



# JANUARY MARKET COMMENT

**Look Ahead—Look Back**

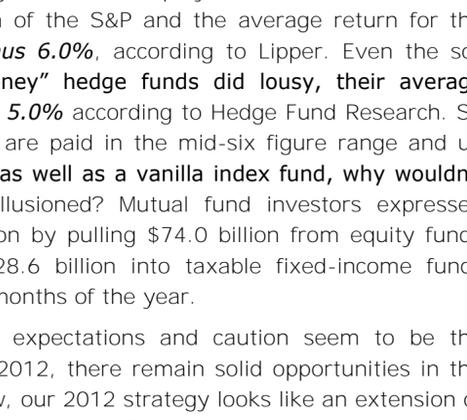
**January 10, 2012**

**Diminished Expectations:** Excuse the less than inspiring title, but as we consider the outlook for 2012, it seems that simple phrase pretty well sums it up. Perhaps it is the human tendency to extrapolate recent experience that is driving the nearly unanimous calls by market strategists and economists to say the 2012 will, like 2011, provide little in terms of real market gains or economic growth but lots of volatility, risk and uncertainty.

Since so many forecasters expect a continuation of 2011 into 2012, here is a quick summary of the past year. Stocks began 2011 extending gains that began six months earlier and the market was up nearly 10% in April when a perfect storm began to brew. “Arab Spring” events caused a spike in oil prices, European debt problems morphed into a near apocalyptic crisis and the U.S. Congress demonstrated a total void of leadership, reason or budget skills. The resulting uncertainty helped slow the economy and caused a collapse of stock prices into September, which was followed by wild volatility—the DJIA averaged a daily intraday swing of 270 points between August and November. Confidence in the market took a huge hit and investor disillusionment exploded. In the final months the economy demonstrated amazing resilience and stocks, like a wildly gyrating gymnast, managed to stick a near perfect landing with gains near zero—the S&P 500 index lost 0.2% for the year.

Index	2011 Close	2011 % Change
Dow Jones	12,218.6	+5.5%
S&P 500	1,275.6	-0.2%
NASDAQ	2,605.2	-2.2%

Some observations from 2011: The non-change in the S&P index helps highlight the importance of quality and dividends. Including the S&P index’s slight negative return was 2.1%.



The 30 stock “blue-chip” Dow Jones index gained 5.6%—

showing the benefit of quality. Another significant aspect of 2011 was the poor performance of equity mutual funds and hedge funds. Only 15% of all equity mutual funds did as well as the flat return of the S&P and the average return for the group was a **minus 6.0%**, according to Lipper. Even the so-called “smart-money” hedge funds did lousy, their average return was **minus 5.0%** according to Hedge Fund Research. So if managers who are paid in the mid-six figure range and up **couldn’t even do as well as a vanilla index fund, why wouldn’t** investors be disillusioned? Mutual fund investors expressed their dissatisfaction by pulling \$74.0 billion from equity funds while adding \$128.6 billion into taxable fixed-income funds over the last six months of the year.

While diminished expectations and caution seem to be the watch-words for 2012, there remain solid opportunities in the market. As of now, our 2012 strategy looks like an extension of what worked for us in 2011. That is, we will stick with quality, seek solid business that generate high cash flow and, hopefully, increasing dividends. We plan to stay balanced and diversified while under-weighting international (particularly Europe) and natural resource sectors—at least in the early months. Many of last years winners look pricy at the moment but just the slightest uptick in the economy could boost anemic confidence levels and drive prices much higher. On the other hand, the year will surely see resurgent geopolitical and economic risks, keeping volatility high and providing opportunities for nimble investors.

While investors need to continue to focus on capital preservation, the search for income will continue to be a challenge throughout 2012. Income and safety are synonymous with fixed income (bonds) in the investment world, but the 30 year bull market in bonds looks ever longer in the tooth. It is a recurrent story. One year ago ten-year Treasury yields were 3% and forecasters expected rates to rise to 3.5% by yearend. In another strike against prognosticators, the 10 year finished at 1.9% due to the Fed holding rates low, the European crisis, and the general desire for capital preservation. Again this year, forecasters expect yields to rise to 3.5% by yearend but it **won’t happen unless the U.S. and/or European economy shows** growth. Money funds, paying just 0.02% on average, and short CD’s (6 month rates currently equal 0.29%) are also expected remain unattractive throughout 2012. Fixed income returns will remain low with above average risk for 2012.

The search for income is another positive for the best quality and highest yielding stocks which did so well in 2011. The S&P 500 still yields 2.1% and although earnings growth, according to Wells Fargo, is expected to slow to 5.1% in 2012 (down from 18% in 2011), that means the market is only selling for 12.3 times 2012 earnings—a very reasonable valuation. Investors who can stand the volatility of the stock market should continue to do well in stocks of companies with strong business models, reasonable growth and decent dividends.

Best regards,

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