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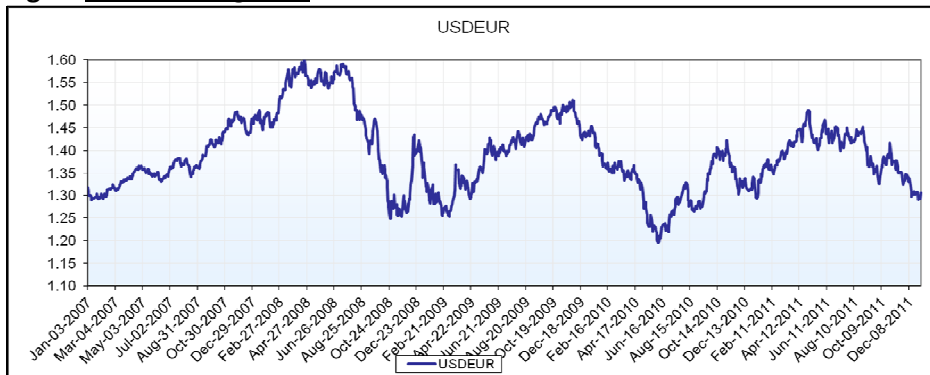
Advocacy Investing®

KEEPING OUR FINGERS CROSSED

- The US economy ends the year in healthier shape
- With a good payrolls report in December, the economy created 1.6 million jobs in 2011
- The euro slumps in response to the bleak eurozone conditions
- Geopolitical factors push oil prices over \$100/barrel
- US economic growth in 2012 expected at an anemic 2-2.5%
- No gain for the S&P500 over the past year in choppy markets

The US economy ended the year on a relatively stronger note, having clocked three consecutive months of positive economic news. It has also shown exceptional resilience, having weathered three major shocks: the Japanese tsunami in March, the near-default of government debt in August and the ongoing eurozone financial crisis. Nevertheless, economic growth remains weak, as indicated by the second downward revision of 3Q11 GDP growth from the original estimate (annualized) of 2.5% to 1.8%. Moreover, while the economy has shown resiliency in the face of external shocks and internal policy-making gridlock, it continues to face the same set of threats—the eurozone financial crisis, a slowdown of the Chinese economy and the likelihood of a fiscal drag in 2012. In addition, the United States (and the world) now both face a potential spike in oil prices driven by heightened geopolitical risks.

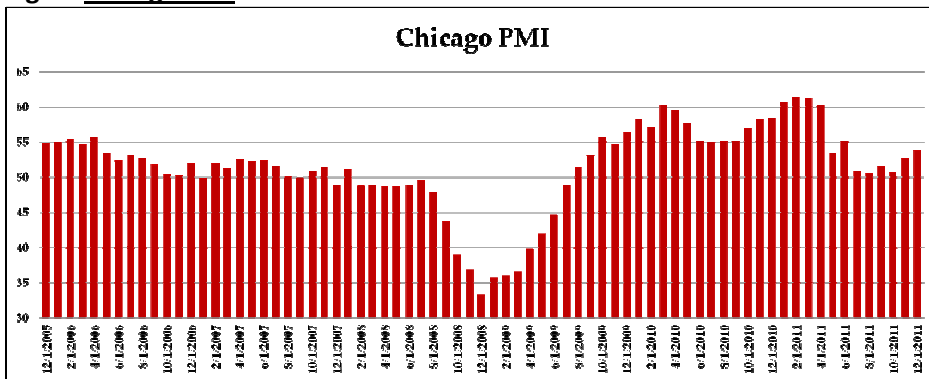
Fig.1: A Weakening Euro



Unhappy Birthday: The euro marked its 10th anniversary on January 1st, but there was little to celebrate. The euro hit a 16-month low against the US dollar (dropping below \$1.28/€) and an all-time low of ¥100 against the yen at the end of 2011. The December 9th eurozone summit (the fifteenth such event since the beginning of the Greek crisis in April 2010) did not resolve the immediate problems facing the single currency zone, but actions by the European Central Bank (which offered essentially unlimited long-term liquidity to the beleaguered European banking system) provided some immediate relief. This has caused the ECB's balance sheet to soar to €2.73 trillion by 12/23/11, a jump of €214 billion in one week. In addition, partially successful Spanish and Italian debt auctions also quieted the debt markets. Yet, the European sovereign debt problems are likely to return center-stage in January. If anything, the eurozone sovereign debt crisis has underscored two important lessons. First, there is no such thing as risk-free debt. Second, incomplete or partial policy measures can only make things worse. By postponing the inevitable, eurozone policy-makers managed to escalate a solvency crisis in one of the smallest and most inconsequential European economies into a major financial crisis and an existential threat to the single currency.

