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S&P 500: 1258

OUTLOOK MEMORANDUM

We Are Feeling Better, But Still Holding Our Cash Reserves

The stock market has recovered since early October as progress has occurred toward resolving the European debt crisis and our own economy has firmed. The most important change has been the shift toward a reflationary policy by the European Central Bank. Fiscal austerity programs to reduce deficits are being implemented in various countries and mechanisms to provide international support have been agreed to. While these do not amount to a long-term solution to this problem, they make the worst-case scenarios feared by the markets last fall much less likely. Despite this progress, the credit markets remain nervous about the massive funds needed by the weak euro nations and European banks this year. Long-term solutions will require reforms both in Europe and here that are politically difficult and will take time to reach agreement on and implement. But, stock market valuations are depressed and the market's recent actions suggest an improving near-term outlook. Thus, there could be a meaningful rally in 2012.

In our October Outlook Memorandum we summarized our view as follows: *The investment environment deteriorated during the third quarter as renewed fears over excessive levels of sovereign debt in the US and Europe caused investors to anticipate a new worldwide recession. There is much evidence to support this view, and we reduced our stock market exposure to reflect this change. But, it is far from clear that the worst-case scenario currently reflected in the markets will occur, or that even this might be adequately discounted at current depressed market levels. While our economy has slowed, it remains on a growth path, with most of the companies we follow continuing to fare very well and expecting 2012 to be a year of further growth. Consequently, if credible steps can be found to limit the damage from the European debt problems, and if our own politicians can make some progress on our own deficit, stocks have substantial rebound potential over the next year. But, until we see some progress, we will remain less than fully invested.*

The stock market made its low for 2011 in early October as we wrote those words. Since then it has been working erratically higher as the major European parties grudgingly have progressed toward containing their problem and as our own domestic data has confirmed that our economy continues to grow, avoiding the double-dip recession that so many had feared. Although this progress is consistent with our leanings of three months ago, it remains unclear that the Europeans will agree on plans to resolve their debt problems that the credit markets will find credible, and that the credit markets will provide the hundreds of billions of euros needed to refinance the maturing debts of Europe's weaker nations and its banks during the first quarter of this year. Disturbingly, all of the sensitive credit market indicators we have been watching remain at alarming levels, suggesting market skepticism that this massive refinancing can be accomplished smoothly. If any stumbles occur, worst-case fears could resurface and the markets again could plunge.

The ECB policy change is a big plus. In our view, the most significant policy change in Europe during the past three months has been at the European Central Bank (ECB). With fiscal austerity being imposed in many of its member nations, the ECB's prior monetary tightness had made needed economic growth and the financing of debts far more difficult. In October we noted that the ECB finally had abandoned its insane policy of monetary tightness with an announced move to neutrality in September. Then, in both November and December, it reduced its benchmark interest rate by 25 basis points, and on December 21 it lent 523 European banks €17 billion for three years, thereby pumping significant new liquidity into the European economy. These are the types of central bank policies Europe needs, and this policy change meaningfully reduces for a while the probabilities of the worst-case scenarios investors were imagining last summer. The ECB continues to worry, however, that any steps it takes to lessen market pressures before Europe's politicians have implemented the needed spending cuts will provide opportunities for the politicians to avoid those spending cuts. In a sense, the ECB has been playing a game of chicken with the politicians, but the ECB blinked by easing.

And, some fiscal reform is occurring. Nonetheless, there has been erratic progress on the political front. On November 1, when Greek Prime Minister Papandreou attempted to put the austerity program he had promised the euro community to a public referendum, it looked like the proposed bailout of Greece would collapse and markets around the world plunged. But cooler heads prevailed, the Papandreou government was replaced, and the austerity program is being implemented. In Italy, which is a focus of investor concern because its sovereign debt is estimated to be an unsustainably high 120-130% of its GDP and which has to refinance more than €100 billion during the first quarter, Prime Minister Berlusconi's government fell when it was unable to implement a needed austerity program. Italy's new government headed by Mario Monti already has approved some of the reform bills and more are pending. Spain's debt is a concern of investors and it is helpful that voters there recently selected

a new government committed to austerity and fiscal reform.

International support mechanisms are being funded. At the super-national level, it is helpful that the euro nations agreed to make the European Stability Mechanism permanent and to accelerate its start to July, 2012 with initial funding of €500 billion. Its purpose is to provide financial aid for any euro state in financial distress. This provision for transferring wealth from the healthy euro economies to the weak ones represents a step toward fixing the obvious flaw in the euro arrangement of its being a monetary union without a fiscal union. Another super-national agreement involved the European Union countries agreeing to contribute €200 billion to the International Monetary Fund to be used by the IMF to provide debt relief to the troubled euro nations. This is another device for transferring wealth from the strong countries of the euro zone to the weak, but it is politically helpful in strong nations like Germany, whose citizens generally oppose bailing out the indebted nations. All of these steps will be very helpful in getting Europe through 2012, but they are one-time remedies that will need to be repeated in the future if the underlying causes of the euro problem are not corrected.

