Q4 2011 Commentary

After nearly stalling for much of 2011, the United States economy began to pick up late in the year. The U.S. economy had an anemic first nine months of 2011, but signs of strength with modest improvements in employment and housing, improving manufacturing data, and a pickup in consumer spending helped end the year on a positive note. Meanwhile, our neighbors in Europe are on a brink of falling into a recession, and emerging markets, most notably China, are seeing slower growth prospects.

2011 was a very challenging year as the market's volatility whipsawed investors and money managers. Our investment themes were interrupted by global macro events such as the Japanese earthquake and the European debt crisis, and also by our own U.S. credit rating downgrade, domestic political wrangling and congressional deadlocks. We struggled to stay ahead of the market's big swings. The surprising stumble in the economy after the Japanese earthquake and the noxious headwinds from Europe, were factors that made forecasting tough in the past year. Europe's debt troubles and global economic jitters have convinced many that the markets are largely at the mercy of policy makers, making them harder to predict.

The European debt debate will continue into 2012. There was an agreement reached in December for deeper economic integration, tougher budget discipline and sanctions for deficits. This agreement is a starting point, but it will take months to finalize and could lead to further market deterioration. We need to be careful and watch for any spillover effects the EU debt crisis may have on the U.S. economy. While we are encouraged by these efforts, we are not out of the woods, and markets are likely to remain volatile and vulnerable.

At the company level, those companies in our portfolios have continued to post solid, positive and growing earnings. We are staying the course with our themes in industrial, technology, energy, and healthcare stocks. We will continue to pay special attention to earnings and forward looking guidance companies may provide. In 2011, some companies had a difficult time navigating and forecasting the global slowdown and U.S. political deadlock. This will probably continue into 2012 as Europe deals with its debt crisis and we enter a presidential election year.

Consumer confidence improved late in the year. It is interesting that during the year consumers were complaining about their plight when in fact they were spending, as indicated by the 8% yearly gain in consumer spending. This is very positive and needs to continue. The labor markets were improving at year-end, with jobless claims hitting their lowest level since early 2008. Housing is looking to be in a bottoming process, and the continued low interest rate environment should encourage homeownership.

We enter 2012 with some of the same trends that affected us in 2011, mainly the European debt crisis, and a sluggish U.S. recovery. Hopefully, we will continue to see the jump in consumer confidence we saw in December. Any signs from China and other emerging markets that they are not entering a slowdown would be very positive and help a rebound. Positive action by European leaders in working through their debt crisis would also be a catalyst for the market to move higher.

The trick in the year ahead will be to keep profits, sales and share prices moving upward as U.S. consumers navigate a slowly improving job market and moderate economic recovery. Also we believe the U.S. economy will grow modestly in 2012, aided by liquidity, modest earnings growth and cheap valuations. However, the uncertainty associated with a global debt crisis, U.S economic recovery, and the upcoming U.S. presidential election will continue to keep stocks volatile.

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