Courage is doing what you're afraid to do. There can be no courage unless you're scared. –Edward Rickenbacker

We expect the challenges investors will face in 2012 will be as formidable as last year. As we look at our economy, the capital markets, and our political environment since the Financial Crisis of 2008, it seems we still haven't addressed the big issues; and, it appears we don't have much of a plan to address these issues in the near future. So, with a pragmatic sense of the current environment, we offer three general themes for 2012:

1. Our economy is deleveraging which raises unique challenges for investors;
2. Traditional monetary and fiscal policies are running out of ammunition;
3. The structural problems imbedded in the economy and capital markets, which include the political environment in Washington DC, will hinder economic progress.

The single biggest risk to the rate of economic growth in this country is the debt burden of the federal government. It took 228 years for our country to achieve $7 trillion in federal debt. *It only took us the last seven years to double it to $14 trillion.* Like Europe and Japan, we have reached the limit to how much debt we can assume and we lack the courage to address the problem effectively.

There is a difference between an economy that is in a recession and one that is deleveraging. An economy that is deleveraging is plagued with benign growth, dismal credit expansion, and low demand. In a recession, banks loosen lending standards to extend credit which stimulates growth. In a deleveraging, credit remains tight as banks focus on increasing capital levels. Domestically, we have not experienced the pain of a sustained deleveraging since the 1930's. The process will likely last the better part of a decade and will be complicated by the lack of consistent financial regulation. We expect the backdrop of deleveraging will be a constant theme for developing investment strategies and assessing relative value in the capital markets.

Since the Financial Crisis, we have recognized there are structural problems that exist in both the economy and the financial system. We believe that these structural problems are so powerful and deterministic to the performance of financial assets that we need to break them out separately to better assess risk and return. By reference, in last year's Economic and Capital Market Outlook | 2011, we wrote:

> *…we believe that the inherent risks to investors are deceptively high in today's markets given the extended government intervention in our capital markets, the huge budget deficit, the muted outlook for job growth and the lack of business formation that currently exists. The Fed is hopeful that the economy can grow its way out of these excesses and generate enough demand to drive tax revenues and consumption to absorb the slack resources in the system. Our concern is that a massive global debt crisis has already formed and, left unaddressed, will ultimately threaten the fragile economic recovery that is taking place. Thus, our investment theme for 2011 is again focused on conservatism and principal preservation and less on extended risk strategies.*

As we look at 2012, our view remains consistent with last year's. We are cautious on the fragile state of the U.S. economy and believe that some markets are not pricing risk efficiently due to the Federal Reserve's intervention. We are in the throes of a global debt crisis and world leaders have not been effective in addressing the problems. And, we believe volatility will remain at last year's escalated levels.

Gregory J. Hahn, CFA
President & CIO

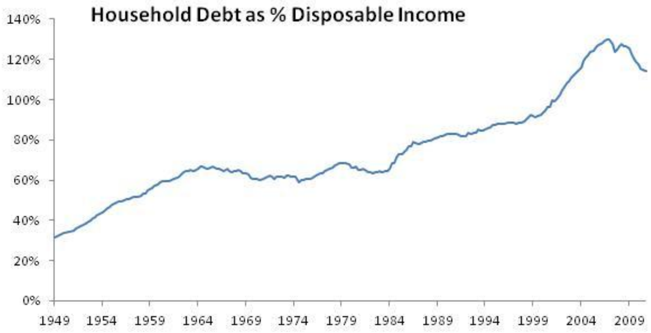
In order to provide a foundation for a discussion on the domestic economy, allow us to briefly summarize our view on how our economy works. We believe this is useful because in many areas of the economy, we are in unchartered waters which have profound implications for investing.

