December 2011

# Executive Summary

**2012: Light at the End of the Tunnel or a Mirage?**

If someone told you at the beginning of 2011 there would be more than 3,400 points of daily movement in the S&P 500 over the coming year, would anyone have guessed the S&P would finish the year unchanged? That is exactly what occurred. Investors in the equity market experienced massive volatility for little or no gain. Investors in European and small cap equities fared far worse. The Morgan Stanley Capital International Europe, Australia, and Far East Index (EAFE) finished the year down 12.14 percent and emerging markets equities declined 20.6 percent.

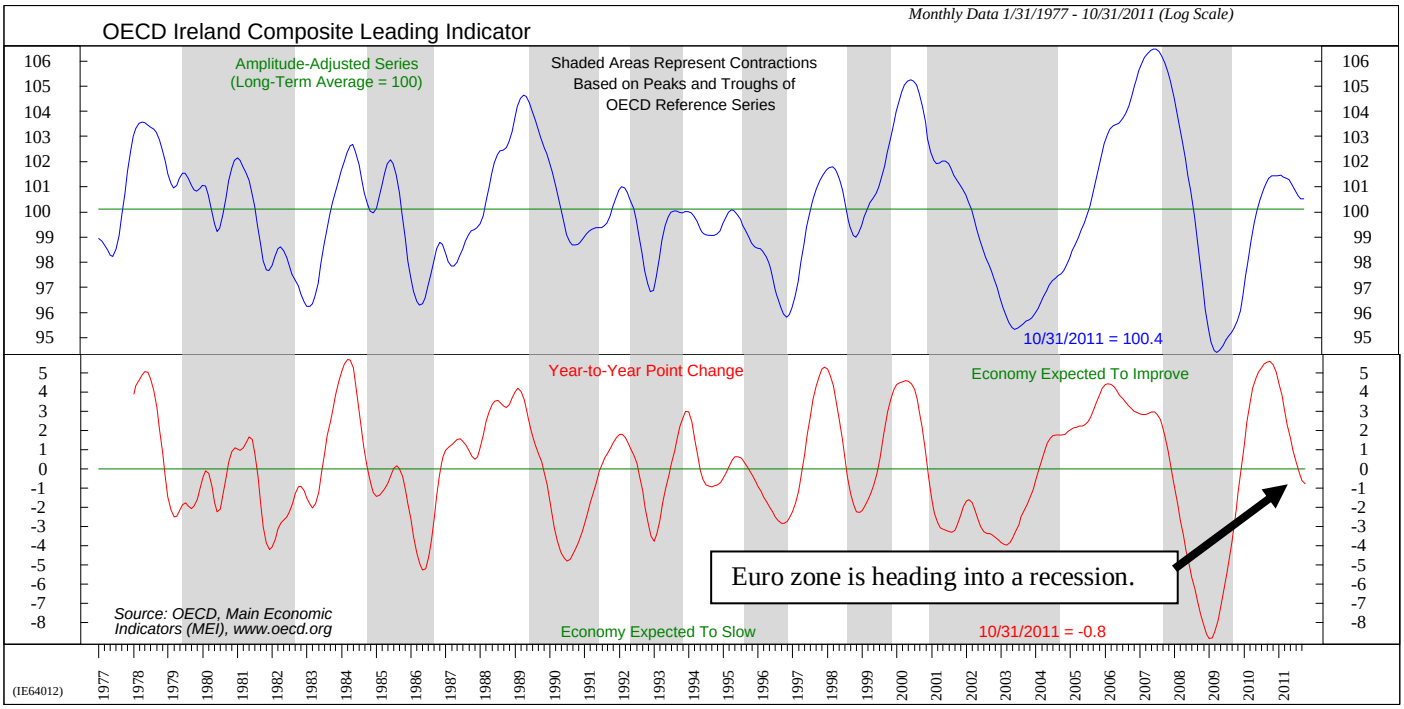
Income strategies were the leading opportunity for investors in 2011 as returns from bonds and dividend-focused equities far exceeded those of other asset classes. Good corporate fundamentals were overshadowed by the European debt crisis, a slowdown in China, and continued record U.S. deficits. S&P 500 operating earnings increased by 15.81 percent in 2011 over 2010; yet the market remained flat. The markets are pricing in an earnings slowdown in 2012, but it is not yet evident if the global economy is headed back into recession or moving toward a second half surge in the latter part of 2012.

