BCM
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"Ring out the old, ring in the new"
Alfred, Lord Tennyson, (6 August 1809 – 6 October 1892)

"Ring out the old, ring in the new"…governments. New governments have sprung up out of crisis everywhere in the past year – Greece, Spain, Italy, Poland, Belgium, Macedonia, Egypt, Lebanon, Tunisia, Iraq, Yemen, Libya, and North Korea. Moreover, 2012 is a pivotal election year for both the US and China. Given the extent of fiscal change in the global landscape, the apparent lack of a global leader, and the depths of the ongoing European debt crisis, the ability to forecast major global macro movements is diminished substantially. This uncertainty is likely to keep markets on edge, and could continue to keep volatility high. Looking back in time, the S&P 500 through the first half of 2011 was up 5%, lost 15% in Q3, and then rose 11% in Q4, to end the year just better than flat.

In fact, the outlook from many well respected economists is very bipolar: Fiscal austerity (slowing economy) vs. monetary stimulus (expanding economy). In BCA's opinion, "A world of private sector deleveraging, fiscal austerity and monetary stimulus implies it probably will remain quite volatile next year as the forces of restraint and monetary reflation battle it out." Bill Gross believes that his "New Normal" is morphing into the "Paranormal." This "new duality - credit and zero-bound interest rate risk - characterizes the financial markets of 2012, offering the fat left-tailed possibility of unforeseen policy delevering or the fat right-tailed possibility of central bank inflationary expansion."

But within this uncertain global macro landscape we are intrigued by the relative strength of the United States economy, and of domestic companies. Despite tighter fiscal policy in 2012, the US has extremely easy monetary policy, with the FED stating that they don't envisage raising rates before mid-2013, and are ready to ease more should conditions warrant it. Consumer confidence is almost back up to recent 2010 peaks, the unemployment rate has fallen to 8.7% vs. a 9.9% peak, and housing is showing some signs of life after five years of decline. Corporate profit growth on US earnings is better than expected. Domestic banks are well capitalized, and loan growth has been rising 21 out of the past 24 weeks. There is $2 trillion of cash on corporate balance sheets waiting to be deployed once animal spirits return. We believe that there is upside risk to the US real GDP consensus forecasts of 2.1% in 2012.

In trying to be respectful to both the strength of the US economy, and the uncertainty surrounding the debt crisis in Europe, we continue to believe that our barbell strategy is relevant. We hold a combination of GARP (growth-at-a-reasonable-price) stocks for when the economy is moving forward, and high dividend yielding defensive stocks to help support the portfolio during times of relative weakness. In addition, we are looking for strong companies with good dividends and/or strong balance sheets that have secular growth stories whether or not the economy grows, just in case the European likely recession comes our way.

As for the bond portfolio, the yield-to-maturity on bonds remains at historic low levels. We brought bond allocations up to benchmark last quarter, and we kept them there this quarter. In order to capture more yield we have begun to look a little further down the rating curve. In addition, we have added more high yielding stocks to the portfolio. While the low yields are distressing and frustrating for those who live off the income from their portfolio, the flip side is that low yields can help give some additional support to economic growth overall, and especially to the mortgage market, where 30-year fixed rate mortgages are now under 4%.

We look forward to speaking with you soon and thank you for entrusting us with the management of your money. Wishing you and your family a very prosperous 2012!

Sincerely,

John A. Zaro III, CFA
Managing Partner

Laura K. Drynan, CFA
Partner

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