The domestic *economy* is simply the cumulative sum of all the transactions that take place within the country. The *capital markets* allow companies and individuals to access capital (through loans, debentures or stock) in order to facilitate economic activity. We have maintained that we will not experience sustained economic growth without a healthy financial system. A strong financial system, including well capitalized banks, is necessary in order to have healthy capital markets so that, in turn, banks have confidence to make loans and investors have the confidence to enter into trades. The expansion of credit is a critical aspect to economic growth and can only take place if the banking system is well capitalized. As a result of a benign regulatory environment, the Financial Crisis of 2008, and a partisan political environment, our economy is currently plagued with *structural problems* that are barriers to sustainable economic growth. Simplistically, we define a structural problem as anything that directly or indirectly impedes the normal transactions within an economy. If we ignore the structural issues and just focus on the fundamentals, the U.S. economy is showing marginal signs of improvement. *However, we do not believe economic growth is sustainable when we account for all the structural issues which are impeding progress.* As a result, we expect the U.S. economy will muddle along as it did for most of 2011.

The Consumer Sector

Representing roughly 64% of the U.S. economy, the consumer sector showed marginal improvement last year. Two things matter most – jobs and income. Without either, the consumer can't really spend money. Consumer spending increased an estimated 2.6% through the fourth quarter, as the economy added on average 140,000 jobs a month during the past year; and the Conference Board's measure of consumer confidence jumped 10 points in December. The year finished strong with the economy producing 200,000 jobs in December lowering the unemployment rate to 8.5%. *Still, the economy is not consistently producing new jobs at a rate that supports meaningful sustainable growth.*

Stability in housing prices is important for both the consumer sector and the economic recovery. Home prices measured by the S&P/Case-Schiller index posted a decline of -3% over the prior twelve months through October for 2011. This represents the slowest decline in prices since early 2007 as 30-year mortgage rates hit an all time low of 3.91%. So, that just means we are less bad. Unfortunately, the housing finance system has become deeply inefficient with mortgage borrowers almost completely reliant on government support via Fannie Mae and Freddie Mac. We expect to see improvement in the domestic housing market in 2012 as the rate of foreclosures decline, home prices stabilize and new housing starts increase. However, don't look for home prices to increase meaningfully for several years given the huge inventory overhang and tight mortgage lending.



After reducing debt for three years, the U.S. consumer is in a much healthier position – but, there is a long way to go to bring the household debt back in line with disposable income levels. In the face of an uncertain economy, personal consumption increased slightly and personal savings rates declined through the year. *We believe that the consumer sector is not in a position to make a consistent contribution to economic growth yet.*

The Corporate Sector

The corporate sector has been the stalwart in the economy over the past two years. According to the Institute for Supply Management (ISM) monthly survey, the manufacturing sector expanded every month in 2011. Manufacturing finished the year on a positive note, with new orders, production and employment all growing in December at faster rates than in November, and with an optimistic view toward the beginning of 2012. With reduced debt loads and higher cash balances, corporate balance sheets are extremely strong. We expect that companies will continue to hoard cash until there is clarity to tax policy, regulation, the economy and the political environment. While that is not necessarily the stewardship we would like to see as a shareholder, we are inclined to show some grace. Corporate management is in the process of learning to navigate business decisions in the face of an economy that is deleveraging. *We expect that the business decisions to* *enhance shareholder value in a deleveraging environment are the same as before; but, it's just harder to execute.* Also, with liquid capital markets and historically low cost of capital, we expect to see an increase in merger and acquisition activity next year.

Corporate earnings for the third quarter of 2011 generally beat consensus estimates. However, revenue growth slowed and profits fell, hurt by Europe and declining demand from emerging markets. We expect corporate earnings in 2012 to be under more pressure due to continued economic uncertainty and falling global demand. The result will be reduced investment and capital expenditures which will negatively weigh on GDP next year. In addition, weaker sales and profit compression will hurt hiring plans further slowing GDP growth. In addition, the earnings for U.S. companies operating in Europe are at risk if we see further deterioration in the Euro.

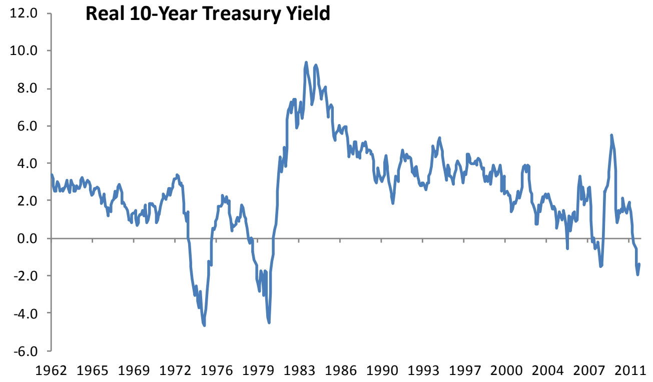
The Government Sector

We expect the government sector to continue to contract through next year. In a normal recovery, we would expect to see modest job growth in government positions. However, last year over 183,000 jobs were lost in government. With austerity measures on the horizon, we would expect a smaller government sector to be less of a contributor to domestic economic growth.

