore, marks a major departure from past patterns as the result of a private sector initiative to repair balance sheets. The impact of this on the economy surely would have been predictable by Friedman and Schwartz. Fortunately, they saw other factors driving the potential for long-term growth.

Balance Sheet Repair Well Underway in the United States

Since the start of the financial crisis in 2007, U.S. households have been repairing their financial position. They have been saving more, spending less, and paying down debt. Debt held by U.S. households was cut by $700 billion to $13.2 trillion today from $13.9 trillion in 2007 (first chart below). Over the same period, household income rose gradually by about $500 billion to $11.6 trillion from $11.1 trillion (second chart below). Lower household debt plus higher income combine to lower household balance sheet leverage (bottom chart below). That ratio has fallen sharply from 2007 and demonstrates that household deleveraging has advanced significantly in recent years, leaving the average household balance sheet in a better position looking forward.

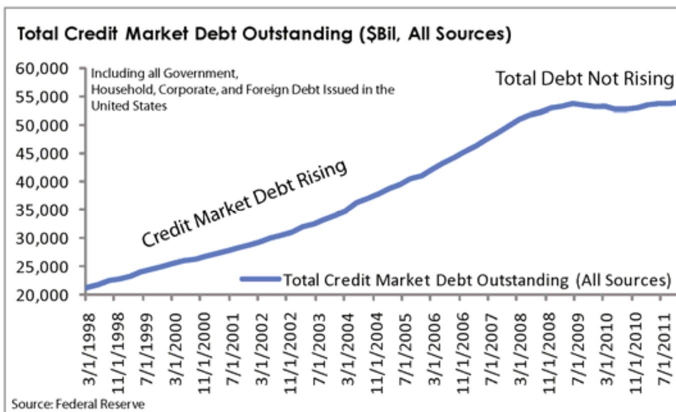






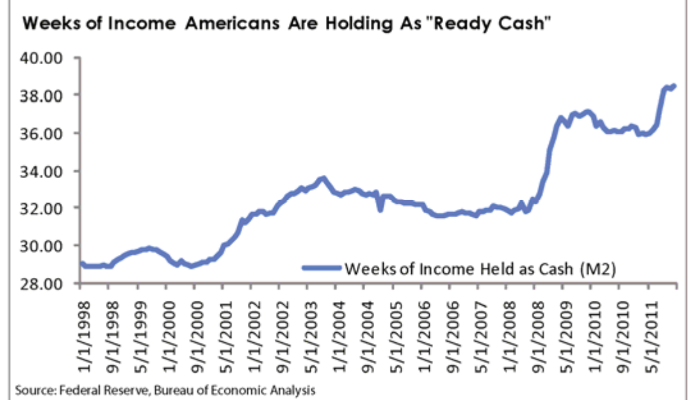
Government Debt Expands as Private Debt Contracts

Partly to help accommodate private sector shrinkage, government debt has surged since 2007. Deficits amounting to over $4 trillion in the last three fiscal years have meant a significant leap in Federal Government debt. Adding the increase in government debt to the contracting stock of private debt caused the total amount of credit market debt to remain largely consistent since 2007 (chart below). The Federal Government has doubled indebtedness to over $10 trillion from $5 trillion in 2007, thus negating the private sector's debt shrinkage. This was justified from a macro-economic perspective as the deficits, and related borrowing, thwarted a feared drop in both money supply and the rate at which money circulated within the economy. It did not, however, produce a vibrant recovery, a surge in inflation and interest rates, or a collapse in the dollar, despite many a pundit's protests and remonstrations.



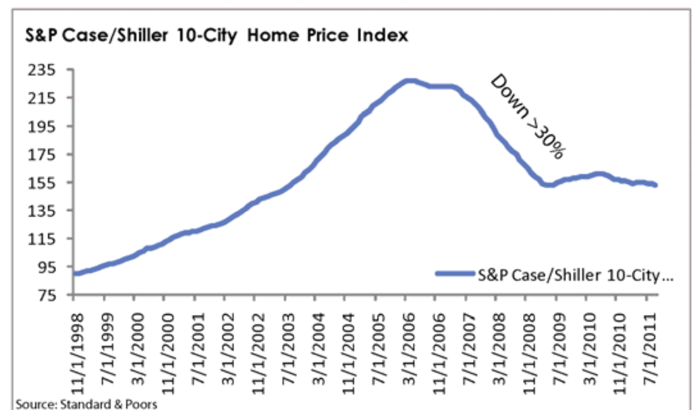
The fact remains that Americans' (and Europe's too, but that is another commentary) savings habits have become more conservative. Today, Americans are saving more of their income than in the 2000-2005 debt-accumulation phase. The savings rate has climbed to about 4-6% of disposable income (or $400-600 billion) from 1% in 2007, despite a challenging economy. This savings means less spending now, but eventually becomes a pool of investable funds available for funding future investment.

Households are also choosing to hold a greater percentage of income as "ready cash." In the more heady 1990s, it was common for the average American to hold 28 weeks of income as "ready cash" (chart top of next column). That ratio has increased by nearly 40% to 38.5 weeks of income. This reflects near-term uncertainty, but can also be seen as a potential future source of funds to fuel demand should the economy, and the state of confidence, unexpectedly improve.

