FEBRUARY 2012 MARKET COMMENTARY

Continuing the theme of recent newsletters, I remain bullish on equities in the long-term, and in the short-term, I also believe there's reason for investors to be optimistic. Profits are up, borrowing (at least for corporate America) is cheap and equity valuations are low. Yet, investors are mostly waiting to jump back in leaving ample opportunity for anyone willing to take the plunge. In fact, investors continue to bolt for the exits at the first sign of anything negative. The reasons appear to be pretty straightforward. Political disarray on both sides of the Atlantic continues to weigh heavily on investor sentiment depressing the prices of stock and various other risk assets.

Let's look at the bad news first. Europe's failure to diagnose and fix its problems is creating tremendous uncertainty. Europe seems unwilling or incapable of addressing its many problems, partly because they're really big and really ugly. The gluttony and sloth of a bureaucratic, entrenched welfare state can't be eliminated overnight. Yet, it's becoming increasingly clear – even to politicians – that there's a cliff at the end of this road, and changing course is the only option.

Fortunately, I still believe that Europe's problems – and they are many – will be resolved without inflicting tremendous pain on international markets even if the Euro dissolves. The reasons are pretty simple. First, allowing an economic Armageddon runs against the self-interest of the healthy economies. No one may want to help Greece or Portugal, but allowing these countries to take down the rest of Europe is even less appealing.

Second, emerging markets now account for up to 80 percent of global GDP growth with China and India comprising about half by themselves. Europe hasn't contributed to growth and isn't expected to either. Instead, emerging markets have assumed this role as they now play the game of capitalism far better than developed western nations and are reaping the benefits of much freer markets. While some estimates for emerging market growth have trended slightly lower over the last year, projections remain strong and more countries appear poised to join the wave.

In the U.S., uncertainty will continue with upcoming elections in 2012. The President's populist themes of attacking business, banking, private enterprise and anyone with any money will continue to rile markets. Yet, anticipated changes in the Senate that are expected to slow or stymie government's ongoing attack of the private sector will likely balance concerns over more burdensome bureaucracy and regulations. In the midst of the political rhetoric, the private sector should continue to plod forward albeit slowly.

While politics present challenges, the private sector offers more encouragement. Corporate profits remain strong, exceeding analyst estimates for the 11th straight quarter through September 2011. Moreover, corporate profits continue at record levels whether measured on an absolute or per share basis. And, corporate cash levels also keep setting new records. Some of the recent GDP strength (fourth quarter's growth rate was 2.8 percent) will likely dissipate after inventories are replenished, so, profits won't continue to beat expectations indefinitely. But U.S. firms should remain strong in spite of various challenges.

As corporations slowly part with cash, unemployment should continue to dribble lower although the pace of decrease will be slowed by discouraged workers reentering the labor market as more positions become available. More people working should increase consumer spending, and we'll likely see continued progress, even if slow, in key economic areas such as housing. Mobility should also increase as people more readily accept jobs assuming they can sell their homes.

Cheap money also continues to help corporate profits in the U.S. The yield curve remains fairly steep meaning short term money is less expensive than even the ridiculously low interest rate longer term loans. Historically, low short term rates increase profitability driving stock prices higher. Furthermore, the Fed has committed to keeping rates low into 2014.

Inflation also remains low partly because it's being held down by the housing prices. It's not a current concern although any savvy investment plan needs to assume that inflation could be a longer term challenge. Currently low inflation, however, continues to help corporate America.

Lastly, valuations remain well below historical averages across the U.S., developed and emerging stock markets. U.S. valuations are nearing the levels reached during 2009's panic, and price to earnings ratios are at values last seen on an extended basis in the mid to late 1980s. After a poor 2011 for foreign stocks, emerging markets price to earnings ratios are at levels not seen in 20 plus years other than the short-lived exception of March 2009. Developed market stock valuations are almost as low. Equities around the globe are cheap by almost every measure.

For these and more reasons, equities of both U.S. and foreign markets appear to represent an excellent investment opportunity over the next decade. It seems likely that interest rates and inflation will increase which could adversely affect corporate profits. Yet, over time, stocks have proven to be an excellent inflation hedge as companies raise prices to offset increased costs. And, management continually figures out ways to adjust to increased borrowing costs.

Yet, probably most significantly, relatively low equity valuations provide ample room for error. Historically, when stocks have been at similar levels to those of today, solid returns have ensued over the following decade. And low valuations extend beyond just equities. Many risk oriented assets such as real estate, commodities, and private equity are also priced attractively. If you have cash, now appears to be a great time to secure assets.

Many investors seem to have little choice other than embracing performance oriented assets. More traditional "safe assets" such as bonds, appear poised for problems. As mentioned in previous newsletters, the flood of money into bonds seems to have created a bubble in this asset class that will pop as rates revert to more normal levels. Even the anticipation of rate increases could easily send bond markets tumbling. In this context, to maintain purchasing power, many investors may be forced to abandon traditional safe assets that may not really be very safe, for risky assets priced at safer levels.

Over the next year and beyond, political issues and other inevitable global challenges will undoubtedly jar markets making any decision look wrong at some point. Yet, if you have a long-term perspective, many factors look very attractive and should reward investors willing to assume intelligent risk. We wish you the best as you make your investment decisions.

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