Monetary Policy

Normally, the central bank moves the level of short term interest rates to adjust lending as a means to calibrate the rate of economic growth and inflation. Well, as a result of the Financial Crisis of 2008, all of that is broken. Now, monetary policy is effectively limited to the Federal Reserve buying securities in the open market and telling investors that it will maintain interest rates at low levels. In fact, the Fed took an unprecedented step last year and has indicated that it will maintain interest rates at low levels until 2013. However, if the economy can continue to produce jobs and avoid significant deterioration in the face of structural problems, we believe that interest rates should move higher before 2013.

Since the Financial Crisis, the Federal Reserve has purchased over $2.5 trillion worth of Treasury and Mortgage-Backed securities in the open market. This has had a profound effect on the level of interest rates. Last year, in an effort to push interest rates even lower, the Fed sold short maturity bonds from its portfolio and used the proceeds along with its normal cash flow to purchase longer maturity securities. *The Fed is essentially manipulating interest rates lower through open market purchases. And, by transferring debt from the capital markets onto the Fed's balance sheet, they are assisting in an orderly deleveraging of the capital markets. The Federal Reserve has essentially run out of options to impact economic growth and is left with using its balance sheet to absorb excess debt in the capital markets as a means to assist in a more orderly deleveraging process.* The combination of low inflation and low interest rates has been negative real yields on the Treasury securities. Because of the current ineffectiveness of monetary policy, our economy is susceptible to exogenous shocks (such as the failure of a large bank) that would cause a sharp contraction in credit and hurt economic growth.

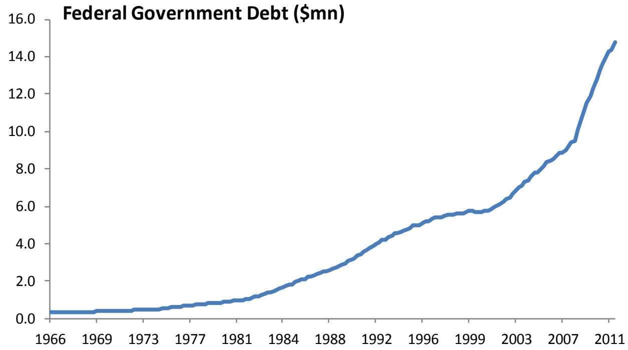


Inflation

The rate of inflation, measured by the CPI index, has been tracking roughly 2.5%; however, there are reasons to believe that inflation is trending lower in 2012. First, commodity prices including copper and cotton are declining which one would expect as global demand also declines. In addition, labor costs appear to be stabilizing as hourly wages of private-sector U.S. workers were up 1.8% last November over the prior year. The risk to our outlook is that maintaining short term interest rates too low for too long and at the same time printing money to fund the Fed's Quantitative Easing programs are planting seeds for inflation to rise rapidly in the future. *Our view is that with excess resources in the system including excess capacity and labor in the face of a global slowing, pressure on inflation will remain muted for the foreseeable future.*