Massive outflows of equities since May 2011 pulled $163 billion from equity funds. Bond funds were flooded by investors flocking to more stable income producing instruments. Equities are trading at historically low levels based on trailing earnings, so investors might think twice if they are tempted to abandon them. The S&P 500 is currently trading at less than 13 times earnings versus a 30-year average of 18 times. Developed international equities are trading at less than 9 times trailing earnings, and emerging markets are trading at a 20 percent discount to their historical average. At the same time, high quality bonds are trading at some of the lowest yields in history with the 10-year U.S. Treasury now trading at 1.95 percent, 10-year AAA-rated general obligation municipal bonds are yielding 2.08 percent and 10-year AAA rated corporate bonds are yielding 3.79 percent. We are fans of income producing instruments; however we would prefer investors focus on oil and gas Master Limited Partnerships (MLPs), preferred stocks, high yield municipal and corporate bonds, royalty trusts, high dividend paying equities, and income producing real estate. These instruments will typically perform much better in a recovering economic environment than high grade bonds.

Over the past few months, the economic data has pointed to a slow recovery in the United States, possible recession in Europe, and a slowdown in China. The following situations are key to capital market performance in 2012.

**European Debt Crisis**

The European debt crisis is not only slowing growth within Europe, but it also has the potential to impact consumer and business confidence across the globe. The potential fallout from a break-up of the euro zone concerns many economists around the world. Economic data is pointing toward a renewed recession in the euro zone, which could have substantial negative feedback loops along with it. The euro zone is the largest consumer of Chinese exports, which have declined dramatically over the past few months. Germany is the key to a resolution to the euro zone crisis. If Germany demonstrates that they are willing to put their balance sheet on the line for the benefit of other countries, while also allowing the ECB to print money to re-capitalize their banks, a turning point in this crisis could be at hand.

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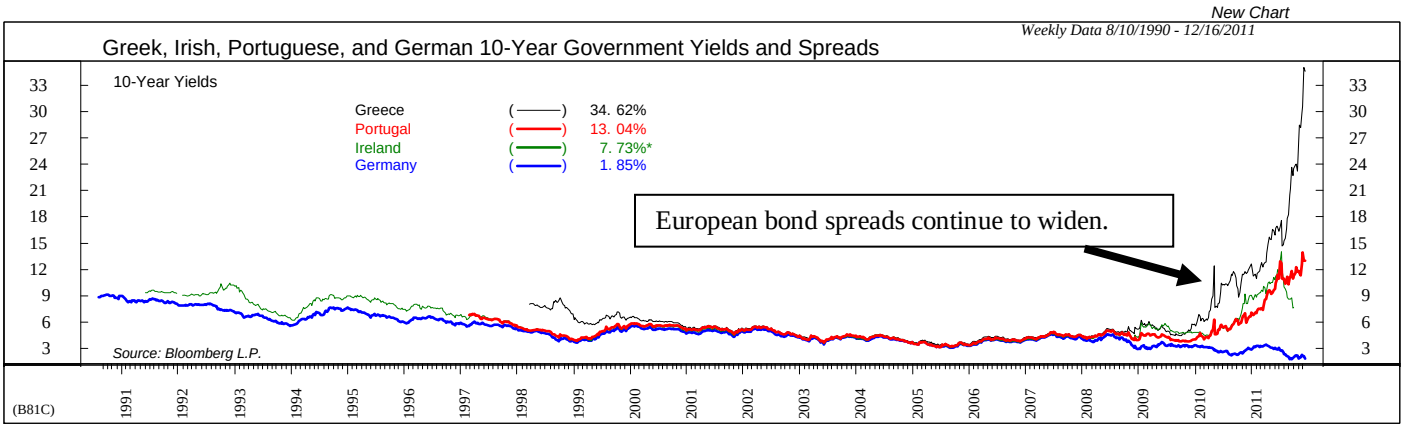


