

2011 Fourth Quarter Investment Review

FINANCIAL MARKETS

- ◆ Equity markets rebounded in the fourth quarter following a volatile and weak third quarter. The continuing European sovereign debt crisis coupled with banking problems increases the prospect for a European recession. However, stronger domestic economic data and more stable data in other regions suggest that the prospect of a deep, widespread global recession may be overstated and the probability of a hard landing for the U.S. economy has diminished.
- ◆ All major equity market indices showed positive results in the quarter - the S&P 500 Stock Index rose 11.8%, the Dow Jones Industrial Average increased 12.8% and the NASDAQ showed a 7.9% advance. Foreign stocks trailed domestic equity returns, with the MSCI EAFE Index up 3.3% and the MSCI Emerging Market Index up 4.4%. International returns lagged for the calendar year as well. The S&P 500 ended the year up 2.1%, while the EAFE Index and Emerging Market Index declined 12.1% and 18.4%, respectively.
- ◆ Returns for all domestic economic sectors were positive for the quarter, led by strong showings in the economically-sensitive Energy, Industrials, Materials and Consumer Discretionary sectors. Returns were weakest in the more defensive Telecommunications and Utilities sectors, a reversal from the previous quarter.
- ◆ Domestic equity mutual funds had their second worst year on record for redemptions, as \$132 billion was withdrawn. A slightly higher amount flowed into taxable bond funds.
- ◆ Treasury bonds were little changed in the fourth quarter as robust demand for safe haven assets kept yields pinned near their lows. Real interest rates remain negative as the Federal Reserve intends to keep short-term interest rates at zero until 2013, or possibly longer. While fears of a recession diminished, the continued turmoil over European sovereign debt fueled heavy demand for government debt. The yield curve flattened significantly with 30-year bond yields declining 1.44% year-over-year.
- ◆ Corporate bonds recovered moderately with the equity market rebound in October, yet weakness in financial credits pushed spreads wider into year-end. Credit spreads ended the year at the widest levels since 2009. Emerging market debt continued to suffer from the European debt crisis.
- ◆ Municipal bonds rallied in the fourth quarter as investors returned to the traditionally safe sector. Yields were sharply lower throughout the yield curve. Long maturities experienced the greatest price gains and total return for the year, while shorter maturities lagged in performance.

THE ECONOMY

- ◆ Much to the surprise of the markets and investors, since the end of the third quarter most domestic economic and employment reports have been better than expected. Although numerous concerns still exist which could lead to a global recession, the likelihood of a deep recession has dissipated somewhat with improved prospects for modest economic growth.
- ◆ In the last week of December, applications for jobless benefits improved, falling 15,000 to 372,000. The more reliable four-week rolling average fell to its lowest level in more than three years, while companies added 325,000 jobs in December. During the last month of the quarter, the Unemployment Rate fell slightly to 8.5%, as average hourly earnings and the length of the average work week increased.

FOURTH QUARTER 2011 INVESTMENT REVIEW

THE ECONOMY (*continued*)

- ◆ Broad-based manufacturing here and abroad has firmed. The ISM U.S. Factory Index expanded in December at the fastest pace in 6 months. Production and new orders grew at the strongest pace in 8 months as inventories were reduced. Ford sold over 2 million cars for the first time since 2007, and GM car sales jumped significantly in December versus last year. In the U.S., there has also been increased energy sector activity as drilling permits are finally being issued by the Federal government.
- ◆ U.S. consumers are beginning to loosen their pocketbooks as pent-up demand is driving delayed purchases. Retail sales in December were up 4.5% and exceeded forecasts. Consumer confidence levels are now back to the levels last seen in early spring 2011, prior to the effects of the Japanese tsunami, the spike in energy prices, the “shock” of the Congressional impasse and the U.S. debt downgrade.
- ◆ The U.S. housing industry is stumbling its way out of recession, as both single family and multi-family construction saw increases in November. Housing inventories are approaching “normal” levels. The ISM Non-Manufacturing Index was softer than forecast, but showed growth for the first time since August.
- ◆ Domestic corporate earnings estimates for the fourth quarter have dropped 6.0% since September, the biggest drop since the 31.0% drop in the first quarter of 2009. Still, for calendar year 2011, S&P 500 company earnings and dividends are forecast to rise 16.0% off of a recovering 2010 base.
- ◆ Europe has not yet solved its debt crisis and is attempting to implement austerity programs to slow expanding debt. At year-end, European confidence in the economic outlook fell to the lowest level in over two years, while Germany factory orders fell the most in three years.
- ◆ Last month the Chinese PMI for manufacturing recovered slightly, but remains at a very weak level of growth. The Chinese government is working on new incentives to boost domestic consumption for appliances and autos. The Chinese service sector PMI saw the seventh consecutive year of growth.

