

“Distrust and caution are the parents of security.”
Benjamin Franklin

“Patience is the companion of wisdom.”
Saint Augustine



- **Year End 2011...Please!** Whereas one would prefer to wax nostalgically upon the close of the calendar year, we will be glad to turn the last page of the 2011 calendar. Noting as we do, however, that a Presidential election looms. It's difficult to get excited about the media blitz we will be doused with in the months ahead and reason to believe that few of the uncertainties that prevail today will be clarified.

- Our past three quarterly issues have used many words to describe the environment:

anxious, uncertain : financial markets

disastrous, frightening : weather and natural disasters

disgraceful : the behavior of our political leadership

- To this array of negative connotations, we now add....**distrustful**. In both our country's so-called leadership as well as the fairness of the financial markets, many have grown completely distrustful. Sadly, we get it.
- **Investment returns reflect this** as investors continue to favor investments that provide the perception of principal safety: (year-to-date total returns through 12/20/2011)

Bonds

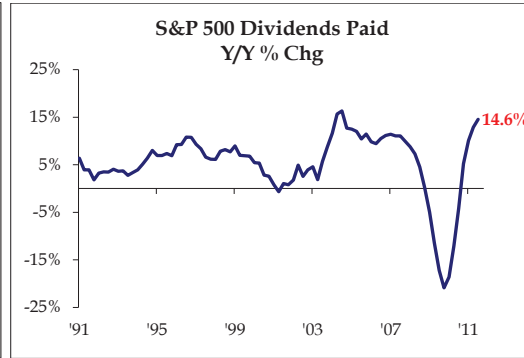
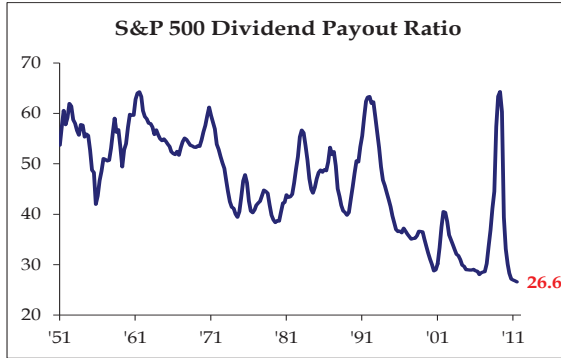
Intermediate Gov't/Corp Bond Index: +5.47%
5-Year Municipal Bonds: +6.62%
6-month Treasury Bills: +0.27%

Stocks

Standard & Poors 500: +0.74%
EAFE Index: -12.92%
Emerging Markets: -19.12%

- **Don't be fooled** by these numbers.... The buoyant returns from bonds are not so much the result of their interest income as they are the result of the further decline in interest rates. The decline in interest rates has been the result of investor and Federal Reserve purchases of bonds, pushing prices higher. By extension, future bond returns will now be lower.
- **By contrast**, note that the near-zero return from the S&P 500 has occurred despite earnings –the propellant for share prices - having grown by over 15%.
- **So profound is the bias toward the “return of my money”...** investors are willing to earn less interest income on a bond than they are already losing to the rate of inflation. Further, reversing a trend not seen in decades, dividend yields are, for the most part, higher than bond yields.

- **Dividends!** We would point out that in the past 60 years the dividend payout ratio (dividends relative to earnings) has never been lower. Flush with cash, these same companies elevated their dividends by over 14% in 2011. This **growth in income** – in our opinion – is the single most important investment issue today.



Strategas Research Partners

- **And we thought economics was the dismal science...**The past year has certainly seen more reference to politics and public policy in this piece than what we would prefer, but at present, investment behavior is being highly influenced by both. Health care and banking industry reforms are so lengthy and obtuse that the details have yet to be determined months after the legislation. Tax and entitlement reform have been left largely unanswered with only short-term, finger-in-the-dike responses. Businesses and investors alike have little on which to make long-term decisions and there appears little reason to expect this will clarify in 2012.

