

Economic Conditions & Market Outlook

With 2011 ending, many investors wishfully welcomed the New Year with the hope it would bring the same perspective offered in one scene from *Gumball Rally*, a 1976 comedy film about an amateur, no-holds-barred, cross-country car race. At the start the race, a professional driver/ringer covertly hired by one desperate-to-win contestant reaches over the new Ferrari's steering wheel, rips the rearview mirror off the windshield and cavalierly flings it over his shoulder. He then glances at the stunned owner of the car sitting in the passenger seat and exclaims in a thick accent, "The first a-rule of Italian driving - what's a-behind you is not important!"

Unfortunately, what is behind us - December's year end - will not be the finish line for potential impact from several of the unresolved issues that gummed up the works in 2011. *Barron's* Michael Santoli aptly observed that the economy and markets last year provided the financial equivalent of 'feathering the clutch' in a car on a steep incline; with the natural tendency being to quickly drift backwards but getting just enough fuel at just the right times so that the engine neither stalls nor creates sufficient momentum to move substantially forward.

In actuality, a race of any type is perhaps a poor analogy when referencing last year's market performance. Despite the unprecedented and gut-wrenching daily market gyrations outlined in our last *Investment Update*, the Standard and Poor's 500 equity index finished 2011 almost precisely where it started twelve months prior-closing December at 1257.60 after beginning January with a valuation of 1257.64, down an imperceptible 0.0032%. While this insignificant change in the S&P 500 index for the year provided market watchers with a curious statistical anomaly; for most investors, it felt like going nowhere fast on a very bumpy road.

Other equity indices showed a more perceptible difference from start to finish, with the Dow Jones Industrial Average closing up 5.53% for the year and the Nasdaq ending -1.80% lower. However, these rather muted annual returns belie the spastic swings of last year's markets. For example, the S&P 500, DJIA and Nasdaq indices lost -14.33%, -12.09% and -12.91% respectively in 2011's third quarter alone. While rebounding from that performance wreckage to end the year relatively unscathed may not be akin to a trip down victory lane, it is hopefully indicative that the economy and markets may start to have a somewhat smoother ride in 2012.

Despite our expectation that this is likely the case, as noted previously, several significant issues that dogged investors last year cannot yet be dismissed as being behind us and may continue to periodically drag on the markets in the months and years ahead. First and foremost of these is overhang from Europe's lingering financial problems. While the European Central Bank's unlimited, three-year loan facility has eased immediate bank liquidity concerns and helped keep Eurozone financial woes from daily front page news, long-term sovereign debt solvency for countries such as Greece, Portugal, Spain, et al, remains unresolved.

Likewise, concerns over the United States' burgeoning budget deficit reached a crescendo late last summer with the debt ceiling debacle and subsequent downgrade of the U.S.'s credit rating. This issue will undoubtedly continue to weigh on the U.S. economy and dampen investor psyche until elected officials recognize the severity of the problem and demonstrate the political will to reign in public expenditures. Congressional Budget Office numbers for fiscal year 2011 show that government spending equated to approximately 24% of the total U.S. gross domestic product (GDP), while taxes collected approximated 15% of total GDP, a deficit spending gap that cannot be sustained without worrisome consequences.

Some of the optimism that buoyed the markets at year end actually came from Congress agreeing to extend the Social Security payroll tax cut for another two months. While it may sound somewhat contradictory to the paragraph above that there would be a positive market reception for reducing revenue to a federal program already facing exponentially expanding costs; like most U.S. voters, investors are exasperated with Congress' apparent inability to agree on anything. The surprise of seeing elected officials actually pulling in the same direction temporarily trumped the fact that U.S. deficit spending needs serious, long-term solutions, in addition to providing the bottom line economic benefit of keeping more spendable cash in consumers' pockets.

However, any positive impact this spirit of cooperation had on the markets will quickly fade in the months ahead if Congress and the Administration return to their incessant wrangling and impotent policymaking. Suffice to say, we are not betting that the inside-the-Beltway crowd will be lastingly reforming their partisan squabbling and spendthrift ways in a meaningful fashion anytime soon, particularly during an election year.

Despite the expanding U.S. deficit, Europe's unresolved sovereign debt concerns, Washington's current political dysfunction, a Federal Reserve left with few monetary policy stimulus options and a grudgingly slow economic recovery that is more often viewed as half-empty vs. half-full, we cautiously suggest the potential exists for the U.S. economy and investment markets to continue to gradually improve as the year progresses. Here are some reasons why.

As December ended, several key economic indicators logged positive results that surprised on the upside. Housing data has been gradually improving for a bit but November's existing home sales figure rose a notable 4.0%, far surpassing the consensus expectation of a 1.6% upward move. Likewise, Commerce Department numbers showed durable goods orders rising 3.8% for the month, handily beating the anticipated 2.2% growth formerly projected. The Institute of Supply Management (ISM) report for December also showed expansion in U.S. manufacturing economic activity for the 29th consecutive month, with all eleven ISM categories - New Orders, Production, Inventories, Prices, etc. - demonstrating solid and sustainable trends in the right direction.

Some of the economic fundamentals that registered steady improvement in 2011's fourth quarter have continued the positive momentum into the New Year. Among broader measures, GDP growth is expected to modestly accelerate throughout 2012. Tempering commodity prices will help keep inflation concerns in check and the outlook for employment growth should continue to improve. The oft-quoted net unemployment rate is influenced by multiple factors - from new unemployment claims, to existing claims, to new jobs created. The volume of existing joblessness will likely keep the net rate higher-than-hoped-for at 8.3-8.5% throughout the year but the trend of lessening new claims combined with increased new jobs creation does provide a positive.