FUTURE PROSPECTS AND PORTFOLIO STRATEGY

- ◆ Domestic economic indicators are improving, but global macro uncertainty in policy areas such as taxes, fiscal and monetary policy, debt burdens and regulatory expansion will likely overhang the markets until after the presidential and Congressional elections.
- ◆ With earnings estimates declining for 2012, equity markets are now fairly valued based on historical measures. Sentiment is also neutral, having recovered from the negative levels late summer and fall. Interest rates remain near historical lows, making equities, particularly those with higher dividend growth, relatively attractive.
- ◆ Inflation will likely remain muted in the coming year, as slack in the labor markets keeps a lid on wages. Meanwhile, commodity prices have retreated as demand has waned in developing economies.
- ◆ Bond yields are expected to remain low while the Federal Reserve supports the long end of the yield curve and the debt crisis in Europe lacks a resolution. We continue to position taxable bond portfolios defensively with duration below benchmark since the reward is low for taking interest rate risk. We favor higher quality corporate bonds.
- ◆ Municipal bond yields are near historic lows yet the municipal yield curve remains steep, though less steep than a year ago. Prospects for additional gains depend on further curve flattening. Issuance is forecast to increase modestly in 2012. Political risk of changes to tax exemption or changes in income tax rates could cause disruption to the municipal market.

The Arrington Building
1802 Bayberry Court
Suite 400
Richmond, Virginia 23226

804.288.0404
800.787.7414
FAX 804.288.7872
www.lowebrockenbrough.com

FOURTH QUARTER 2011 COMMENTARY

2012 Outlook

Debt Deflation versus Monetary Stimulus

For 2012, investors will continue to face a world challenged by numerous difficult economic problems. The crisis in Europe, excessive levels of public debt in developed economies, large deficits, fiscal austerity, global imbalances, deleveraging, and political transitions in many countries continue to keep investor tensions elevated. Of these issues, it seems like debt deflation will battle with monetary stimulus to be the dominant themes in 2012. While the near term risk for equities remains high, the broad environment for risk may improve throughout the year as monetary conditions continue to ease around the globe. 2012 will be the first year since 2009 that we experience simultaneous monetary easing around the world.

The Federal Reserve is committed to low rates through the middle of 2013. A number of emerging market central banks have shifted from their tightening policies of last year to easing measures, and more is likely on the way as inflation moderates. Europe is desperately taking steps to keep their crisis under control by providing liquidity to the banking system along with cutting borrowing rates.

The biggest risk to debt deflation overwhelming the positive impact of easy monetary conditions remains in Europe, where government bond rates remain high and bank funding stress measures continue at elevated levels. Steps have been taken to address liquidity constraints in the European banking system through lower borrowing rates and extended loans, but nothing of substance has been done to address the solvency issue in debt-stricken countries. Markets will face an early test in 2012, as both Italy and Spain have large auctions of government bonds scheduled in the first quarter, on their way to needing to raise \$590 billion Euros for the entire year. The perceived success or failure of these early auctions will be telling in both equity and fixed income markets.

Given the issues that global growth will face in 2012, we believe it makes sense to maintain some levels of cash in equity portfolios to be able to take advantage of continued volatility and to provide some protection in case the European situation deteriorates further. Valuations look reasonable but are not compellingly cheap, except relative to interest rates. Equities are modestly undervalued at 13.2X trailing operating earnings versus a long term average around 15X. We believe that unless some of the structural economic issues are addressed more forcefully that valuations will remain below average given slower growth rates and negative real interest rates in many developed markets. Earnings are currently about 20% above their long-term trend line with the risk that a significant economic slowdown causes earnings to fall to these levels. Based on trend line earnings, stocks are trading right in line with their long-term averages.