With no magic bullet in sight, the eurozone limps into the new year battered, but still intact. However, the region will face a number of challenges. The immediate challenge for the eurozone governments will be to refinance almost €500 billion in sovereign debt due to mature in 1Q12. While most of this debt (Germany and France) should be easily refinanced, some of the larger sovereign debtors (Italy and Spain) will face choppy markets. More broadly, the eurozone faces the complex interplay between sovereign policy issues, banking sector weakness and an economy slipping back into recession. In addition of having to recapitalize weak banks, the governments will have to square the circle of returning to economic growth in the face of severe fiscal austerity.

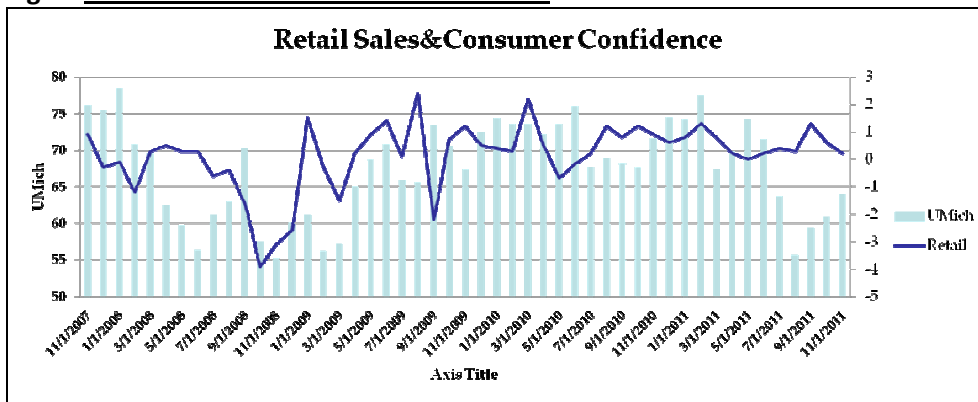
Fig.2: Chicago PMI



US Momentum: Data releases continue to point to a sustained economic recovery. Manufacturing survey data showed a sustained improvement in December. The Empire State and Philadelphia indices are both in positive territory. The Chicago PMI remained above 60 for the second consecutive month and the ISM-Manufacturing rose in December for the third month in a row to 53.9. While industrial

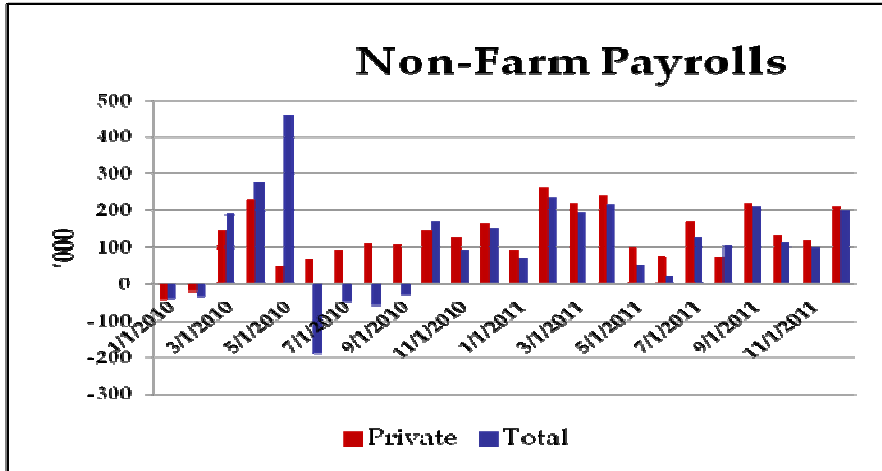
production fell by 0.2% month-on-month (m/m), durable goods jumped by 3.8% m/m, and factory orders rose by 1.8% m/m. On the household front, we saw large gains in consumer confidence (both the Reuters-University of Michigan and the Conference Board measures were up in the mid- to upper 60s). Both personal income and personal consumer expenditures rose by 0.1% in November. The Christmas season was mixed. Same-store sales were up 3.4% (y/y) compared to 3.3% in 2010, but the bulk of the increase came late in the season and resulted from deep discounts, which cut into retailers profits. Moreover, the gains were concentrated at both ends of the markets--the upscale and the value-oriented retailers-- at the expense of mid-level ones. Nevertheless, continued consumption gains will depend ultimately on sharply improved employment prospects, which have yet to materialize.

