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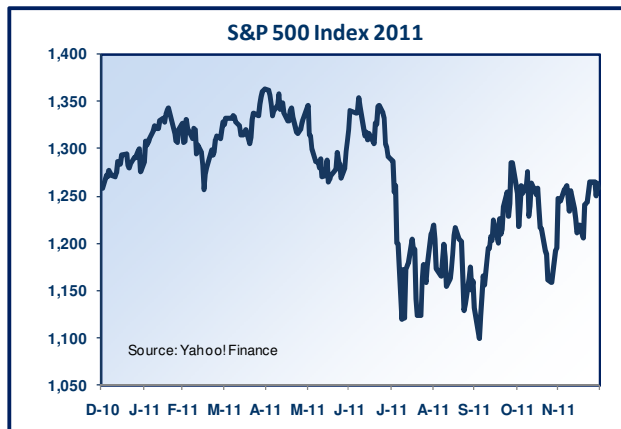
INVESTMENT COUNSEL

Quarterly Review and Outlook

4th Quarter 2011

Round Trip

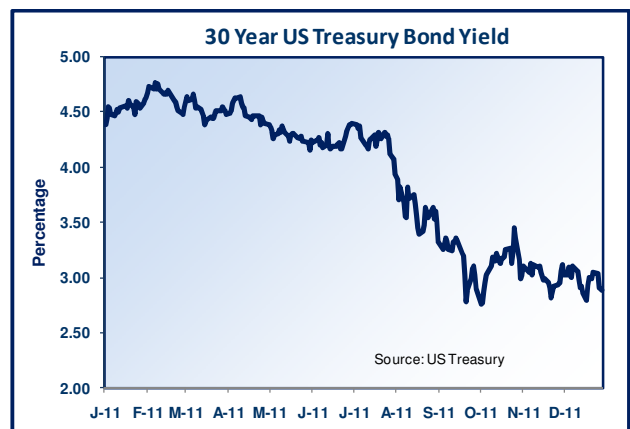
After an exhausting race through a global minefield, we find ourselves back at the starting line. On New Year's Day 2011, the S&P 500 stood at 1257.64. One year later, the index closed at 1257.60. Yet despite the apparent lassitude, the journey was far from uneventful and the fact that we broke even was cause for relief. Clearly the US economy continued to recover, showing signs of modest but encouraging improvement in output and employment. However, a host of challenges conspired to constrain the global recovery and highlighted the fragility of the expansion in the wake of the financial crisis. Since most of these challenges remain as yet unresolved, 2012 may end up looking much like 2011.



As noted, the S&P did nothing but mark time on a price basis, and yielded a total return of 2.11% with dividends reinvested. The Dow Jones Industrial Average turned in a better performance, up 8.38% thanks to

blue chip dividend-payers in the price-weighted index. Small caps continued to struggle against the headwinds of weak domestic demand, sending the Russell 2000 index down by 4.18%.

Perhaps most surprising was the decuman surge in the US Government bond market. Despite a historic downgrade of Uncle Sam's credit score, treasury bonds at the long end proved to be the best asset class, with the Barclays Capital Long Term Treasury index posting a startling 29.93% gain. Investors brushed off the downgrade and continued to pour into treasuries as a safe haven against the rumbling global storms. Flight to safety, combined with the Federal Reserve's implementation of "Operation Twist" aimed at further reducing mortgage rates, conspired to mash down yields on government paper. By year end, the 30-year US Treasury bond yielded less than 3%, defying the prognostications of most of the bond market gurus.



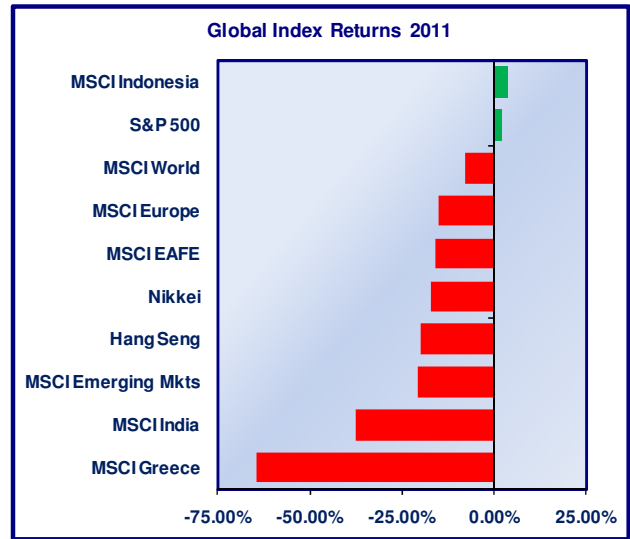
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While stock market returns in America were respectable if uninspiring, they were positively refulgent by comparison with the rest of the world. According to the Financial Times, global equity markets suffered a loss of \$6.3 trillion in value during 2011, thanks to a series of crises, natural disasters, and concerns about the diminution of emerging nations' outsized growth rates. The broad MSCI EAFE index of global non-US stocks lost 15.74% for the year, and the MSCI Emerging Markets Index gave up 20.60%, a sharp reversal from the 16.40% gain in 2010.

