

POLITICAL, ECONOMIC AND CAPITAL MARKETS REVIEW & OUTLOOK FOR 2012

Summary

- Global political instability will continue to dominate the investment markets
- Sluggish economic recovery will continue in U.S. and Asia, while Europe will be mired in recession
- Potential crisis in Europe or military confrontation in the Middle East would destabilize global markets
- Investment markets will be volatile; returns will be modest, but favorable
- Global financial and capital market systems will demonstrate their resilience

Political Commentary

In 2011, politics dominated the investment markets. It was a year of dramatic events. We anticipate that 2012 will be a year of transition and that political factors will continue to dominate economic activity and financial markets.

Early in the year we witnessed emergence of the “Arab Spring,” where long-established oligarchies in North Africa and the Middle East began crumbling one after another. At the start of the year, few anticipated this. At the end of 2011, the process continues, as tensions in Syria continue to grow and protests against despotic regimes spread to other areas of the world.

In 2012 where despotic governments have been toppled, the societies will struggle to find their way forward, as various factions compete while they attempt to establish a new order. The outcome of these social movements remains uncertain. These social revolutions are in addition to ongoing instability and conflicts in the Middle East, including the Palestinian/Israeli conflict, Iran’s nuclear ambitions, and shaky regimes in Pakistan, Iraq and Afghanistan.

In the United States in 2011, political events were contentious. A routine increase in raising the ceiling on the U.S. federal debt in mid-summer became the field of battle for an effort to stem unsustainable levels of government spending. In this process, the functioning of the U.S. Government began to break down and the United States lost its sacrosanct AAA debt rating. Efforts of the “Super Committee” of Congressional leaders to bring the political parties together in debt reduction failed. At year-end 2011, the political processes continue to falter.

Alongside the political fighting in Washington, D.C. this past year was the populist “Occupy Wall Street” movement. This movement started in New York, then sprang up in urban centers throughout the U.S. and other major cities around the world. The reasons for the protests were varied and the goals of the participants were unclear. Still, the protests were strong and persistent in highlighting popular animosity towards the small and elite class of wealthy individuals and financial institutions, and their undue influence over government.

In 2012, the political sphere in the U.S. will be focused on the presidential election in November. Over the course of the year politicians of all stripes will seek to highlight their agendas and differences from each other, while jockeying for advantage. The election is touted to be the most expensive in history, and will likely be fierce and bitter. These election debates will exacerbate the tensions within U.S. society. Government will function poorly. These conflicts will reflect badly on the United States, and will be unsettling to others around the world.

In Europe, throughout 2011, political leaders and monetary authorities attempted to address a crisis in the financial system due to excessive sovereign debt of peripheral countries, such as Greece and Portugal. Over the course of the year, the crisis deteriorated and began to threaten major European countries, such as Spain and Italy – as well as the demise of the entire European Economic Union itself.

Going forward, European political leaders and monetary authorities will continue to be consumed by their attempts to work their way through the current financial crisis. Here, too, the outcome is very uncertain. If sovereign defaults take place, or a banking collapse occurs, the financial shock would reverberate throughout global financial markets. We see the most likely outcome is that a breakdown in Europe will not happen. Instead a patchwork of fixes and reforms will do just enough to prevent or effectively contain a sovereign default. Nonetheless, even if some type of tenable political solution is cobbled together, the debt overhang will still be a drag on global economic growth.

Finally, we note the continued rise of China as a powerhouse on the global political and economic stage. In 2012, we expect that the growth of the economy and political power of China will continue. However, in the years to follow, we anticipate slowing growth and rising social unrest, which could destabilize the small ruling elite.

Economic Review and Outlook

2011 experienced a sluggish economic expansion in the U.S. which was hampered by several crises overseas. Outside the U.S., developed countries in general struggled due to their accumulated sovereign debt, while emerging markets continued to expand at a healthy pace. We expect the world economy to experience modest improvement in 2012 with the notable exception of Europe, where austerity measures will push the continent into recession.

The largest hindrance to growth in the U.S. was the apprehension by consumers and businesses to spend. 2011 ended with both consumers and businesses more capable of spending than at the beginning of the year. At year's end corporations held over \$2 trillion of cash on their balance sheets. Consumers are now paying just 16% of income toward debt repayment, which is at the lowest rate since 1993; a tremendous improvement compared to their debt burden during the housing boom.

In 2011 the world economy was beset by several supply chain shocks. The Japanese earthquake and tsunami wreaked havoc on the production of automotive and electronics industries for much of the year. Flooding in Thailand also had major effects in the electronics industry which are still being felt. While it is difficult to enumerate, both of these large-scale disasters had a negative impact on world economic growth for 2011. Hampered by these disasters, 2011 provided lackluster global growth.

Compared with historical economic recoveries, 2012 should be a year of robust expansion. However, the overhang of debt in the developed world makes this economic recovery unique. Similar to 2011, our economic outlook for 2012 is that the U.S. will continue to have a sluggish recovery, while world GDP will grow at a slower pace due to European austerity measures and cooling emerging markets.