Fig.3: Retail Sales and Consumer Confidence



House prices still on the decline: The housing market is not expected to show great dynamism in 2012. While sales of existing and new homes are modestly higher, prices continue to fall, with the latest Case-Shiller 20-city index showing a drop of 0.6% in November. Actually, house prices declined faster in 2011 (minus 3.4%, October-to-October) than in the previous year (minus 1% for the same period). After a four-year slump, nominal house prices are at their lowest since March of 2003, and real prices are around October 2001 levels. Based on faster household formation and increased affordability, we could see housing stabilize in 2012, but if past historical trends hold, a full recovery could take 6 years or more from the onset of the crash, pushing it back to 2014.

Fig. 4: Non-Farm Payrolls



Labor Markets: High frequency labor markets data have been positive, with first time jobless claims, under 400,000 since the end of November, dropping another 15,000 in the first week of January to 372,000—the 4-week moving average is now around 373,000. The December payroll number was the strongest since September, with 200,000 new additions. Private sector payrolls were up 212,000, while government employment fell by 12,000. The private sector gained jobs across the board, with the goods-producing employment up by 48,000 and the service sector gaining 164,000 new positions. Overall, the economy created 1.64 million jobs in 2011 (1.92 million additions in private payrolls and a drop of 280,000 in government payrolls), up from 940,000 in 2010. However, total jobs created over the two year period made up for only one-third of the 8.8 million jobs lost in the 2008-09 recession. The unemployment rate fell to 8.5% from 8.7% in November, but this decline reflects in part the continued fall in labor force participation, now at 64%. Hours worked increased by 0.1 hours to 34.4, and hourly earnings increased by 0.5% (m/m). While some of these gains reflect seasonal patterns and exceptionally mild weather—which helped the construction sector—they seem to represent an improving trend.

Fed Minutes: The Fed released the minutes of the 12/13/2011 FOMC meeting. The minutes read as follows:

“The information reviewed at the December 13 meeting indicated that U.S. economic activity expanded moderately despite some apparent slowing in the growth of foreign economies and strains in global financial markets. Conditions in the labor market seemed to have improved somewhat, while overall consumer price inflation continued to be more modest than earlier in the year and measures of long-run inflation expectations remained stable.”

Given the outlook for modest growth and the high levels of risk, the FOMC voted to continue to keep short-term interest rates at near zero, maintain its “Operation Twist” to June 2012 and reinvest

maturing mortgage backed –securities held on its balance sheet. 10-year yields remained slightly under 2.0% in the last weeks of the year 2011 and the beginning of 2012. The US dollar has clearly shown that it remains the safe haven currency, gaining 13% since its 2008 low, a trend which has helped to keep US long-term interest rates at historical lows.

Oil Jitters: Oil prices jumped at the end of the year in response to an Iranian threat to close the strategic Straits of Hormuz in the Persian Gulf. The Iranian government was reacting to the very tough sanctions imposed by the both the European Union (EU) and the United States on the country—in particular, sanctions on the Central Bank of Iran, which would have the effect of severely constraining Iran’s ability to sell its oil. While the Iranian government backed off from the threat and offered new negotiations on the nuclear issue, the move unnerved oil markets, with oil prices (\$/barrel, West Texas WTI) jumping to over \$100/barrel. It is reported that the EU countries have agreed in principle to implement an embargo on Iranian oil. The EU’s planned embargo would be implemented gradually over the next few months; such a move would affect about 600 thousand barrels per day. Moreover, several European countries that are heavily reliant on Iranian oil would be partially exempt. Even if Iranian oil sales were replaced by Mediterranean crude (as Libyan output recovers) or Saudi output, it would mean a higher cost. Nevertheless, the impact on market psychology of an embargo on Iranian oil or any other interruption is truly a “black swan”, and all bets would be off.