Interestingly, one of the few countries to turn in positive results besides the US was Ireland, up 7.75% as markets responded positively to the Irish willingness to adopt decisive austerity measures. Greece, on the other hand, suffered a 65% decline in their market index (on top of a 46% drop in 2010). Ouch.

Investors in Asian markets suffered their share of dyspepsia. Japan's Nikkei 225 average lost 17%, and the Hong Kong Hang Seng index dropped 20%. Concerns about the potential for a slowdown in growth of the Chinese juggernaut and speculation regarding the growing real estate bubble on the mainland were already on the table when the Japanese suffered a devastating earthquake and tsunami on March 11. The widespread destruction and the subsequent meltdown at the Fukushima nuclear facility crippled the nascent expansion of the Japanese economy and sent supply shocks around the world. Manufacturers from Apple Computer to General Motors were impacted by parts shortages that disrupted production. Then in October, a devastating monsoon and flood in Thailand damaged facilities that supply disk drives to the

major computer manufacturers and negatively impacted the entire sector.



Meanwhile, on the Continent, the ongoing saga of fiscal incontinence continued. The global financial crisis brought several EU members to the threshold of default. Having constructed a monetary union and formally adopted a common currency in 1999, the confederation neglected to provide similar unification of fiscal authority and looked the other way as some of the weaker countries loaded up on debt and lost control of labor productivity. Prior to last year, debt markets assumed that all EU members were effectively indemnified from default and therefore entitled to very low rates. In 2011, the game changed and markets began pricing in the risk of inevitable restructuring in several of these heavily indebted countries. Eurozone leaders continued to fiddle while Athens burned, and the flames quickly spread to Madrid and Rome. A lengthy and sometimes leisurely process of crisis response did nothing to instill confidence, and by year-end the markets were assuming the eventual default and possible expulsion of at least one member of the union.

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Regardless of the outcome of the ongoing rescue mission, it is a foregone conclusion that recession in the Eurozone will recrudescence in 2012. The MSCI European market index lost 14.98% in 2011 and seems unlikely to recover soon, as the medicine required to resuscitate the European confederation may prove to be beyond its willingness to swallow. Formal fiscal union under which the individual members surrender some of their budgetary sovereignty is a necessary but not a sufficient condition. The EU must also urgently address the systemic decline in labor productivity that has resulted from the confluence of creeping state socialism, protectionist unionization, and endemic corruption. This is a tall order indeed. Some incremental improvement is possible in 2012, but don't expect Eurozone ministers to deliver a sockdolager any time soon.

It is ironic that the US turned out to be the shining light (relatively speaking) despite a host of concerns and challenges on the home front. It is hard to recall a year in which so many important policy decisions were held hostage to such a dysfunctional political environment. And yet looking back over the year, there have been numerous signs of improvement in the US outlook that are cause for optimism. It is still the case that the American economy is the most robust and resilient in the world, and is probably the horse to bet on again in 2012 as the litany of global woes continues.

Earnings growth for large US corporations continued at an impressive pace, building on momentum from 2010. After a string of eight consecutive double-digit quarterly gains, S&P 500 earnings appear to have grown at a 7-8% clip in the fourth quarter, somewhat less energetic but still impressive considering the lethargy of the recovery.

Going forward, profit growth will undoubtedly decelerate but continue expanding, lending support to stock prices.

The employment picture is also brightening a bit, although progress is uneven. The unemployment rate declined from 9.4% to 8.5% over the course of the year, with a net addition of 1.6 million new jobs. That makes 15 consecutive monthly gains totaling 2.7 million jobs since the depths of the recession. One particularly encouraging development is the renaissance of the manufacturing sector in the US. Although it accounts for less than 10% of employment, the sector has been contributing disproportionately to new job creation, generally pays higher wages, and is providing more work hours per week than the service sector. According to the Institute for Supply Management, the goods-producing slice of the US economy has now expanded for 28 straight quarters.

Another long-awaited sign of life is the improvement in sentiment among small businesses. The NFIB monthly survey of small business owners reported a fourth straight increase, suggesting the possibility that hiring may soon pick up among the enterprises in the economy traditionally responsible for most of the job creation. While the index is still below pre-recession levels, the consistent improvement is reason for optimism.

Given the relative stability of the US capital markets and the high degree of trepidation regarding the rest of the world, America may be the best bet and 2012 may look a lot like 2011.

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