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LINSCOMB & WILLIAMS
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1971 - 2011
40
YEARS OF DISTINCTION

MONTHLY MARKET COMMENT

In This Issue

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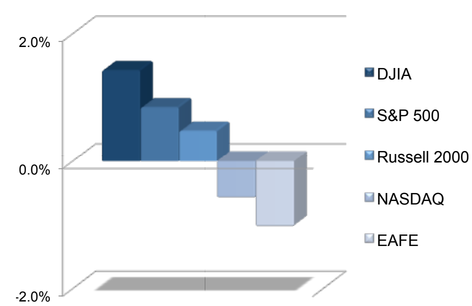
Market Update

For the most part, stock prices moved higher in December, bringing the rollercoaster ride of 2011 right back to where it began. The **Dow Jones Industrial Average** rose 1.43% to end the year at 12217.56. The **S&P 500 Index** was up 0.85% to 1257.60, while the **Russell 2000 Small-Cap Index** provided a positive return of 0.48% to close at 740.92. The **Nasdaq** was the only major U.S. index to decline for the month, dipping 0.58% to 2605.15. The **EAFE** index of international stocks dropped 1.03%, hurt by the US Dollar which continued its climb against the Euro.

Major Index Appreciation

As of 12/31/2011



December 2011

As investors are aware, 2011 was a volatile year for stocks as they traded over a wide price range, only to end the year virtually unchanged. The S&P 500 Index closed fractionally lower than at the start of the year, although the total return was positive due to dividend payments. The Index moved up or down 2% on 35 of the trading days, making this year among the most volatile ever for stock prices. The Dow Jones Industrial Average rose or fell more than 100 points on 104 of the trading days this year. In addition, market weakness between July and early October brought about a steep drop before rebounding into year end. According to *Ned Davis Research,* we experienced 12 market pullbacks of 5% or worse during 2011, almost twice the long-term average. Overall, the US markets were much stronger than the international markets. Emerging markets were the worst performers, followed by the Asian market and then Europe. In the US, the largest dividend-paying blue chips outperformed mid- and small-capitalization stocks, as investors remained starved for attractive yields and flocked to the largest companies that generated the most free cash flow with a proven record of raising dividends and/or repurchasing shares.

A year ago we wrote that in 2011 "our best guess is things will not be as bad or as good as people think," and that, "the economy will grow at a sufficient pace to provide decent earnings growth without generating inflation but unfortunately not at a rate that will put much of a dent in unemployment". This generally proved true, as the fears continued from as far back as 2010 that our economy would fall back

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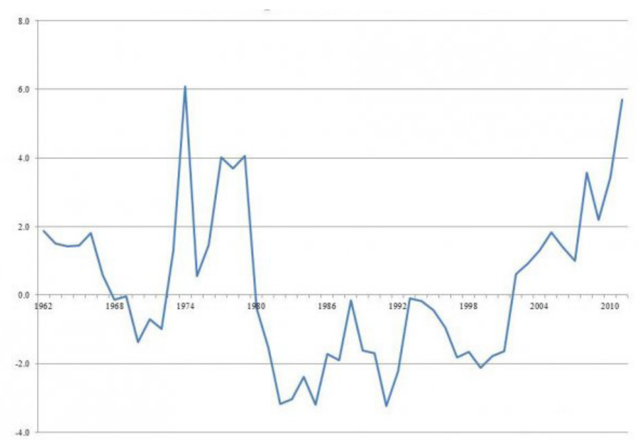
Market Update, *continued*

into recession. In 2011, these fears persisted, fueled by a slowdown in growth from the fourth quarter of 2010 (which was exacerbated by disruptions in the supply chain due to the Japanese earthquake, tsunami, and nuclear meltdown, and increasing concerns over the European sovereign debt crisis—not to mention the first ever downgrade of US long-term Treasury debt). Even with those concerns, we expected the stock market could be up in the 8–12% range, and this proved true for the 30 stocks that comprise the Dow Jones Industrial Average. However, the broader market averages were held back due to renewed weakness in the financial sector which declined about 19% last year and because of unpredictable exogenous shocks that acted as an additional drag on the already fragile US economy. Though overall 2011 earnings grew by 16% (above the expected range of 13%), the price-to-earnings (PE) ratio on the S&P 500 declined, as perceived economic risks from the European sovereign debt crisis weighed heavily on the minds of investors who, as a result, required a higher risk premium. Quarterly earnings have now bested analysts' expectations for 11 straight quarters as our economy has struggled to crawl out of its worst recession since the Great Depression.