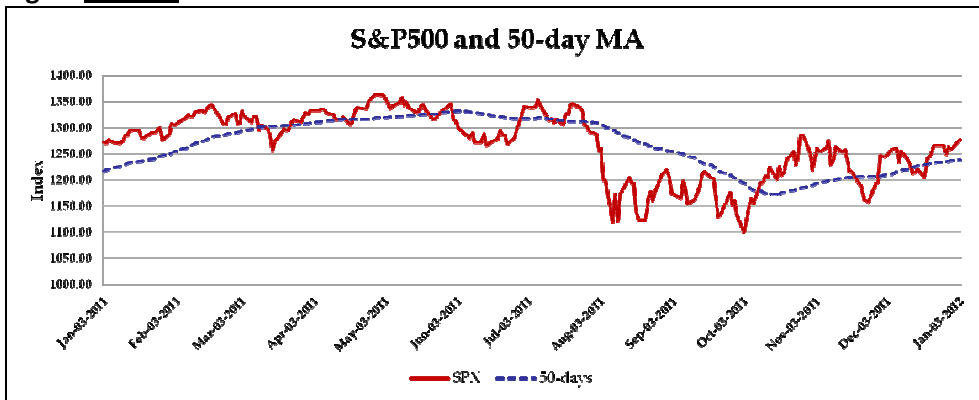
What to expect in 2012: The US economy just finished a strong quarterly economic performance, with economic growth expected at 3-3.5% (annualized). However, this trend is not expected to extend beyond 1Q12. The global backdrop remains weak, offsetting some reasons for optimism. The eurozone economy is sliding towards another recession, with even its largest economy, Germany, slowing down sharply. Chinese industrial production indicators (PMI) recovered in December to over 50 after contracting for two months in a row. JPMorgan’s Global Manufacturing PMI also rose to above 50 in December to its highest level since June, and JPMorgan Global All-Industry PMI (which includes services) increased from 52 in November to 53 last month. With these conditions in mind, the IMF has revised its 2012 global growth forecast from 4.5% to 4%. In addition to slower global growth, there are a number of factors that will affect the global and US economic prospects:

- The burden of economic growth will be on the private sector as fiscal policies tighten around the globe
- The political gridlock in Washington will continue through the electoral cycle
- Europe’s intertwined sovereign debt and banking problems will remain unresolved. The burden of keeping the economies afloat will rely increasingly on a very reluctant central bank.
- Bank lending will be constrained as the European credit crunch will have global ripple effects
- Oil prices will remain high and volatile, averaging \$100/bbl in 1Q12

Moreover, the global economy faces three downside risks in 2012: shock waves from the eurozone sovereign debt and banking crisis, a fiscal tightening in the United States and a sharper slowdown in the Chinese economy. To this list, we should add the potential for oil price spikes in response to unpredictable developments in the Iran nuclear standoff.

On the positive side, the US economy has shown a degree of decoupling from the global economy, but it will be difficult to see much upside to our forecast. Overall, we can expect that the US will avoid a double-dip recession, although economic growth will remain a subpar 2.0-2.5% in 2012. Over the longer-term, policy gridlock could extend beyond the presidential and congressional election of 2012, which does not bode well for a sustained economic recovery.

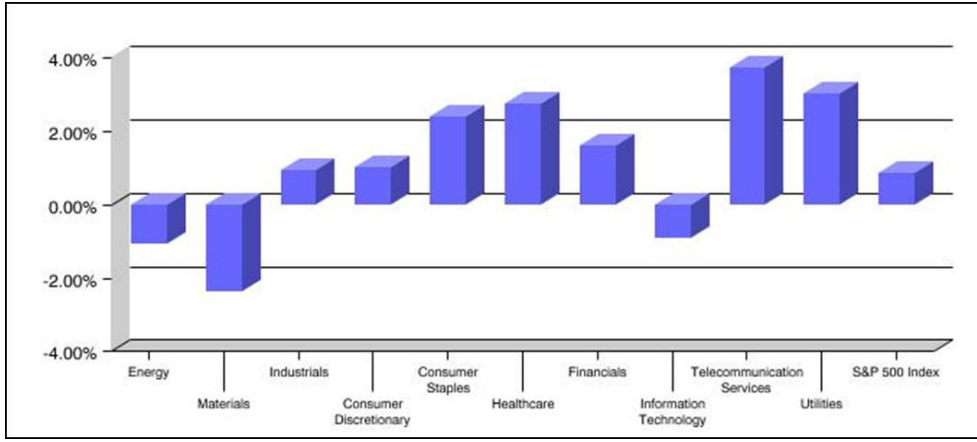
Fig.5: **S&P500**



A Rocky Year for Capital Markets: The global capital markets leave behind a 2011 characterized by significant wealth destruction, high volatility and a flight from risk. Despite a December rally, global equity markets suffered about \$6.3 trillion (12.1%) decline over the year. Both equity and debt issuance fell sharply to the lowest levels seen in the 2008-09 financial crisis, and US equity funds suffered a \$160 billion funds outflow—after a \$53 billion inflow the previous year. The rocky markets did not spare commodities or emerging markets, which all suffered losses in 2011.