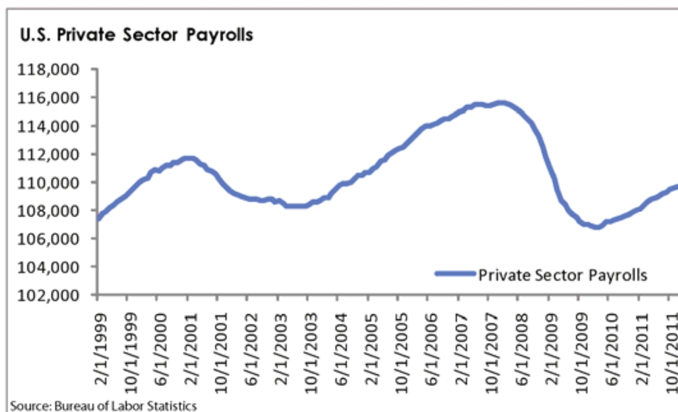


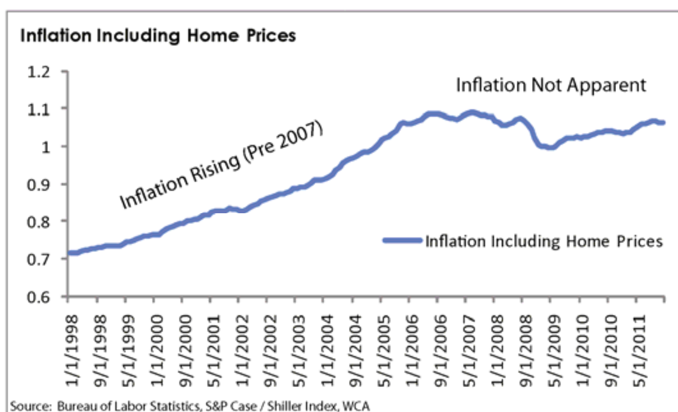
Lower Inflationary Pressure Restoring Purchasing Power

A dollar goes further today than it did a couple of years back if you are looking to buy a house (chart below). A dollar buys the same amount of gasoline now as it did before the financial crisis (current national average gallon of regular is $3.21 — the same price as the average price in the 12 months prior to the start of the financial crisis). Thus, a silver lining in the deleveraging process is a tendency toward softer prices, which can make things we buy more affordable, so long as incomes remain reasonably steady.



On that front, income in the United States continues to rise slowly, along with employment. Since 2009, 2.9 million private sector jobs were added (first chart below). An additional $500 billion of annual income has been added above the 2007 level. Income is about 4% higher than a year ago, while the official inflation rate is running near 2%. If we take the liberty of including changes in home prices as part of the official inflation rate using a similar methodology as was in place before 1983, the "adjusted aggregate price level" today would be flat versus 2007 (second chart below).





Where Do We Go From Here?

The economy is performing in a sub-par way as the result of a slowdown in credit and money growth tied to a material falloff in net new borrowing. However, we believe that the ingredients for long-term growth and prosperity remain intact. Intellectual and creative capacity the world over has never been as accessible and abundant as it is today. Technology is accelerating the spread of industry and ingenuity around the globe. Human capital and other resources are available as never before, and productivity is growing. Most of the world is at peace and well-organized under a set of laws that allows for continued mutually beneficial trade and commerce. This is what matters most for driving long-run growth and prosperity.

We are hopeful, therefore, that 2012 can be another constructive year despite obvious challenges. We are equally aware that potential pitfalls exist, and that is the reason we maintain a disciplined investment process. Milton Friedman and Anna Schwartz continue to remind us that financial history is always evolving.

Recent episodes in history are only a part of this evolutionary process, and have the potential to create opportunities for patient and disciplined investors along the way.

Index Definitions

Barclays U.S. Government Inflation-Linked Bond Index measures the performance of the U.S. Treasury Inflation-Protected Securities ("TIPS") market. Used as a proxy for "inflation-protected bonds."

Bloomberg/EFFAS Bond Indices U.S. Government 1-3 Year Total Return Index is a transparent benchmark for government bond markets. Indices are grouped by country and maturity sectors. Bloomberg computes daily returns and index characteristics for each sector. Used as a proxy for "short-term Treasuries."

Bloomberg/EFFAS Bond U.S. Government 10+Year Total Return Index is a transparent benchmark for the total return of the 10+ year U.S. Government bond market. Used as a proxy for "long-term Treasuries."

FINRA-Bloomberg Active Investment Grade U.S. Corporate Bond Index and FINRA-Bloomberg Active High Yield U.S. Corporate Bond Index are comprised of the most frequently traded investment-grade and high yield U.S. corporate fixed coupon bonds represented by the Financial Industry Regulatory Authority (FINRA) transaction reporting facility. Used as proxy for "high-yield bonds."

FTSE NAREIT Equity REIT Total Return Index is a total return performance index of all equity REITs tracked by NARIET. Used as a proxy for REITs.

MSCI EAFE International Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets excluding the U.S. and Canada. As of June 2007, the MSCI EAFE Index consisted of 21 developed market country indices. Used as a proxy for "developed foreign."

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. Used as a proxy for "emerging markets."

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 index. The Russell 3000 Index measures the performance of the 3,000 largest US Companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Used as proxy for domestic "large cap stocks."

Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 index. Used as proxy for "small cap domestic stocks."

Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Used as proxy for "domestic growth stocks."

Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios. Used as proxy for "domestic value stocks."

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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. High-yield bonds have greater credit risk than higher quality bonds. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.