- **“A man in debt is so far a slave.”** (Emerson)...The problems here and in Europe are found in having over-borrowed from the future. We have discussed **payback** in these pages previously, but the simple fact is that monies previously borrowed must be paid back and this, in and of itself, reduces future spending.

- **Payback = Cutback...**No one likes to cut their expenses, especially not politicians. Unfortunately, rather than rallying the country around the patriotic need to secure the future of our children, the country’s leadership has instead created a war of us-against-them. This, in the most generous country on the planet....

- **No escape...**Fiscal austerity is coming.

- **The “bond vigilantes” will prevail...**Such austerity can either be dealt with proactively or not. As to the latter, we give you Italy to bear witness that the ability to borrow is not infinite.











- **Bond market hell...**For investors who don’t fully appreciate the consequence of such a rise in interest rates on bonds, know that the market value of Italy’s 10-Year government bonds fell by over 20% in the period from August 2010 to September of this year. Don’t think that couldn’t happen here.

- **Europe...**For the immediate future, the fate of the Euro will remain the potential bomb in the room. The problem is less about a sovereign default and more about the European banks which would likely fail as a result. Such a failure could lead to a credit crisis similar to what occurred here following the failure of Lehman Brothers in late 2008.

- **Still...****Our contrarian senses** tell us that the Euro’s impending failure may be the most anticipated disaster in financial history. For our part, we understand the danger, but we wouldn’t bet against tough-minded Angela Merkel. She knows full well that the Euro needs to survive if Germany is to compete globally in the years ahead.

- **As seen in this illustration...**The collective 17 countries are an economic force to be reckoned with. Alone, the GDP of Italy is roughly equal to that of California.



2010			
Rank	Country	GDP \$Million	Debt/GDP
	 European Union	15,203,145	
1	 United States	14,526,550	94.36
2	 China	10,119,896	33.83
3	 Japan	4,323,504	220
5	 Germany	2,944,352	83.96
7	 United Kingdom	2,181,456	75.5
9	 France	2,134,941	82.33
10	 Italy	1,778,832	119
13	 Spain	1,372,720	60.12
37	 Greece	318,670	142.76

- **Absent a meltdown in Europe...** Stocks in the developed markets are extremely cheap (1.5x book value and 12.5x earnings) while emerging market stocks are even cheaper (less than 11x earnings).
- **Is there a ray of light or are we caught in an inescapable swirling motion?** Yes, there is light, but it is emotionally difficult to see in an environment where *distrust* prevails.
- **A glimmer from our smallest state...** To be sure, the take-the-bull-by-the-horns version of putting one's fiscal house in order is much harder to find.... Straining our eyes.... Could it be?...No, it's not Santa, it's....it's **Rhode Island!**