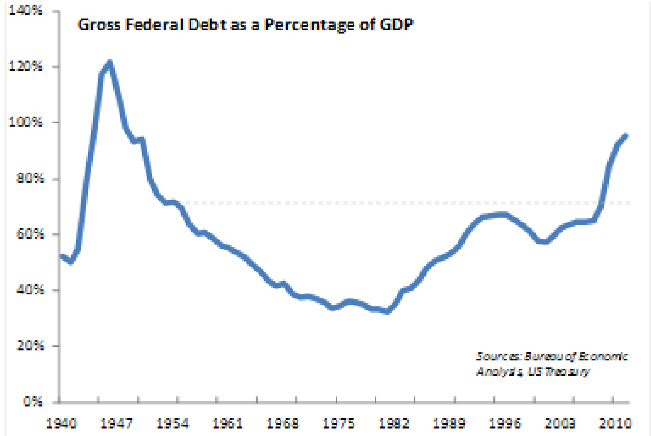
The economy and capital markets are plagued with structural problems that will continue to impede economic growth until they are addressed. These structural problems include but are not limited to: uncertainty in tax policy, healthcare reform, unaddressed systemic risks in the financial system, the huge federal debt load, large corporate cash balances, political gridlock in Congress, the European Union, new capital requirements for banks under Basel III, and uncertainty in financial regulation. *These issues are impeding the expansion of credit, business formation and risk taking within the economy.* Ultimately, we need to resolve the imbalances that have resulted from the Financial Crisis in order to reignite the economy and jump start credit expansion.

The single biggest risk to the rate of economic growth in this country is the debt burden of the federal government. It took 228 years for our country to achieve $7 trillion in federal debt. It only took us the last seven years to double it to $14 trillion. This is the cancer that is creeping through our economy and capital markets. We estimate that our net federal debt to GDP ratio is over 85% not counting unfunded pension liabilities. We need to deleverage.



According to Federal Reserve data, U.S. corporations are sitting on over $1.5 trillion in cash. Because of uncertainty in tax policy, the political environment and the economy, we expect corporations will continue to hold large cash balances instead of investing in their business to enhance shareholder value. Interestingly, almost half of the cash is held overseas which cannot be brought back on shore without paying a 35% repatriation tax. In spite of intense pressure from businesses, we do not expect the administration to offer up a tax holiday similar to 2004. *Right now, the cash balances of U.S. corporations held in European banks are needed to help shore up their weakened funding base.*

One of the foundations for capitalism is that we have a knowable set of rules that governs our financial system. It is also important that these rules are enforced consistently. We continue to struggle through developing the rules required for financial regulatory reform under the Dodd-Frank Act. According to the Financial Crisis Inquiry Report, one of the major elements that contributed to The Financial Crisis of 2008 was a lax regulatory environment and undercapitalized banking system. With new annual stress tests and some of the highest capital levels in the past twenty years, we believe the U.S. banking system is much stronger today. Yet, as funds were redirected toward building capital and supporting collateral for counterparty trades, it has limited the expansion of credit and taken a toll on the economy.



Sources: Bureau of Economic Analysis, US Treasury

One of the key rules coming out of the Dodd-Frank Act is known as *the Volker Rule,* which is intended to restrict banks from proprietary trading with the intent of reducing systemic risk in the financial system. The banks don't like it because it restricts their potential profitability and perceived competitive position. The complexity of the Volker Rule will require additional compliance and further increase costs to the banking industry.

The political gridlock in Congress continues to impede economic progress. The partisan bickering this past year resulted in absolutely no progress in addressing tax reform or reducing the huge debt burden the country has taken on after the Financial Crisis which ultimately led to the downgrade in the AAA credit rating of the United States. Last month, the debate over a mere two month extension on the payroll tax increase underscored how dysfunctional our Congress has become. We expect the campaign season of 2012 to be nasty and full of mudslinging. We need a Congress that has the political will to shape a vision for America that spurs private credit expansion and risk taking while at the same time reins in the excessive spending.

Europe Will Linger in a Deep Recession

Through the third quarter of 2011, the 17 member Eurozone region showed economic growth of only a modest 0.2% in GDP. *However, the escalating debt crisis and the sweeping fiscal austerity measures largely occurred in the fourth quarter and the effects still have not been felt. Thus, we expect fourth quarter to show a contraction in GDP growth for the Eurozone region.* The problems in Europe will continue to weigh on the global capital markets in 2012. After all the dithering and meetings that took place in Europe to address the debt problems last year, nothing has really been fixed. And, until the egregious spending on social services and pensions is reduced to an affordable level, the EU is just buying time. *All they've really done is lengthen the fuse on the bomb.* We expect Greece will still have to default in the first half of 2012. And, with over 2.6 trillion euro in debt, Italy has become the battleground to save the euro. This will set the stage for more volatility in the global capital markets.

