



WHITHER PROFITS

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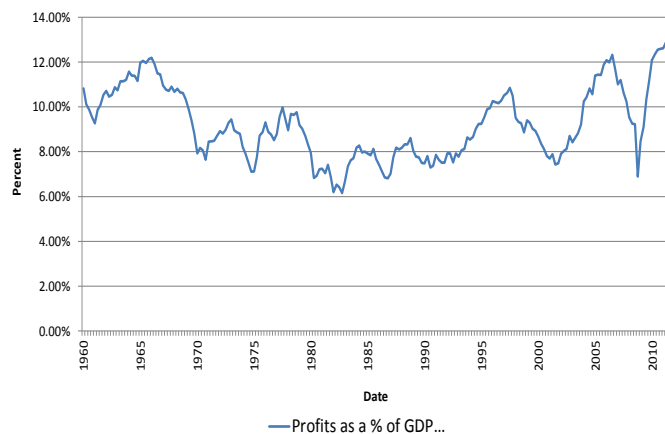
Despite getting off to a strong start in the first four months of 2011, the U.S. stock market turned more volatile in the remaining months of the year. Over the course of the year, the S&P 500 traveled over 500 points with a net total return for the year of 2.1%. Most of the volatility for the market was produced by a succession of four “shocks” – the Japanese earthquake, the Arab spring, the U.S. debt ceiling debate and subsequent credit downgrade, and growing financial stress in Europe. Over the course of the year, the consensus view for U.S. economic growth turned from strength for the outlook of 2011 to worry about a renewed drop in activity during the summer, followed by a renewal of confidence about moderate but sustained growth during the fourth quarter.

At the outset of 2012, the U.S. economy appears likely to sustain 2% growth in the months ahead. Nonetheless, the underpinnings of this growth are fragile. Aggregate governmental spending has turned from a source of stimulus to an increasing drag on overall growth. Consumer spending over the December holidays was quite good, but wages are not consistently growing in real terms and savings are once again being drawn down. Capital spending is holding up, but could be stronger given the financial strength of most large companies. Exports are likely to slow reflecting reduced foreign demand. Employment growth may remain uneven. The outcome of the November election adds to uncertainty. Overall a moderate growth environment will continue to prevail for 2012 and into 2013. Inflation and interest rates should remain low. The rest of the world, especially Europe, is expected to see slowing growth. Europe might enter a mild recession. As already mentioned, moderating activity in the rest of the world may have some impact on U.S. growth. The potential of further “shocks” cannot be ruled out.

As seen in the accompanying chart, U.S. profits as a percentage of GDP are historically high. Concern about the continuation of the growth of this relationship may be a reason why the valuations of most U.S. equities appear relatively low. One astute observer of the markets has

noted that since 2000 pricing strength has contributed more to profits growth than has compensation reduction. Moreover, since the late 1990's the contribution to the profits growth for U.S. corporations has more than doubled from foreign sources. The U.S. economy is operating below its potential for growth and if it were to move towards realizing its potential, current high profitability might be sustainable. However, the likelihood of the U.S. economy reaching its potential is not great in the foreseeable future, and some might argue that growth could remain below its potential for years into the future. So an issue of sustaining a high level of corporate profitability is in front of us. In 2012 U.S. economic growth is expected to be moderate. GDP growth for the rest of the world will continue to slow down. Both of these trends will not be helpful to sustain a high level of profitability by U.S. companies with large foreign exposure. Indeed, analyst downgrades of earnings estimates for the fourth quarter and 2012 are outpacing upgrades.

Corporate Profits as a Percentage of GDP*



*Quarterly from the 1st quarter of 1960 through the 3rd quarter of 2011.

Source: US Bureau of Economic Analysis

Continued from page 1

While the S&P 500 has recently moved above its 200 day moving average and may climb higher near term, we suspect the U.S. stock market will remain volatile during 2012 with a low point to point return as occurred in 2011. Some of the volatility may be driven by adjustment to slower earnings growth and some may be occasioned by further concern about European financial issues. In this setting, investors are likely to continue to focus on the stocks of domestic U.S. oriented companies with sustainable growth and/or relatively attractive current dividend yields. The market leadership of 2011 was growth and dividend yield, but in 2012, the focus may be more on domestic U.S. companies than multinationals.

In contrast to the U.S. and Europe settings, we believe that emerging market equities may gain increasing interest over the next 12-18 months. The stocks of emerging markets declined over 18% in 2011. In the aggregate, price earnings ratios are about 9x projected earnings compared to 13x for the S&P 500 and 18x for the S&P 600 small cap index. The prices of emerging market equities have declined largely because of tightening monetary policies reflecting concern about increasing inflation. Inflationary pressures have subsequently subsided and central banks have begun to pursue easier policies. While the economic news from the emerging countries is likely to remain negative in the months ahead, we believe that increasing liquidity produced by accommodating monetary policy will eventually have a positive impact upon emerging markets' stocks. To us, the long term growth outlook is more favorable for many of the emerging markets than it is for the developed markets. More specifically, we project a 7% long term return for emerging market equities versus a 4-5% return for developed market stocks. If this forecast is correct, emerging markets could represent 52% of global market capitalization by 2030 compared to 38% in 2010. In contrast, developed markets, including the U.S., would represent 48% in 2030 compared to 62% in 2010. In the months ahead, we will be identifying specific emerging markets that appear attractive.

Portfolio allocation over the next 12 months should emphasize current yield through investment in U.S. corporate bonds and high grade municipal bonds. Equities' selection should also highlight current yield and potential dividend growth. Domestic U.S. oriented companies are

preferred over most multinationals for investment with new cash. Growth stocks may continue to attract more attention than many cyclically sensitive value issues. As the year progresses, we advise initiating positions in equities of selected emerging stock markets.

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