

The Oarsman Outlook

January 2012

Domestic stocks surged higher in the year's final three months, largely reversing the prior quarter's losses and pushing 12-month returns into positive territory for the third year running. Major U.S. stock benchmarks gained more than 10% on the quarter, though most overseas markets rose substantially less (and, as a group, were down on the year). Real-estate and commodity-related investments provided lesser, but still positive three-month returns. Bond yields were essentially unchanged, remaining near all-time lows (the 10-year U.S. Treasury ended the period at 1.87%, compared with 1.92% at the end of September), with Treasury and municipal bonds slightly outperforming corporate credits; three-month returns were generally in-line with coupon rates (i.e., around +1%).

Among U.S. stocks, the best results came from companies in the Basic Materials, Capital Goods and Energy sectors. Communication Services, Consumer Staples and – somewhat surprisingly – Technology stocks lagged. Small-company stocks as a group did somewhat better than those of large firms, while “value”-oriented stocks modestly outperformed those in the “growth” category.

Benchmark Performance – Equities

	<u>Fourth Quarter 2011</u>	<u>Last Twelve Months</u>
S&P 500 Index	+11.8%	+2.1%
Large-Cap. Core Mutual Fund Avg. (Lipper)	+11.0%	-0.7%
Small-Cap Stocks (Russell 2000)	+15.5%	-4.2%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	+2.7%	-14.9%

Benchmark Performance – Fixed Income

	<u>Fourth Quarter 2011</u>	<u>Last Twelve Months</u>
Barclays Intermediate Gov't/Credit Index (taxable)	+0.8%	+5.8%
Barclays Municipal Bond Index (tax-exempt)	+2.2%	+10.7%

Review

The final quarter of 2011 began with world markets beset by the ongoing European debt crisis, political dysfunction in the U.S., and gloomy economic data from nearly all corners of the globe. Reflecting these worries, the first few days of the period saw U.S. stocks flirt with a 20% drop from their spring/summer highs – the traditional definition of a Bear Market. Beginning in October, however, incremental progress regarding the Euro Zone situation (or perhaps relief that things didn't spiral out of control), combined with a string of better U.S. economic reports, was sufficient to ignite a fierce rally: in the span of just three weeks, US stocks gained nearly 20%, while ‘safe-haven’ investments like U.S. Treasury bonds and gold fell.

After the October market sprint, skittish investors seemed to spend the rest of the quarter alternately feeling increasingly comfortable with incoming economic data (especially

from the U.S.) and increasingly dubious that the Euro Zone financial crisis was more likely to get better than worse. While U.S. markets moved only a couple of percentage points (net) through November and December, volatility (an indication of investor uncertainty and nervousness) remained elevated both day to day and over longer periods, with benchmark indexes dipping nearly 10% between late October and late November before once again rebounding strongly in December.

Bond yields were flat during the quarter, remaining at levels not seen since the 1950s. This surprising behavior (yields often rise in tandem with stock prices) stemmed from offsetting impulses: firming economic activity in the U.S. and rising stock prices on one hand, lingering fears of a Euro Zone collapse, and slowing economic growth overseas on the other. Of note, municipal bonds were among the best-performing fixed-income investments on the quarter and for the year – defying high-profile predictions of widespread defaults.

On the earnings front, corporate America continued to navigate the difficult economy more successfully than many American workers and families, with profits posted during the October reporting season up almost 16% versus the same period a year ago. And despite Wall Street analysts continuing to nudge their year-ahead estimates higher (as noted in the *What's Changed?* box below), the average valuation of U.S. stocks deteriorated somewhat.

What's Changed?

To provide insight regarding recent stock market performance, we can deconstruct the three-month return from stocks into three components:

- 1) Dividend Income (for three months this is the annual yield divided by four)
- 2) +/- Change in Earnings per Share* (average for S&P 500 companies)
- 3) +/- Change in Valuation (Price/Earnings Ratio)

= Total Return

** based on forecast earnings for next 12 months (Source: S&P Outlook)*

So, *what changed* during the recent quarter to give us the +11.8% S&P 500 total return?

Fourth Quarter (October - December) 2011		
Dividend Income	+0.6%	+11.8%
+ Change in Earnings	+2.0%	
+ <u>Change in Valuation</u>	+9.2%	
= Total Return	+11.8%	

Our read: *Wall Street analysts remain optimistic about earnings despite the weak economy. However, valuation remains reasonable (and substantially below the year-ago reading), which should make stocks less vulnerable should analysts temper their enthusiasm.*

Outlook

As we enter the New Year, the economic and financial-market outlook is again dominated by a few (by now somewhat familiar) major stories. Perhaps most critical for the markets is the ongoing drama in Europe. Also important is the fragile state of the global economy as it enters a third year of recovery following the near-meltdown of 2008-2009. Finally, the divisive and increasingly dysfunctional political climate in the U.S., only exacerbated by the advent of campaign season, continues to weigh on consumer and business confidence, while distracting market participants from more fundamental matters.