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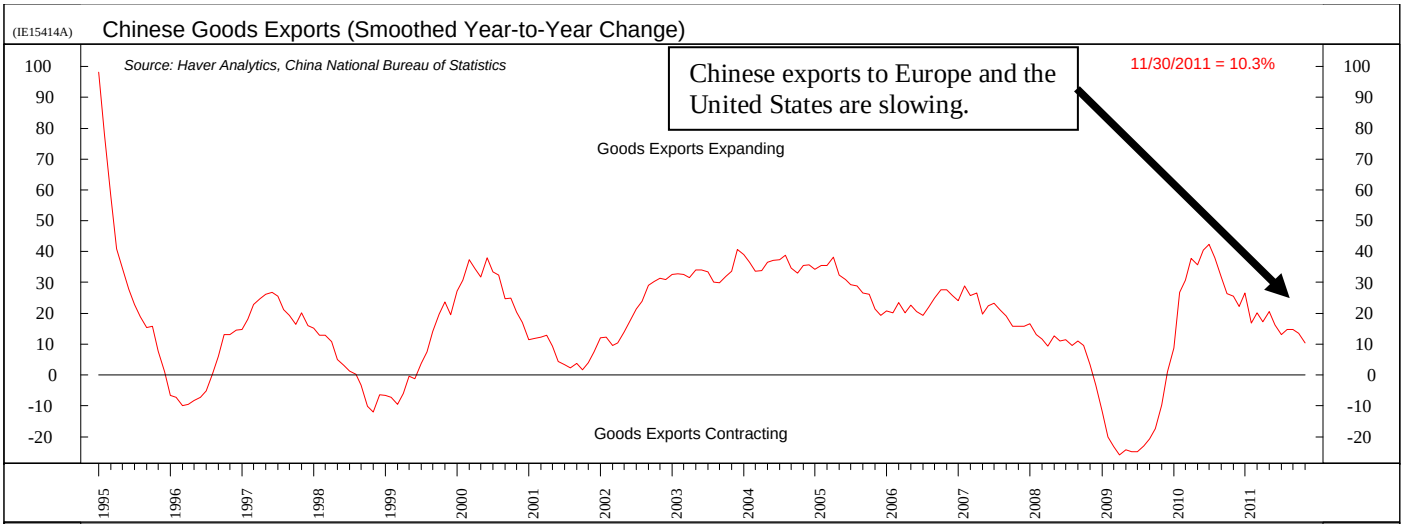
## China

China looks to be heading for a hard landing in their real estate market. Debt lending against real estate in China has been on a tear since 2008. The government attempted to offset a global decline during the U.S. credit crisis in 2008 by lowering their lending standards and interest rates. Real estate speculation became rampant and housing prices increased as much as 20 percent from month to month in early 2010. In some major cities, such as Beijing, prices for residential real estate rose over 80 percent (Source: *The Telegraph* 28-Feb-2010). We are now seeing the other side of this real estate bubble. Condo prices in Shanghai have peaked, and developers are slashing prices on unsold inventory by 20–30 percent from prices paid just six months ago. China, a major global consumer of commodities, looks as though its demand for commodities will be slowing over the coming quarters. This will place downward pressure on the commodity complex including energy, grains, and industrial metals. Chinese stocks are forecasting a hard landing as the Shanghai composite was down 19.6 percent in 2011 and remains 61.2 percent below its 2007 peak (through 12/19/11). The good news is that China, along with Brazil and India, is now beginning to ease its monetary policy which had been in a tightening mode for the past two years. Equity markets tend to bottom when monetary policies shift ease. Have Chinese equities now bottomed after a 61 percent decline over the past four years? We may know this year.

