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Looking Back and Glimpsing Ahead

2011: The Year That Wasn't

Last year the market resembled a dog chasing its tail: a lot of commotion without much progress. The S&P 500 Index posted a total return of 2.1%, all of it attributable to dividend yield. Despite the dramatic gyrations of the market, the S&P 500 virtually stood still, falling 0.003% for the year.

Every year has traits all its own. We would characterize 2011 as a year that failed to deliver, in a positive sense. Specifically, a year ago many investors and economists were looking for higher interest rates, dampened earnings results and a double-dip recession. None of these things came to fruition.

The Federal Reserve anchored interest rates in 2011. As we start out in 2012, short-term interest rates remain at historically low levels. Mr. Bernanke basically promised that short-term interest rates will remain low into 2013. The ten-year Treasury is sitting just below 2%. A year ago it was slightly higher than 3.2%.

Earnings results in 2011 were "talked down" a bit in some sectors. However, results were more in line than not. 2011 earnings estimates for the S&P 500 rose 4.5% as the year progressed. Estimates started out at $92.70 per share and are now expected to be $96.80 per share. The same trend is in place for 2012 S&P 500 earnings estimates. Early on, the estimates were $98.90 per share and have moved up to $103 per share. Three interesting observations come to mind when looking at S&P earnings estimates. First, as we stated, earnings estimates continued to increase throughout the year (albeit not always in a straight line). Second, earnings are expected to grow 12% in 2011 relative to 2010, and at an annual rate of 6.6% in 2012. Third, earnings results have not simply reflected cost cutting measures. Rather, they have mirrored product and price mix improvements in addition to improved operating efficiencies. This last point is quite noteworthy since revenue growth is necessary for healthy long term growth.

The fact that the US economy did not fall back into recession during the latter half of 2011 is both positive and surprising when recalling the numerous forecasts anticipating a double-dip recession. Although the domestic economy was sluggish, as the year drew to a close there was a noticeable absence of significant further deterioration both in the housing sector and employment. In fact, there were slight signs of improvement in both areas.

Lessons From Last Year

LAME LEADERSHIP

This political phenomenon was evident on both sides of the Atlantic as the European Union (EU), German-French, and other summits raised expectations but not results. Meanwhile, US political partisanship produced embarrassing stand-offs causing a sovereign debt downgrade, an eleventh hour extension of payroll tax and unemployment stimulus. Capital market intolerance of political profligacy (government spending) surfaced in Europe, indicating there were limits to how far governments can kick the can down the road.

GLOBALIZATION RULES

Economies and markets were inextricably intertwined from a global perspective. Globalization is alive and well economically, financially and politically. The decoupling thesis seems a fantasy. The contagious

byproduct of globalization became particularly clear during the closing months of 2011 as manufacturing and service sector growth indexes as well as trade balances began to falter or stall in Europe, Asia, the US, and Latin America.

On the 2012 Radar Screen

We anticipate modest economic expansion threatened by a growing risk of recession from global contagion. Relatively speaking, the US should fare better than Europe and some emerging market hot spots. The housing sector is expected to be tenuous. However, there are some positive data points. Existing home prices in various regions are undergoing some improvement. In addition, the inventory of new homes has stayed around five months, according to the National Realtors Association. While there is no doubt that we will witness foreclosures in the future, the vehemence with which financial institutions pursued foreclosures in the past seems to have ebbed.

The most recent observation regarding employment indicates an improvement in private payroll employment, while the government payroll continues to slide from its peak in 2010. This will most likely continue as some postal employees are laid off and certain post office facilities are closed down in 2012. The outlook for the unemployment rate remains muddied and somewhat counterintuitive as it is expected to rise even as the economy improves. This would be reflective of job applicant growth outpacing actual job growth. The bottom line on employment is that there is plenty of room to hire new employees without sparking concern over wage inflation. Another positive point is the drop in the under-employment rate which has fallen from a peak of 17.2% in October of 2009 to 15.2% in the most recent survey.

“Core” inflation (excluding energy and food), as measured by Personal Consumer Expenditures (PCE), the government’s favored yardstick, is below the 2% upper band that the Federal Reserve is comfortable seeing. We think this will remain so in 2012. While the headline PCE deflator has moved to 2.5%, a little inflation is not a bad thing as it provides a pricing umbrella for companies. This may help to cover or at least counter some costs, thus protecting profit margins. Barring any significant upward push in wages or an exogenous shock to the system, (like a blockage of the Straits of Hormuz), we do not expect substantial inflation pressures to materialize in 2012.

Themes For This Year

LOW YIELD ENVIRONMENT

Bond yields are likely to remain low due to tremendous demand for safe assets in an uncertain, risky global environment. Financial repression, in which governments keep interest rates low to fund debt obligations more cheaply, will continue. In addition, the global economic backdrop will be punctuated by rising recessionary risk, thus fueling demand for safe assets.

HIGH YIELD DEMAND

Demand for high-yielding assets such as corporate bonds, emerging market debt, master-limited partnerships, preferred equity, and high dividend stocks, will remain strong. Stocks with high dividend yields and good dividend growth prospects should continue to outperform the broader market. Since 2005, 80% of the outperformance of high dividend stocks relative to the S&P 500 is attributable to the decline in bond yields. (Please see our accompanying chart at the end of the commentary.)