Our research on the subject suggests we are not alone in concluding that the European debt crisis is almost impossible to handicap. Despite a yearlong succession of ‘comprehensive solutions,’ a true resolution remains elusive, and a cataclysmic cascade of sovereign defaults, bank failures, and collapse of the monetary union itself seems barely less likely than it did three, six or twelve months ago. Despite some mildly encouraging, incremental steps taken and milestones passed in recent weeks (the European Central Bank’s new program of three-year loans to the region’s banks; several better-than-expected auctions of new Spanish and Italian government bonds), most analysts believe the total ‘firepower’ available to prop up the region’s sovereign bond markets remains insufficient, leaving open the possibility of a messy, Lehman Brothers-like climax to the crisis.

Even a disorderly unraveling of the Euro, however, could have a less-than-catastrophic impact on this side of the Atlantic. A Euro Zone recession is already widely anticipated and discounted; the deeper contraction that would accompany a collapse of the currency might have a relatively minor direct impact on the American economy, as Europe is a less important market for U.S. exports than are Canada, Latin America and the Pacific Rim. Harder to gauge would be the indirect impact on still-fragile U.S. consumer and business confidence and, most critically, the U.S. banking system. On this last point, while U.S. banks have low exposure to ‘peripheral’ Euro Zone government bonds and banks, a collapse that brought down major French and/or German banks would be more worrisome. Bottom line: a collapse of the Euro would represent a major dislocation of global markets whose ultimate reverberations are impossible to predict with confidence; accordingly, we will continue to monitor both political and financial-market news for early-warning signals that may help us react to unexpected developments.

As noted, the U.S. economy was firming as we headed into 2012, though the same cannot be said of other major world markets. Domestically, the mid-2011 soft-patch seems to have passed, as a broad array of economic data – unemployment claims and payroll growth; purchasing-managers’ surveys; consumer confidence and spending measures; and even (though more tentatively) the real-estate market – have turned more up-beat. Though local-/state-level spending cuts and waning federal stimulus programs will be a modest drag in coming months, the U.S. economy seems to be expanding at a solid, if unspectacular clip, and fears of a ‘double-dip’ recession have been allayed for now. Overseas, however, the Euro Zone seems set for at best a mild contraction, while in major emerging economies (e.g., China, Brazil, India) growth is being deliberately slowed by anti-inflation policies (though some of these have recently begun to be reversed). The net result is likely to be the slowest rate of global growth since the 2007-2008 recession, which will pressure corporate revenues

and exacerbate fiscal imbalances. Though a partial offset will likely come from lower interest rates and commodity prices, 2012 nevertheless looks to be a year in which the economic underpinnings of the financial markets are not particularly supportive.

To us, one of the more intriguing features of the outlook for 2012 is the paradox presented by the U.S. fiscal position; i.e., government deficits and debt. Many influential voices have spent much of the past two-plus years warning of the imminent dangers posed by large, current federal deficits and the growing ‘mountain’ of government debt. This school of thought played a key role in last summer’s debt-ceiling debacle, which nearly resulted in the U.S. government renegeing on its financial commitments and was the proximate cause of Standard & Poor’s downgrade of Treasury debt.

Yet, as deficits and debt have, over the past three years, grown to levels not seen since the aftermath of the Second World War, market-determined yields on U.S. government bonds have fallen to levels not seen in decades – hardly an indication that investors share the apocalyptic angst often suggested by the headlines. Rather, markets seem to be indicating that the fiscal imbalance (at least for the time being), is insufficiently worrisome to offset the depressing effects of weak economic growth and large, underemployed surpluses of both capital and labor. (As noted, even the fourth-quarter firming of U.S. economic news was met in the bond markets by a further decline in yields.)

Of course, this paradox reflects a debate that might have been primarily about effective economics, but has also assumed an important political-ideological dimension. Discussion of deficits, debt and the role of government in the economy is sure to figure prominently in the upcoming election campaign. We will monitor with keen interest how this debate evolves, particularly if the current combination of disappointing growth and ultra-low bond yields persists, and how that evolution is received by the financial markets.

Despite an environment featuring ample economic and political uncertainty, we believe the U.S. stock market is well positioned for the year ahead. With stock prices essentially flat over the past year, during which earnings advanced more than 12%, the average valuation of large-company U.S. stocks now stands at just over 12 times estimated current-year earnings - compared to a more typical reading of 14-16 times. Even if earnings were to disappoint by 10%, stocks at current prices would remain reasonably valued. Moreover, as we have noted in past letters, dividend yields above 3% from world-class growth companies like Intel, Emerson Electric, PepsiCo and Johnson & Johnson look increasingly appealing the longer Treasury yields remain mired below 2%. Finally, the possibility (we are almost tempted to say likelihood) that uncertainty surrounding European debt, U.S. politics and the pace of global growth will abate as the year progresses raises the prospect of a an expansion of valuations and increase in prices.

We encourage you to let us know if you have questions about our management of your investments - and hope you enjoy a healthy and prosperous New Year!

Sincerely,

Alan Purintun, CFA
Principal & Portfolio Manager

Robert W. Phelps, CFA
Principal & Portfolio Manager