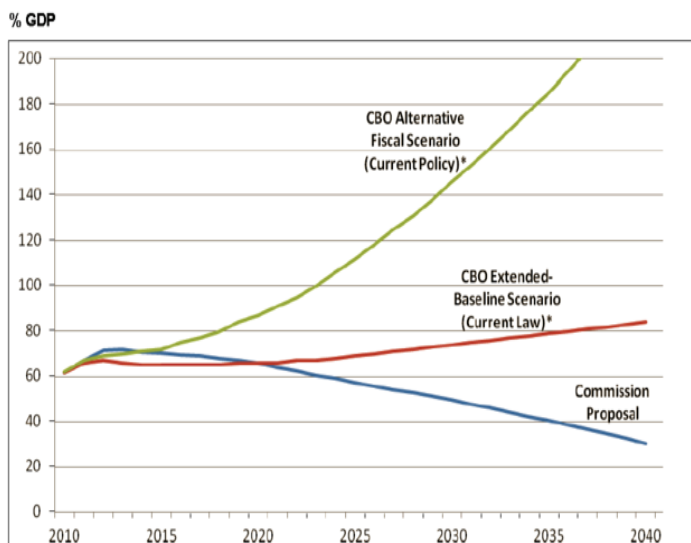
Two years ago, when Gina Raimondo was deciding to run for Rhode Island general treasurer, she saw a newspaper article about budget cuts affecting libraries in Providence and Cranston and bus service on nights and weekends. It hit a nerve for Raimondo, worried that her home state's growing pension commitments would crowd out money for such vital services. "Essentially, the longer we delayed fixing pensions, the harder it would be for the state to provide these services. The reality was that the system was at a breaking point," Raimondo said in a lengthy interview. Raimondo, a Democrat, won election in 2010, and Lincoln Chafee, a former moderate Republican U.S. senator, became an independent governor. They took office in January in the nation's smallest state — which had one of its biggest unfunded pension problems, with an unfunded pension liability estimated at \$7.3 billion, according to Washington think tank the Pew Center on the States, up 47% from \$4.7 billion in 2009. Disregarding skeptics who said they were stepping on a political third rail, the two set out to overhaul Rhode Island's burdensome pension system. "People said you can't touch benefits. They said the unions were too strong, it was a political taboo, don't touch it," Raimondo said. "People were always shooting for a fix, for next year's budget. We said not next year. We want retirement security for the long term. And as treasurer, I was not going to go away for a while." The far-reaching package that passed last month creates a hybrid plan merging conventional public defined-benefit pension plans with 401(k)-style plans. It also includes a suspension of cost-of-living adjustment increases for retirees and raises the retirement age for employees not yet eligible for retirement. The new program will take effect July 1. (The Bond Buyer, 12/14/2011)

- **Just maybe...** If, having successfully dealt with the elephant in the room and not burst into political flames, Rhode Island might just become the prototype for dealing with the much larger issues faced by our Federal government.
- **There is no silver bullet...** Even if these issues are dealt with in straightforward fashion, the influence of payback will be felt for many years. Fiscal sobriety will be the "new, new thing". And, while we may be in monetary detox, the borrow-from-the-future regimen was an end-game whose time is up.
- **Is the world as we know it coming to an end?** Far from it. In the back of everyone's mind this day was coming. The sooner it is dealt with forthrightly, the sooner we can all adapt and get on with our lives.
- **Adapting...** In our day-to-day world, one of the biggest issues retirees face is their withdrawal rate....With interest rates at near-zero and stock market volatility of nausea-inflicting proportions, what does a retiree do? Not to be the Grinch in the room, but the most immediate and guaranteed "return" one can earn is to reduce their expenses. Whereas the "safe" withdrawal rate over recent history has generally been thought of as +/- 5%, today the thought is 4%, even 3% of one's principal.
- **No different than Social Security or Medicare...** longevity is playing a critical and inescapable role in this equation.
- **The solution was in their hands...** We thought the President's own National Commission on Fiscal Responsibility and Reform put forth a credible plan. To be sure, there was something for everyone to dislike, but isn't that the point?.....

(from Wikipedia)... On November 10 NCFRR co-chairs Simpson and Bowles released a draft proposal for consideration by other commission members. The proposal presented five "steps"

1. \$200 billion reduction in discretionary spending reducing defense procurement by 15% and closing one third of overseas bases, eliminating earmarks, and cutting the federal work force by 10%.

U.S. Public Debt as a % GDP Under Various Scenarios



Source: Report of the National Commission on Fiscal Responsibility and Reform - December 2010
 *Note: Explanations of the Alternative and Baseline scenarios are included on graph's article page.

2. \$100 billion in increased tax revenues through various tax reforms, such as introducing a 15 cent per gallon gasoline tax and eliminating or restricting a variety of tax deductions such as the home mortgage interest deduction.
3. Controlling health care costs by maintaining the Medicare cost controls associated with the recent health care reform legislation, in addition to considering a public option.
4. A reduction in entitlements, including farm subsidies, civilian and military federal pensions and student loan subsidies.
5. Modifications to the Social Security program to raise the payroll tax and the retirement age.