We had expected the PE ratio to remain flat as it was already trading well below its 10-year mean, and as the above chart shows, the relative value of stocks versus US government bonds (as measured by their yield spread) is reaching the highs of 1973-74.

We also continue to believe that with money market funds yielding a pittance and bond yields at 30-year lows, investors would return to common stocks, as their level of valuation and dividend yields would prove irresistible to investors trying to find a way to achieve the returns they needed to reach their long-term goals. Indeed dividend-paying stocks were by far the best performers in 2011, as evidenced by the total return of the Dow Jones Industrial Average. However, overall investor pessimism proved too much for the broader averages, as on the aggregate individual investors continued to pull money from equity mutual funds and put the proceeds into bond funds, even as companies increased their pace of dividend increases and insider buying and record levels of corporate stock buy-backs remained strong. Strong corporate profits and cash flows, combined with payout rates near their all-time lows (under 30% compared to an historical average of 52%) should continue to provide double-digit increases in dividend yields in 2012 even after a surge increases in 2011 of 89.2% as compared to increases in 2010. Currently, there is a record $1 trillion of cash reserves on company balance sheets, excluding the financial sector. Standard & Poor's projects "dividend increases (will) continue across the board for all sectors with another double-digit gain in actual cash payments." Indeed, investors need to be careful about the tendency to extrapolate from recent experience as investor pessimism is near the level from which the great bull market of 1982 began. Forecasting "recency" has not proven to be financially productive for investors over the years. Though whatever trend one is currently experiencing may feel as though it will continue forever, this is actually not the case. As Standard & Poor's points out, since 1900 the median difference in annual price performances for the S&P 500 has been 17 percentage points, providing a potential wide range of possibilities for 2012. However, with current PE ratios at a 30% discount to the median PE of the past quarter century and a 10% discount to the median PE since 1936, the odds would seem to favor the upside of this range, as investors are being well compensated for the perceived risks.

S&P 500 Earnings Yield minus 10-Year Treasury Note Yield



For 2012, we think it is reasonable for the S&P 500 to provide a total return of between 7% and 11% by year end should the consensus 10% earnings growth Wall Street analysts currently project come true. The surprise for investors this year would be even stronger returns if PE ratios happen to revert to their average. This could happen if the fears currently reflected in stock market prices fail to occur and the allure of attractive dividends and low stock prices trump investors' lack of conviction about the future in an uncertain political environment where politicians both domestically and abroad seem unable to address any of our underlying economic problems.

As we enter January, investors seem preoccupied with pricing of equities at levels that reflect fairly severe outcomes in terms of the current observable risks to the economy. Thus, it would seem

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The Economy

Economic conditions in the United States have been improving steadily since October, as the potential knockout blow from the European debt crisis has so far failed to materialize despite the signs of an economic downturn in Europe. Our data continues to paint a picture of healing with modest, but sustainable growth as we move into 2012. Monetary policy is extremely accommodating, while inflation remains well within levels acceptable to the Federal Reserve. Business inventories are lean, consumer sales were somewhat stronger than expected for the Christmas season, and production backlogs continue to grow. Car sales are up strongly and are at their highest annual rate since August 2009, driven by new products and replacement demand.

Economists now predict fourth-quarter GDP will be better than 3%, and see the current economic momentum continuing into 2012. We have now had 13 consecutive weeks of stronger economic data. The four-week average for unemployment claims has dropped to 375,000, a new low for the expansion and well below the 653,000 four-week average at the peak of the recession. Layoff announcements continue to decline, and consumer confidence has been on the rise for five straight months. The real estate market is bottoming, if it has not already bottomed, and homebuilder stocks have soared almost 60% since October, signaling firmer to higher prices, and sales should be on their way as home affordability is at a generational high. Meanwhile, spurred on by the growth in apartment starts, construction spending has increased for the third time in the past four months. Unemployment has dropped to 8.5% (close to a three-year low) and manufacturing activity as measured by the ISM Manufacturing index has had 28 consecutive months of expansion, having grown in December at its fastest pace in six months. Payrolls rose well above expectations in December to the 200,000 level, twice the gain in November, as both wages and the average work week increased.

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The year 2011 turned out to be the best year for job gains (1.64 million) since 2006, well above the 940,000 new jobs created in 2010. Nevertheless, a lot of work remains to be done to make up for the 8.75 million jobs lost during the Great Recession as unemployment over the past three years marked its worst three-year period since 1939–1941.