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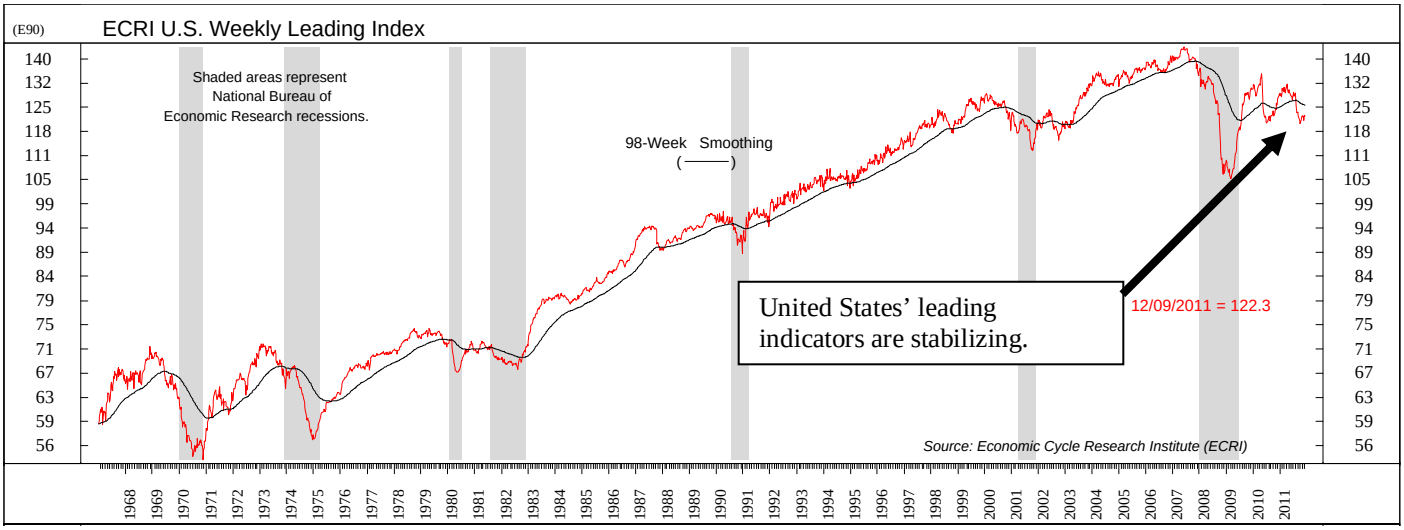
## U.S. De-Leveraging Cycle

The U.S. economy remains in a de-leveraging phase. The good news is that U.S. consumers have reduced their debt-to-income ratio back to 1992 levels. In addition, corporate income statements and balance sheets are as strong as any time in history. The problem is that the U.S. federal government is running record deficits and is showing no conviction to resolve this situation. The good news is that in January 2013 expense reductions will take place automatically in Washington that will reduce the Federal deficit by $1.2 trillion over the next decade. Jobs data, retail sales, and U.S. consumer confidence are beginning to show signs of turning, and we will need to watch this data closely over the next couple of months to see if this is a short-term aberration or the beginning of an upturn in U.S. economic activity.