- **Drowning in regulations...** It is no wonder businesses are cautious about expanding and banks are cautious about lending to the few who would.

- **The Dodd-Frank Bill...** Over 800 pages, it calls for 400 new rules. To date, Congress has finalized just 16% of those 400 regulations. How can those businesses affected operate with such uncertainty?

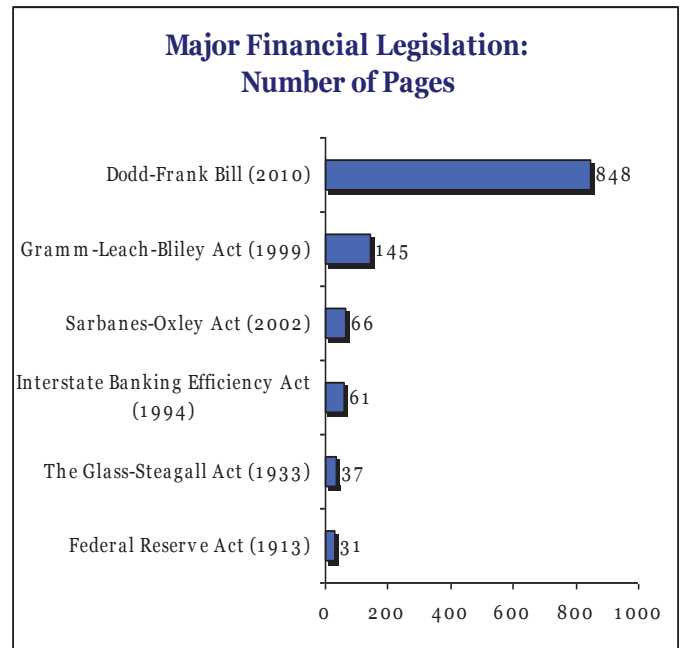
- **Whiplash...** We referenced in 2009 that the near-collapse of the banking system would certainly result in heightened regulation, but honestly, we had no idea.

- **In the investment arena,** the individual investor increasingly perceives that the playing field is not level. And, while we certainly join the cry that there are too many who remain untouched by their fraudulent actions, it would be a mistake to think that the market is under the control of a few.

- **We give you...** John Paulson, one of the “geniuses” who made billions by shorting the mortgage market in 2008. As of the most recent report, Mr. Paulson’s Advantage Plus Fund was down over 45% this year, resulting in a letter of apology to his investors. Inescapable is the fact that with great potential reward comes great potential risk.

- **We have to agree with Time...** Of all of the many, varied and emotional events of 2011, the most profound was and is the revolt against oppression.

Strategas Research Partners



Yemen, Egypt, Japan, Slovenia, Jamaica, Libya, Greece, Italy and Tunisia

All saw changes in their leadership.

- **2012 could be just as eventful...** Countries representing over one-third of the world’s GDP have presidential elections.
- **Another ray of light?** The Virginian Pilot recently reported that local foreclosure activity has plunged while nationally, housing starts have turned up. While we seriously doubt a significant upturn in housing is underway, perhaps the worst is behind us. This would certainly have significant implications for employment activity.
- **The next big, BIG thing?.....Shale.** Just maybe. In Ohio, Pennsylvania, West Virginia and North Dakota, the search for oil and gas is booming. While we do recognize that new extraction methods have environmental risks, the early results of these activities could be game-changers, both to consumers and on the geo-political front. Some studies (WSJ 12/5/2011) suggest that the U.S. could surpass Russia and Saudi Arabia by 2020 as the world’s largest oil and gas producer.
- **It’s been a trying year, not just here at home, but for the entire planet...** We remind ourselves that given the choice, the majority of the rest of the world’s population would relish the opportunity to live in the United States of America. While the process can be messy, we wouldn’t trade places with anybody.
- **God bless you!** Especially as many of our military are returning home, we send our heartfelt thanks to all who risk their lives to protect our many freedoms.

December 2011