Strength in global manufacturing, especially in China and India, shows that so far the industry is surviving any strains from Europe's sovereign debt crisis, though it is not disputed that Europe is in at least a "light" recession. However, Standard & Poor's projects 0.4% GDP growth for all of 2012, though there is a high degree of uncertainty in their forecast. They believe that finally a credible framework is taking shape to help ease the sovereign debt crisis, though they see many risks in its execution. Certainly a sign of progress is evidenced by policy changes at the European Central Bank since Mario Draghi took over in November. There have been two reductions in short-term interest rates since then and an unprecedented new lending operation to the banks for periods of up to three years. This has reduced liquidity worries and provided a back door means to help strengthen the market for European sovereign debt as the ECB has rapidly grown their balance sheet in order to protect Europe from a freeze up in liquidity that could lead to a crash. Though this by no means solves Europe's problems, it does provide time to work on building a more stable political union. This will take some time, probably years, if it occurs at all. It appears Europeans are ready to suffer in the short term to hold the European Union together, so there is hope they will enact the necessary reforms.

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Though the ECB is not yet ready to directly buy sovereign debt, it appears they are more than willing to use indirect means to prop up prices by providing cheap funding for banks and by using the International Monetary Fund (IMF) to support the prices of sovereign debt. This will have the beneficial effect of lowering the value of the Euro, which will help soften the economic pain from reduction in government spending by stimulating their export markets as their goods become cheaper which drives export growth. These efforts should give the politicians time to make the difficult budgetary structural changes that are required if they are to form a more tightly bound fiscal union. So far, this appears to be working, though there will certainly be more pains along the way.

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The Year in Bonds

Though unexpected at the beginning of the year, US Treasury yields dropped further with the one-year US Treasury note decreasing in yield from 0.60% to 0.34%, while the ten-year US Treasury note ended the year yielding 1.88%, down from 3.30% in January. The 30-year US Treasury bond ended December at a yield of 2.90%, down from 4.34%.

In January 2011, most expectations were for interest rates to be higher at year end, but in August the Federal Reserve indicated it intended to keep its short-term rate between 0–0.25% for the next two years. Then in September, the Federal Reserve announced “Operation Twist” which involved selling short-term securities out of its portfolio in order to move into intermediate to longer term securities with the goal of bringing those longer rates lower. Finally, fears over the European Sovereign debt crisis created major buying of the US fixed income securities despite Standard & Poor’s downgrade of US debt. Corporate bonds were not nearly as strong last year, but perhaps the most significant surprise was the performance of municipal bonds.

It was a little more than one year ago that Wall Street analyst, Meredith Whitney, told *60 Minutes* that 2012 would be the year of massive municipal bond defaults. Smaller investors panicked and sold $13.3 billion in municipal bond mutual funds in December 2010 and another $12.4 billion in January, which forced a huge supply of bonds onto the market, resulting in sharply lower municipal bond prices. Those who held onto or purchased more during this temporary downturn were well rewarded. Though everyone was aware of the fiscal problem of state and local governments, *60 Minutes* and Meredith Whitney were incorrect in concluding that these problems were not solvable and would lead to massive defaults in the range of “hundreds of billions of dollars”. Actual defaults in 2011 were down from 2010, with 36 issues going bad compared to 81 in 2010. Bonds in default amounted to $2.1 billion, down from $2.8 billion in 2010. This is about 0.5% of a $1.3 trillion par value market. Despite their strong rebound, municipals are attractively priced compared to Treasuries on an historical basis. We continue to strongly favor this market for risk adverse taxable investors.

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any amount of positive news could provide just the surprise to send stocks sharply higher. After all, the market is a discounting mechanism, and in times of extreme pessimism it often overshoots to the downside. Even with the geopolitical dysfunction, central banks have become extremely accommodating in their monetary policies, providing the fuel to drive stock prices higher. Althhough policymakers are almost always “late” in addressing economic problems, there have been numerous and substantial actions to stimulate the economy which should ultimately lead to higher stock prices.

As mentioned, foreign markets were down more sharply in 2011 due to economic worries and a strengthening US Dollar. We expect these markets to remain volatile for at least the near term, but valuations are even more attractive than in the US, as foreign markets (both developed and emerging), are at large discounts to their historical average. This has created even more attractive opportunities to invest in dividend-paying foreign stocks which could well surprise to the upside, if, as we expect, the European Union muddles through its problems and China successfully orchestrates a soft landing.

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