DEFENSIVE STRATEGY

Our asset allocation strategy currently favors domestic bonds, emerging market sovereign debt, alternative investments and high dividend US stocks. We continue to believe the US will be “the least ugly house in the neighborhood” during 2012. Our equity sector allocation chart is as follows:

OVERWEIGHT	
SECTOR	**REASON**
Technology	Growth opportunities Cash for dividends
Health Care	Best cyclical immunity
UNDERWEIGHT	
SECTOR	**REASON**
Financials	Profitability/regulatory challenges Event risk
Industrials	Exposure to Europe
Consumer Discretionary	Slowing income growth Low savings rate Competitive pressures

The Market Outlook: 2012

Like 2011, we anticipate a year of heavy gyrations with range-bound results in 2012. On the positive side of the ledger is a sense of improved, or at least a more neutral sentiment about the economy and the markets. If this is ongoing, the simple stemming of negative anticipation should help the market environment improve. Further, markets generally perform better in election years. Lastly, current 2012 S&P 500 earnings estimates put a price-to-earnings ratio (P/E) of around 12-times on the market. This is down from 14-times in 2011. Relative to its average P/E of 15-times, the S&P 500 appears to be favorably priced.

On the other side of the ledger is continued uncertainty about international economic strength and the ongoing political quandary both at home and abroad. After decades of anticipating what lay ahead in a more globalized world, we are experiencing the double-edged sword of interdependence between countries on multiple fronts.

Another observation about the current environment: every generation or so there is an attitude that equities are dead. This happened from the late 1960s through the very early 1980s. Given the composition of a low interest rate environment, the continued requirement for income and the need to keep pace with inflation, we expect that investors will eventually be corralled back into the equity markets and more specifically into income-oriented stocks.

Dividend yields and dividend growth are expected to continue being the dominant component of total return in the upcoming 12-month period. This is not necessarily new, but it may be news to investors. History is also on the side of dividends. According to Strategas Partners, dividends have represented about 50% of the market's total return since the 1940's. Further, payout ratios are currently one-third the historical average.

Keeping in mind the importance the dividends play in the total return equation, as well as the ongoing low fixed income interest rate environment, and the need for investors to be compensated for partaking in the equity market, we remain focused on equities that have both the characteristics of attractive dividend yield coupled with dividend growth.

In the fixed income markets, a continuation of the same short-term environment looks to be in the cards given the Federal Reserve's pronouncement on keeping yields at historical lows to help the economy. While bond yields have dropped to unprecedentedly low levels, strong demand for safe assets in a weak economic environment, backstopped by government mandated financial repression, could keep yields low. For investors who require fixed income exposure, we recommend investment grade paper with short to medium-term duration.

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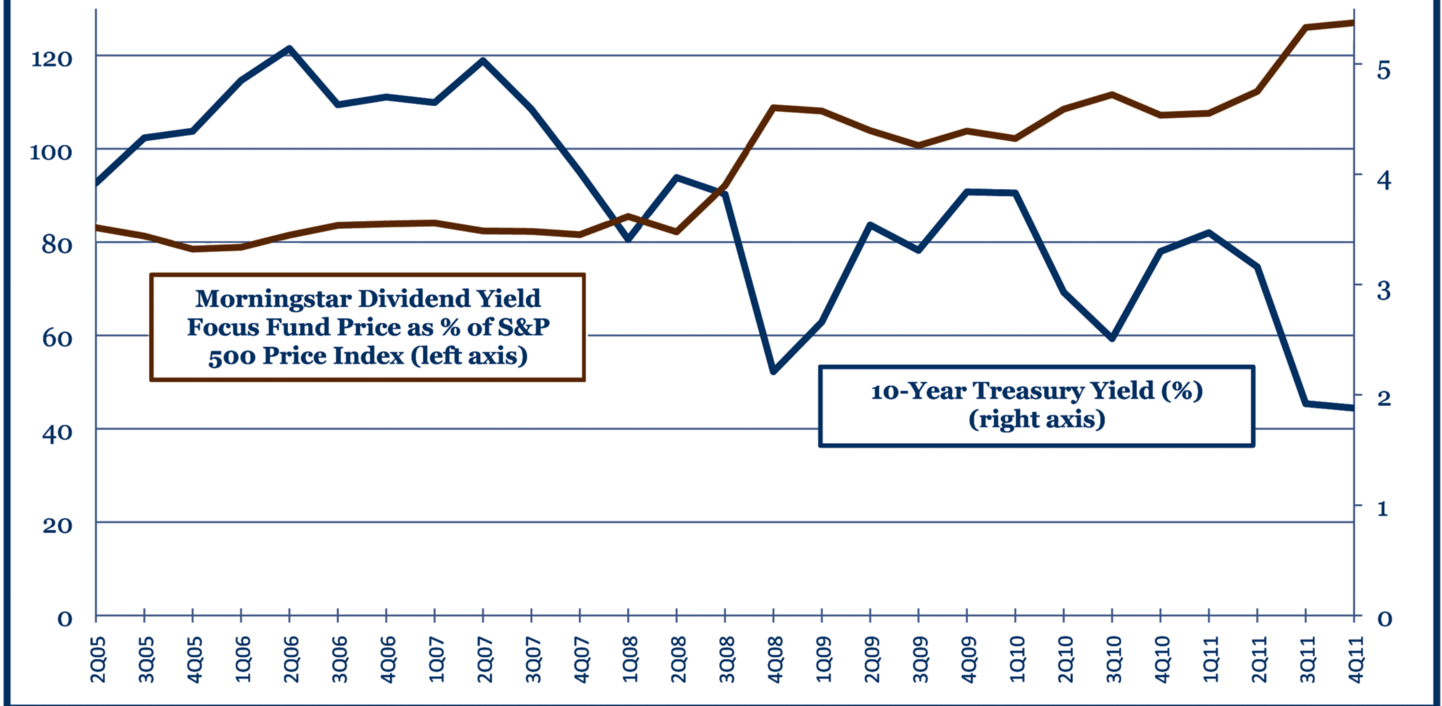

Relative high dividend stock prices move inversely with bond yields

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