On the market side of the equation, it was noted previously that strong upward equity price movement during the last quarter helped salvage what would have been dismal calendar year returns for the major equity indices. This positive market momentum has continued during the first few weeks of 2012, with the S & P 500, DJIA and Nasdaq indices being up 4.59%, 4.12% and 6.97% respectively year-to-date through Friday, January 20th.

While short-sale covering certainly contributed to some of the run-up in equity prices that occurred late last year, the Exchange Volatility Index (VIX), which essentially measures how many investors are betting stocks are going to drop in price near term, is at its lowest point in well over a year. While perpetual pessimists may suggest that this level of investor consensus often sets up the markets for a downward price correction, our view is that ignoring the current opportunity to wait for that inevitability is unnecessarily Cassandra-like.

Our primary analytical focus tends to emphasize fundamentals, many of which continue to look very attractive in specific companies and select niches of the equity markets. Company balance sheets are flush with cash, corporate profits remain strong and share valuations versus forward earnings appear rather inexpensive.

Also indicative that this market may have some legs is that the industry sectors leading the charge into the New Year are very different than the traditionally defensive areas that excelled in 2011. Most notably, Financials and Utilities have reversed return leader/laggard roles among the major S & P 500 components, with other economically-sensitive cyclical segments such as automotive, home building and semi-conductors also shining thus far year-to-date. We have frequently noted that the sustainability of long-term market growth would remain suspect until financials could claw their way back to investor relevance and join the move upward.

Several other macro-market trends and technical factors also indicate the current equity rally could continue a bit longer barring some unforeseen negative outside influence. First, the volume of investment dollars that has moved out of stocks and into bonds over the past five years has been unprecedented, being far outside any prior norms. Second, the current potential return spread of stocks vs. bonds is also at record levels, with equity yields still looking appealingly high relative to fixed income alternatives even after the most recent upward market moves. Third, fear has kept a disproportionate number of investors, institutional and individual, sitting in cash on the sidelines for several years. As the fear of ‘lost principal’ is eventually replaced by the fear of ‘lost returns’, momentum from these investment dollars being redeployed will help push the markets forward.

At the present time, the potential positives outlined in the latter part of the *Investment Update* are jockeying for pole position with the unresolved negatives listed at the beginning. Contrary to that racecar driver’s opinion, successfully crossing the finish line will indeed require an in-depth understanding of what’s behind you, as well as a clear anticipation of what may be around the corner ahead. It will involve recognizing when to brake, when to accelerate, when to change lanes and when to pull off the track because the caution flag is out. Only one thing is for certain, 2012 is bound to be an interesting ride. Ladies and gentlemen, start your engines!

Our Tactical Investment Stance

Roof Advisory Group’s disciplined investment approach emphasizes adding upside value to client portfolios while also controlling downside risk. Strategies include clearly defining investment policy ranges based on each client’s specific investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters and ongoing evaluation of portfolio return relative to various risk measures.

Within this strategic investment management context, the firm makes tactical shifts to address changing market conditions and optimize client portfolio performance. Each client situation is unique but a few of the tactics presently being used across most portfolios managed are outlined below:

- The overall *target allocation* level for managed portfolios is currently slightly-above *mid-point* equity exposure based on each client’s investment policy. This target allocation was *shifted back up* one step in the range in late October in response to *tempering market volatility*. As noted, the fundamental *risk/return* potential in equities remains *more attractive* than either bonds or cash but, at present, we remain *somewhat cautious* in fully raising overall portfolio equity allocation the next level to *one-step below maximum*.

- The *portfolio composition* of all investment policies *continues to be modified* in response *changing market conditions*. By design, *equity yields* in each target portfolio have been *above historic norms* for quite some time and remain high today. In addition to increased equity allocations, *portfolio betas* have been *gradually raised* since the last *Investment Update*. Per norm, *profits are taken* when risk/return potential deteriorated on several equity/fund holdings and positions are *rebalanced to target levels* after notable appreciation.

Overall sector diversification remains a priority. While still outside respective benchmark levels, *Utilities* sector exposure has been *reduced*, while *Financials* sector weightings have been *increased*. In growth-oriented investment policies, *Technology* exposure has been *significantly raised* but remains under benchmark, along with *increases* in *Industrial & Materials*. *Telecom & Healthcare* are presently being held at slightly above benchmark except for more income-oriented investment policies where currently *attractive yields and low volatility* have raised those sectors exposure to slightly more concentrated levels.

Our *large-cap equity bias* remains, as does our *value-style leaning*. However, some of that value-style concentration is now being complimented by *added growth-style* exposure in *higher equity level target portfolios*. Similarly, overall portfolio exposure in cyclical and economically-sensitive stocks has increased. Dedicated *foreign equities* currently remain *underweighted*, with international exposure coming primarily via select *multi-national companies* offering *superior returns/less risk* compared to purely foreign alternatives.

- Ultra-short-term fixed income exposure continues to be *significantly below target levels*, except during tactical portfolio repositioning or rebalancing. The overall *average duration* of bond portfolios remain *short to intermediate* but *select individual bonds* with *longer maturities* are being added where advantageous. *High-quality preferred stocks*, more akin to a fixed income holding, are being used in *moderation* to enhance yield. *Credit quality* and *diversification* are always critical considerations for all fixed income portfolios.

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