The US markets were spared some of the woes that hit the global capital markets, with the S&P500 finishing the year in a December surge that lifted the index by 14.3% from its low point on October 7th, to 1,257-- essentially unchanged from its year-end 2010 level of 1,271. The sectoral performance remained mixed. On a 30-day basis (to end-2011), the defensive sectors carried the index, while on a 90-day basis, all sectors recovered. Moreover, the stock market activity in 2012 was characterized by light volume and high event-sensitivity.

Fig.6: S&P500 30-day Sectoral Performance (12/30/2011)



Europe continues to weigh heavily on the markets, which remain concerned about sovereign debts' rollover and weakening economic data. These concerns have offset the improvement of US economic data and made for a very choppy market performance. A positive sign is that the S&P500 index has been above its 50-day moving average for the last month, which indicates that there could be some upward momentum in the market.

Additionally, the profit picture has darkened in the past few months. Profits for US non-financial S&P500 companies are expected to rise by 6.9% in 4Q11 (over 4Q10), breaking an eight-quarter double-digit growth sequence. Furthermore, as we enter the first quarter earnings reporting period, the European recession and slowing growth in major emerging markets could reduce the growth of earnings even further—market analysts' expectations are for a mere 3% rise in 1Q12. Moreover, the markets are still being spoon-fed good news and have acted in a bi-polar manner; we will need an economic catalyst to break through the 1,300 and 12,500 levels respectively for the S&P500 and the DJIA. In this environment, we believe cyclical stocks should continue to do well and that a value oriented approach, focusing on fundamentals and patience would seem to be the best strategy.

	Prior	Consensus	Actual	Min	Max
December 2011					
Macroeconomy					
GDP (3Q11, % Annualized)	1.3%		2.0%		
CPI (m/m) Nov	-0.1%	1.0%	0.0%	-0.1%	0.2%
Core CPI (% m/m) Nov	0.001	0.1%	0.2%	0.0%	0.2%
Balance of Payments					
Exports (% m/m) (Oct)	1.4%		-0.8%		
Imports (% m/m) (Oct)	0.6%		-1.0%		
Trade Deficit \$ billion (Oct)	\$43.5	\$43.4	\$43.5	\$40.3	\$45.2
Current Account Deficit (\$ billion) (3Q11)	\$124.0		\$110.3		
Industrial Production					
Empire State (Dec)	0.61	3.00	9.53	0.00	7.00
Philadelphia Fed (Dec)	3.6	5.0	10.3	0.0	10.0
ISM-Mfg Dec	52.7	53.2	53.9	52.5	54.0
Chicago PMI (Dec)	62.6	60.7	62.5	58.0	65.0
Industrial Production (% m/m) Nov	0.7%	0.2%	-0.2%	-0.2%	0.5%
Durable Goods (m/m) Nov	0.0%	1.9%	3.8%	0.5%	5.5%
Durable Goods (y/y)	8.4%		12.1%		
Durable Goods, ex transp (m/m)	1.5%	0.4%	0.3%	-0.5%	0.9%
Durable Goods, ex Transp (y/y)	12.9%		7.2%		
Inventories (m/m) Nov	0.0%	0.6%	0.8%	0.2%	1.0%
Factory Orders (m/m) Nov	-0.4%	2.0%	1.8%	0.3%	2.8%
Services					
ISM non-mfg Sep	52	53.4	52.6	52.0	57.5
Consumer Spending					
Retail Sales (% m/m) Nov	0.6%	0.5%	0.2%	0.2%	0.8%
UMich Consumer Sentiment Dec	67.7	68	69.9	65.5	69.2
ConfBd Consumer Confidence (Dec)	55.2	59.0	64.5	52.0	63.0
Personal Income (m/m) (Nov)	0.4%	0.2%	0.10%	0.0%	0.4%
Consumer Spending (m/m) (Nov)	0.1%	0.3%	0.10%	0.2%	0.5%
Housing Market					
Housing Starts ('000) Nov	627	636	685	600	650
New Home Sale ('000) Nov	310	314	315	301	325
Existing Home Sales (MM) Nov	4.25	5.08	4.42	4.38	5.19
Case Shiller-20 (m/m) Oct SA	0.7%	0.0%	-0.6%	-0.8%	0.0%
Case Shiller-20(y/y) Oct	-3.5%	-3.1%	-3.4%	-3.5%	-2.8%
Employment					
First Time Claims ('000) (1st Week Jan)	387	375	372	370	392
Non-Farm Payroll ('000's) Dec	100	150	200	110	200
o/w Private Sector ('000's) Dec	120	160	212	130	210

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