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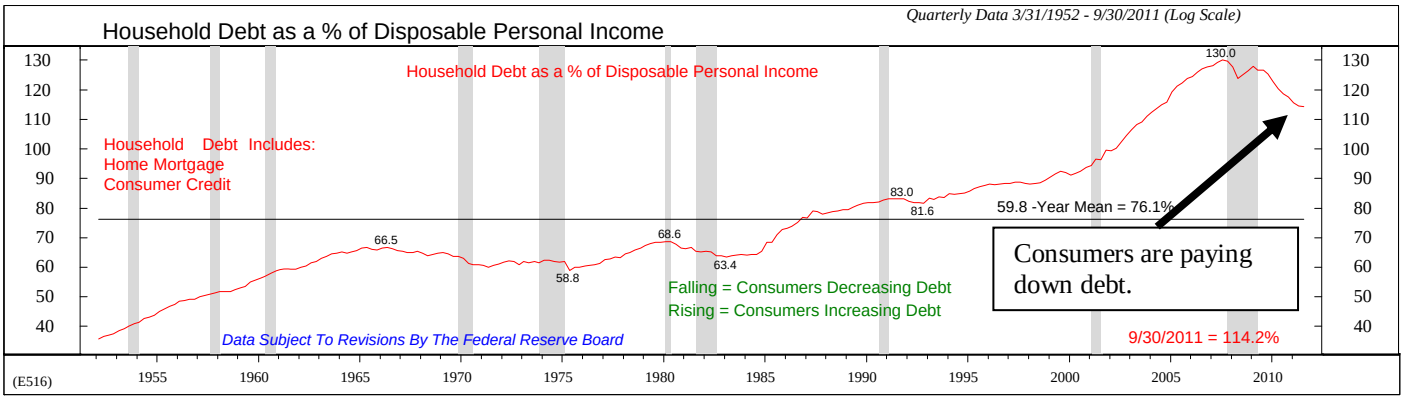


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# Economic Overview

**Positives**

- New claims for unemployment have fallen over the past month indicating fewer layoffs.
- U.S. auto sales and retail sales have shown a modest lift over the past couple months.
- U.S. consumer confidence data has improved for three straight months.
- Central banks around the world are beginning to ease in a coordinated fashion.
- U.S. housing data shows that some markets have now bottomed (Boston, Fort Myers).
- U.S. banks are much better capitalized today than at the peak of the credit crisis in 2008.
- Interest rates are at record low levels allowing consumers, governments, and businesses to borrow at extremely attractive rates.
- U.S. gross domestic product figures have defied those suggesting a U.S. recession in Q3 and Q4 of 2011.

**Negatives**

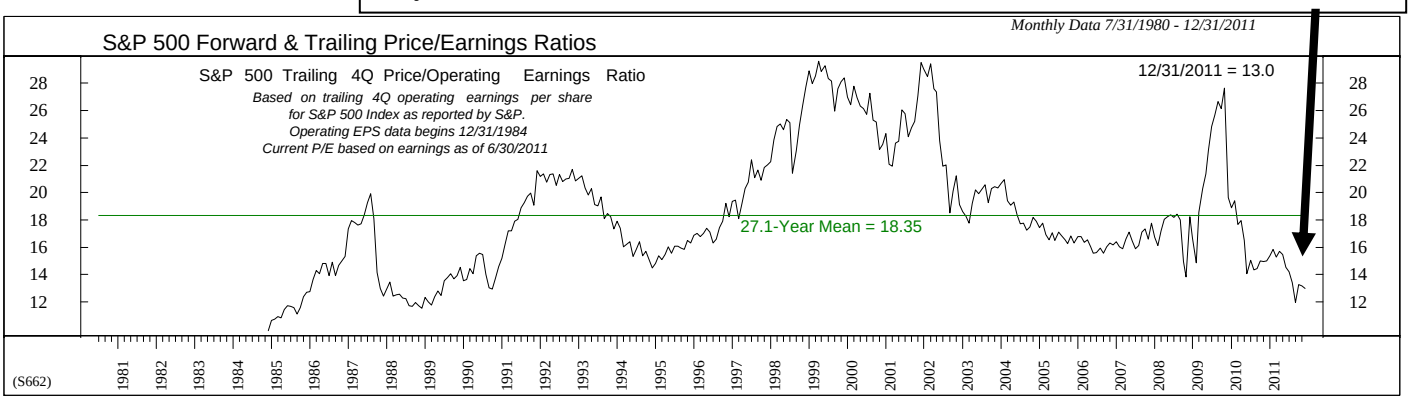
- Transfer payments (unemployment, food stamps, social security, etc.) have become a much higher percent of household income over the past four years.
- The U.S. government is running an approximate $1.5 trillion deficit annually and pays approximately 32 percent of its bills through borrowing. This is not sustainable.
- European credit spreads continue to widen and interbank lending in Europe remains precarious.
- Until the European banks are recapitalized and government budgets are balanced in the Euro zone, we believe this crisis will continue for the foreseeable future.
- We have witnessed an above average number of companies announcing negative earnings for the fourth quarter of 2011 (Intel, Oracle, Texas Instruments, Du Pont, Best Buy).