But, economic reforms are needed. The more fundamental aspects of this problem will take longer to fix. Underlying the high debt levels in the weak euro nations is that their economies are not competitive with others in the world at the current euro exchange rates. Since they cannot solve this problem by devaluing as long as they remain in the euro, the other solutions lie in reducing their wage rates, increasing their productivity, and improving the efficiency of tax collections. All of these are painful and politically difficult to implement. Some small steps are occurring as pension reform is being considered in Greece and Italy, and Monti has proposed relaxing various Italian labor regulations to make it easier for people to start and operate businesses. Ultimately, the best way to reduce debt burdens is to grow their economies as debt is reduced so that the denominators of their high debt/GDP ratios rise while the numerators fall. Until the credit markets see these economies being put on paths to

becoming competitive and capable of achieving real growth, they are likely to view all of the other financial developments as short-term fixes rather than long-term solutions.

Reduced risk of the worst-case scenarios. Consequently, it probably is premature to say that we are putting the euro debt problem behind us. The credit markets are far from being convinced that enough has been done to put lasting solutions in place. More positively, however, the constructive developments of the past three months have made the major financial and economic collapses the markets feared last summer far less likely to occur during 2012. This is significant. Since the stock market was beginning to discount such scenarios in late-September, these positive developments have produced a promising rebound in stock prices. If the huge refinancing of the first quarter can be accomplished while the euro nations reach agreement on additional aspects of a collective support program and economic reform, it is possible that stock prices could be launched on a longer-lasting rebound by the springtime. We would expect to see such a move signaled by a decline in the various credit market indicators we watch from their recent alarming levels. Whether the rebound could be sustained, or not, would depend on future European progress on the competitiveness and growth questions, as well as on whether the US is seen as addressing its own debt problems.

No progress on US deficit. On this issue, the news has been disappointing. The bipartisan Congressional Super Committee set up in August to propose a plan for long-term deficit reduction failed to reach agreement on anything. With the 2012 election battles now underway, we do not expect any significant progress to be made this year. To the extent that fears about long-term debt issues and deflation have been weighing on stock market valuations, we cannot expect to be freed of this concern this year.

US economic growth will continue this year. Throughout 2011 our view was that the fears of a double-dip recession in the US were exaggerated. Recently, the stock market rebound from the

October 3rd low has been helped by growing evidence that economic growth is accelerating. This will provide a helpful background for the market this year. We currently think S&P 500 earnings will rise about 10% this year to about \$108, but this may be conservative. Most of the companies we own achieved earnings growth in 2011 that exceeded the 14% of the S&P 500 as well as beginning-of-the-year analyst forecasts, and we expect this to be the case again in 2012.

Debt-deflation fears have greatly depressed stock valuations in recent years. In making judgments about the stock market outlook for 2012 and beyond it is important to understand the hugely depressing effect that debt and deflation concerns have had on stock prices since 2008. In normal economic times, the P/E ratio of the stock market falls as interest rates rise, and rises as interest rates fall. For most of our careers, low interest rates were considered bullish. But, just as too much of a good thing can be bad for you, interest rates that are too low indicate serious problems are threatening to deflate the economy and thus these low interest rates depress rather than raise P/E ratios.

Interest rates recently have been in this depressed, deflationary zone. For example, the 10-year US Treasury bond yield ended 2011 at 1.88%. Over the past 55 years, there have been only 13 months during which the 10-year US Treasury yield was below 3.0%, and all 13 of these months have been during the past three years. Our research indicates that the current low 10-year US Treasury yield, and the deflationary fears it reflects, recently have depressed the P/E ratio of the S&P 500 by 30-40% versus where it would be in the absence of these fears. Therefore, with the S&P 500 having ended 2011 at about 12.8 times expected 2011 earnings, it has significant appreciation potential if these fears were to begin to subside.

Of course, it would be quite unrealistic to expect the sentiment underlying such a large P/E discount to reverse during the course of one year, especially since the European problem is unlikely to be fully solved in 2012 and the US will not begin to address its problem until next year. But, if Europe is seen as making progress and its first quarter

refinancings go smoothly, it is quite possible that the extremely bearish sentiment will lessen and that both the 10-year US Treasury yield and the S&P P/E will reflect this and rise. A 9% rise in the P/E from 12.8 to 14.0 combined with a 10% increase in S&P 500 earnings would produce a 20% gain in the S&P 500 this year. A rise to a still-depressed 15 P/E would produce a 28% gain. On the other hand, if the euro nations fail to agree on further steps and if Italy or Spain are unable to refinance their maturing debts, the stock market could fall back to its October low. We think the former is more likely than the latter, but the uncertainty and risks are leading us to keep roughly 20% of our stock money on the sidelines until we see more evidence that the credit markets are relaxing.

The S&P 500 may be signaling better times. Sometimes the stock market gives us clues about what “it” wants to do. As shown in the chart below, since its correction low on October 3rd, it has risen by 14.4% tracing a “reverse head and shoulders” pattern that is characteristic of stock

market bottoms of the past. It also has formed a series of waves where each successive low is higher than the prior. In the past, this too has been characteristic of markets on the rise. In doing this, the market has broken through both its 50 and 200-day moving averages (respectively, the red and green lines in the chart) and its 50-day moving average seems headed to cross above its 200-day average sometime in the first quarter of 2012 (possibly on news of successful bond auctions by the indebted euro nations.) If this so-called “Golden Cross” occurs, it would confirm that the market correction is over and the bull market has resumed. These patterns are very similar to those traced during the summer and fall of 2010 following the first leg of the European debt crisis, and the S&P 500 then rose by almost 22% between October, 2010 when that Golden Cross occurred and its subsequent peak at the end of last April. Perhaps this is an optimistic note on which to conclude. We currently have about 80% of our stock funds invested to reflect the above-average risks, but if these risks continue to moderate, we are ready to reinvest our reserves.