By year end housing will become a modest source of growth for the U.S. economy. Housing starts are at historically low levels on an absolute basis, going back to the 1960's. While some oversupply in housing from the boom years remains, population growth now far exceeds new construction of houses and apartments. Construction activity will still be far below that of the last decade, though any increase in construction from such a depressed rate will be stimulative to the economy.

Economically, 2012 presents many topics to be hopeful about while having a select few for concern. Progress may well better be judged by how much debt, public and private, is reduced in the developed countries of the world rather than GDP growth. This yardstick in the next few years will likely prove to be a better measure of long-term prosperity than GDP figures. Taking everything into consideration, the most likely outcome for 2012 will be an improving economy in the U.S. and Asia, while Europe will experience recession due to austerity measures imposed by governments.

Capital Markets Review

After a year of extreme volatility U.S. equity markets ended little changed, while foreign markets were down. The Standard & Poor's 500 Stock Index ended the year up 2%. The year saw a high degree of volatility, with the Standard & Poor's 500 Index fluctuating more than 1% on 96 trading days for the year, which was double the average for the past decade. The market's

volatility was due to a combination of fear from political and social unrest around the globe which was offset by attractive stock valuations.

The political turmoil abroad brought foreign markets lower for the full year. The MSCI EAFE, which measures the stock prices in developed countries outside the U.S., ended the year down nearly 12%. The Eurozone sovereign debt crisis hit European markets particularly hard. Asian markets were also pulled down by concerns in Europe, the Japanese tsunami and concerns over slower growth in China.

With regard to fixed income investments, in 2011 returns were surprisingly strong. While yields on U.S. Treasury securities appeared to be at exceptionally low levels at the beginning of the year, during 2011 they managed to go even lower, resulting in solid returns in nearly all sectors of the fixed income markets. Total return on the Barclays Aggregate Bond Index was 8%. Due to strength in the U.S. Dollar, returns on foreign bonds were somewhat lower, but still positive.

Commodity prices were generally lower for the year due to concerns of the pace of economic recovery. Gold and other precious metals were very volatile, but ended in positive territory despite a selloff in the fourth quarter. Oil meanwhile ended up for the year and also experienced high volatility due to the political instability of the Arab Spring.

Investment Markets Outlook & Strategy

In 2012, we anticipate that investment markets will perform similarly to 2011. The dominance of political factors will once again cause big short-term lurches up and down. Economic weakness in Europe, which will curb global growth, will restrain investment returns. In addition, we anticipate that once again we will see wide discrepancies in returns between various asset classes, investment sectors and individual stocks. Overall, we expect it will be another modest year for investors.

On the other hand, we see some significant differences within the markets between how they performed in 2011 versus our expectations for 2012. Specifically, we think that certain sectors, which were strong in 2011, will likely perform relatively poorly in the year to come. Utility stocks, for example, generally fared well due to their modest market valuations and high dividend yields. In the coming year, however, as such companies encounter increasing capital requirements and regulatory burdens, their common stocks may lag the market averages. On the other hand, foreign stocks, which significantly underperformed stocks of U.S. based companies in 2011, may fare relatively well in 2012.

In general, our investment strategy remains similar to what we laid out at the beginning of 2011. With regard to equities, we continue to favor common stocks of large multinational corporations with strong finances, solid dividends and stable business franchises. This year, in particular, we intend to emphasize investment in stalwart technology companies that support the ongoing

expansion of the internet and global information and communication. We favor both growth and value-oriented companies. We emphasize larger companies over smaller due to their competitive advantages in the in global marketplace and greater facility to meet the regulatory requirements. While U.S. based companies performed significantly better than foreign entities in 2011, we stand by our global perspective and even intend to expand it. In our view, common stock valuations are attractive. While we expect 2012 will be a year of modest returns, we believe the long term outlook for equities has strengthened.

In 2012, it is hard to conceive of significant further decline in interest rates on Treasuries, while the risk of a spike up in rates has increased. This indicates prospectively weak returns on fixed income securities. Still, we see some sectors of the bond markets that offer value for investors. Specifically, bonds of some emerging markets and other foreign issues are well secured and have generous yields. We also see modest opportunities in intermediate grade corporate and municipal bonds.

Yields on money market funds remain at rock bottom levels. We do not expect much change to that in 2012. Therefore, returns on cash will be minimal. However, in light of market volatility and variability we see value in holding cash reserves to reduce short term risks for investors and to provide available capital for market opportunities which may unexpectedly arise.

Summary

2012 will be a year dominated by political news. In the U.S., the elections will be contentious. Meanwhile investors will be fixated on Europe, where leaders will continue to struggle with their debt problems. In addition, military confrontation in the Middle East or elsewhere around the world could erupt at any time. Nevertheless, as politicians squabble and the markets careen, we believe that the global economy will continue to improve and that we will continue to resolve the problems from the recent financial crisis. In our view, at year end 2012, the surprise will be the underlying resilience and strength of the global financial and capital market systems.

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6 January 2012

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