## Technicals

The S&P 500 has now recaptured its 200-day moving average which will serve as a positive for the markets if the market can hold this level for the next few days.

# Fundamentals

Based on trailing 12-month earnings, U.S. equities are the cheapest they have been in the past 25 years.

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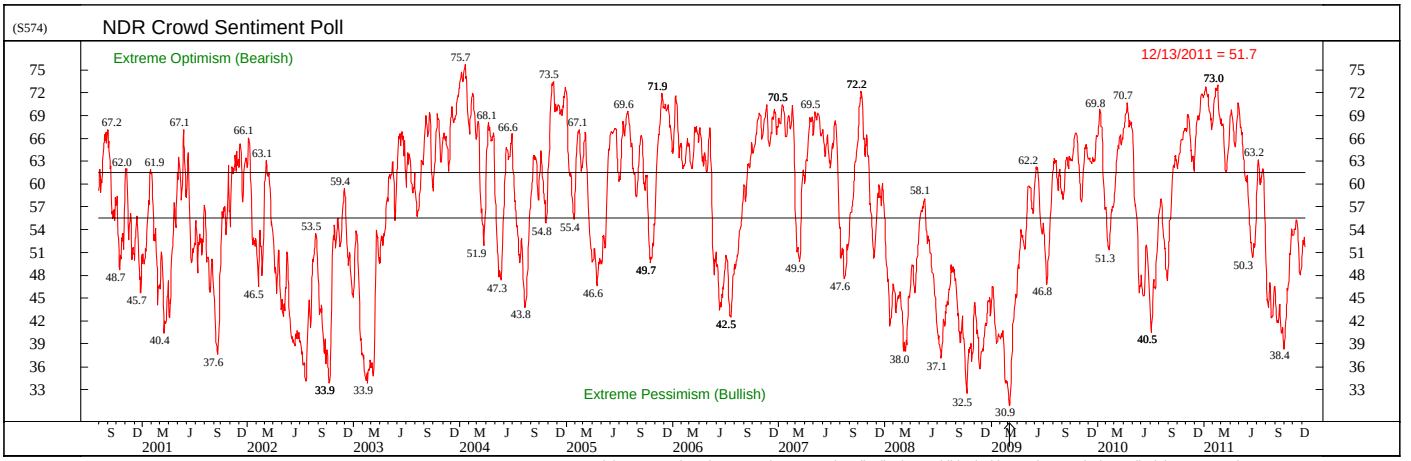
# Sentiment