Valuations across developed international markets are cheaper than in the U.S. given the more immediate issues that they face. We would likely need to see more aggressive action from the European Central bank to significantly increase exposure to these markets. On the other hand, we are more intrigued by emerging markets where valuations are also fairly attractive. A number of central banks in emerging markets have shifted from tightening monetary policy to cutting rates as inflation falls. Typically, it takes about six months for policy shifts to begin to impact economic activity, and we may look to increase exposure as opportunities present themselves.

**The Arrington Building
1802 Bayberry Court
Suite 400
Richmond, Virginia 23226**

**804.288.0404
800.787.7414
FAX 804.288.7872
www.lowebrockenbrough.com**

FOURTH QUARTER 2011 COMMENTARY

Given fair valuation levels, monitoring sentiment levels may be a key way to tactically adjust exposure as we move through 2012. Sentiment levels are currently neutral, but have moved up significantly from the lows seen last summer/fall. The Ned Davis Sentiment Composite is moving toward neutral levels, while the short-term measures suggest that sentiment has become overly optimistic. The Investors Intelligence survey that we monitor shows 49.5% of those surveyed are bullish versus 30.5% bearish. These are optimistic levels, but not yet at levels that suggest overconfidence.

The interest rate and credit environment is very mixed across the U.S. and Europe. In the U.S., rates are very low and credit spreads are slightly wider than their long term averages for most non-Treasury instruments. On the other hand, Europe (outside of Germany) continues to see significant pressure on rates. While the European Central Bank has cut rates, spreads on European debt relative to German yields suggests significant risk to these countries funding themselves at reasonable and sustainable levels. Italy has become the center of the crisis given the size of their debt markets and the significant holdings of Italian debt across the European banking system. Italian 10-year bonds are currently yielding over 7%, over 5% above the comparable bonds in Germany.

The macro economic environment also remains bifurcated, with recent improvements in data in the U.S. and pressure on economic conditions across Europe. Europe entered recession in the fourth quarter, and the magnitude of the slowdown will likely depend on their ability to contain the debt crisis, as well as the impact of the multitude of austerity measures being applied across most countries to get their budget situations under control. Markets have so far given the U.S. a pass on getting our fiscal house in order, even as politicians have failed to live up to any promises of a long-term deficit reduction plan. However, this is not likely to be the case after we move past the elections later this year. In the near-term, markets will also be focused on whether policy makers extend the social security tax cuts and extended unemployment benefits past the two month extension approved at the very end of last year.

Our portfolios remain well diversified heading into 2012 given the wide range of likely outcomes. Equities may well continue to trade in the range they traded in 2011, unless fundamentals break significantly one way or another. This range would represent 11-13.7X the approximate \$100 in earnings we expect for 2012. Earnings revisions have been revised lower over the past six months with only a little over 30% of the companies in the S&P 500 showing an increase in estimates. Many of the more defensive sectors, especially Utilities and Telecommunications, look expensive after their outperformance last year. International and emerging equities are unlikely to underperform as significantly as they did last year; there may be room for outperformance, particularly in emerging markets, as the rate cut cycle leads to improving economic performance. Fixed income portfolios remain defensively positioned relative to duration and maturity. On the other hand, they are more aggressively positioned with overweight positions in spread sectors as Treasuries look very expensive.

In conclusion, markets seem to be discounting slow growth in the U.S. and recession in Europe. Central banks in the developed world are expected to maintain accommodative monetary policy and those in emerging markets also have room to cut interest rates as inflation moderates. Policies of fiscal austerity in conjunction with monetary easing will act as the cross currents that investors must navigate in 2012.

**The Arrington Building
1802 Bayberry Court
Suite 400
Richmond, Virginia 23226**

**804.288.0404
800.787.7414
FAX 804.288.7872
www.lowebrockenbrough.com**