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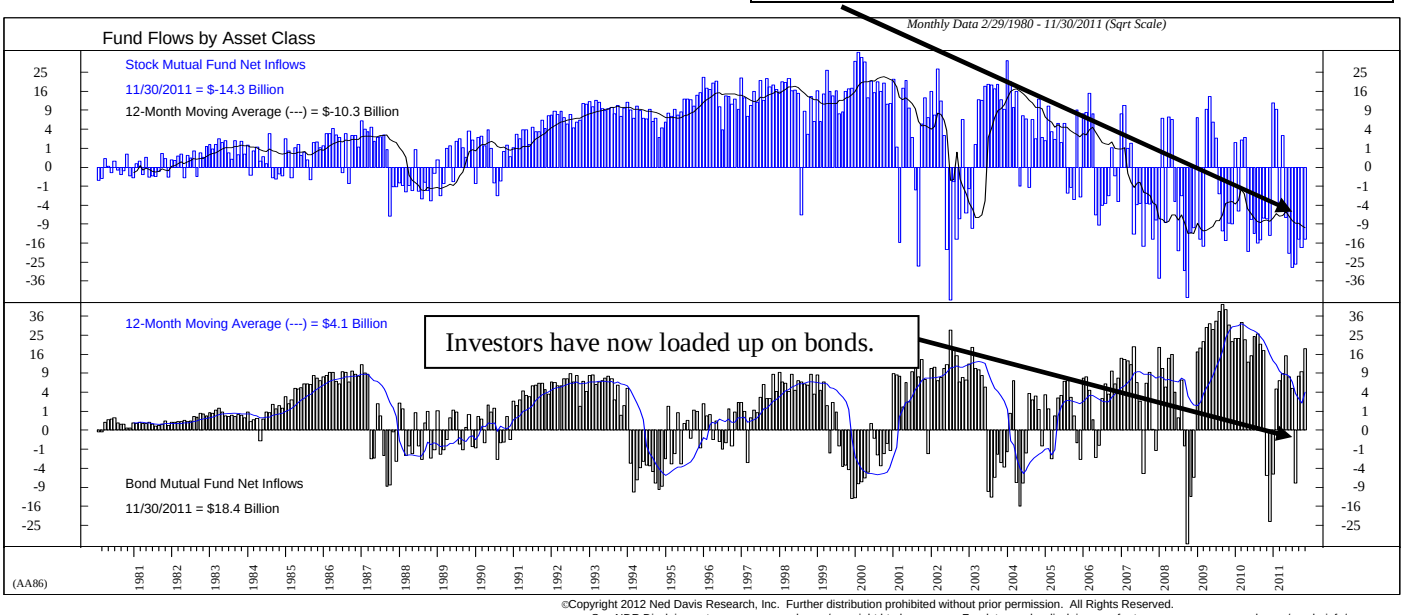
Investors have fled from stocks in the past six months.

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## Conclusion

Because of the massive outflow from equity mutual funds over the past six months and record inflows in bond funds, a contrarian investor would not abandon equities at the current time. We would advise clients that need income to diversify their portfolio with reflationary income vehicles such as master limited partnerships (MLPs), royalty trusts, preferred stocks, high dividend stocks, private income producing real estate, and high yield municipal and corporate bonds. After a terrific year in 2011, an investor who is heavily invested in high quality investment grade municipals and corporate bonds would find themselves very disappointed in 2012 if the 10-year Treasury yield were to climb from the current 1.95 to 3.00 percent by the end of 2012. Risks remain high due to the European debt crisis and the potential for it to cause a systemic global debt crisis. However, we have witnessed massive transformation over the past few months within the euro zone. If Germany displays the willingness to place its balance sheet on the line and also allow the European Central Bank to print euros, which will provide the funding to recapitalize European banks, then one could begin to get more constructive on the global economy and risk assets around the world. This may be a year to become more balanced in one's approach assuming the euro-zone gets its act together. With everyone rushing out of stocks in 2011 and into bonds, a contrarian would consider moving in the opposite direction of the herd. We were positioned defensively in 2011; however, compelling valuations have us looking at adding to risk assets (stocks, MLPs, commodities, and high yield bonds) in 2012.

We wish you a healthy and prosperous 2012!

Sources: Ned Davis Research, Bloomberg, Bankrate.com, BCA, Zero Hedge, StockCharts.com, and Leuthold Group

*This Market and Economic Update is prepared by LarsonAllen Financial, LLC. If you have any questions, please call 1-888-925-2926 and ask to speak with a senior wealth advisor or one of our principals.*

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