We calculate that there is over a two trillion euro funding that is required in order to recapitalize the banking system and fund the budget deficits for countries in the European Union. *Holding the European monetary union together, as well as the euro currency, has been a massive structural challenge.* Europe is now faced with trying to complete the funding needed to inject into the capital markets and banking system just to sustain interbank lending and, at the same time, develop a coordinated plan for member countries to continue to access the capital markets to refinance maturing debt. As the yields on Italian debt rose over 7% last month, the Federal Reserve led a coordinated initiative of central banks to inject liquidity into the European banking system to avoid a total collapse of bank lending.

The austerity measures required for countries to get their bloated debt under control will result in a severe recession throughout Europe. Compounding the problems in the economy are the European banks. In order to comply with the new Basel III capital requirements and the recent stress tests, many of the European banks are required to increase their capital levels. However, unlike in 2008 when they diluted shareholders and issued more stock, this time the banks are curtailing lending and shrinking the balance sheet relative to their current capital levels. *Without a solid financial system and expansion in credit, an economy cannot experience sustained economic growth and we expect this will further compound Europe's economic challenges.*

China's Economy will Slow

China's managed economy is in danger of a dramatic slowdown. *Actually, we expect it to hit a wall for two reasons: a slowdown in construction and a decline in exports.* Over the past ten years, China's economic growth was based on a massive construction development that was designed for both an increased affluent population and subsidized apartments for low income workers relocating from rural areas. As best as we can tell, the construction industry represents 25% of GDP and is critical to China's economy. To support the massive construction projects, China buys steel, glass, copper, concrete and other commodities. According to a recent report by UBS, China uses as much steel annually as the United States, Germany and Japan combined. However, China's recent initiative to boost subsidized housing in order to keep its construction industry humming in the face of a global slowdown may have terrible consequences. These consequences may include stress on the banking system and reduced demand for foreign investments.

While exports have become a smaller part of China's economy, their manufacturing sector is still a large part of the economy. With a global economic slowdown in 2012, we would expect China's export oriented economy to feel the pinch. We have seen a sharp decline in China's Manufacturing Export Orders over the second half of 2011. We estimate that Europe alone is 25% of China's exports; and we believe that European demand will decline dramatically in 2012. *One of the risks that we see is that, as China slows, its demand for US dollar denominated securities will also decline.* To the extent that China's demand for U.S. bonds declines faster than we reduce our debt funding needs, we risk dislocation in bond prices and a spike in interest rates.

The Middle East is a Powder Keg

The Middle East experienced a lot of unrest in 2011, more than usual. What has become known as *the Arab Spring* was marked with increased violence and protests in the region, as well as changes in the regimes of several Middle Eastern countries including Egypt, Tunisia, and Libya. We expect Iran will be the epicenter of more trouble in the region as they continue to pursue their clandestine nuclear weapons program. Ultimately, we believe that Israel will take another shot at Iran's program; but this next time with a heightened level of force. As the developed economies around the world slow and demand for oil declines, we could see a spike in the price of oil if violence escalates in the Middle East.

It was a difficult year for investors as we watched Congress fail to produce a plan to reduce the budget deficit. The result was the first ever downgrade in the credit rating of the United States. In addition, the devastating earthquake and Tsunami in Japan, the uprising in the Middle East, the escalating debt crisis in Europe contributed to the challenges investors faced last year. Yet, the biggest peril we face as investors is the growing debt burden here in the United States. Like Europe and Japan, we have reached the limit to how much debt we can assume and we lack the courage to address the problem effectively.

After a year of global economic and capital market chaos, equities measured by the S&P 500 returned zero percent to investors for 2011 and bond yields actually declined to 1.86% on the ten year U.S. Treasury by the end of the year. The challenges in the economy and capital markets are making it difficult for investors to implement strategies that are consistent with their objectives and tolerance for risk.

Equities

Equity prices through 2011 have been highly correlated with each other which leads us to the conclusion, for the time being, that it is more important to get the asset allocation right (the equity exposure in the asset allocation) than it is to pick a few stocks that are going to outperform the overall market. However, we believe there are wonderful investment opportunities in domestic equities. Ultimately, the primary driver for equity valuation will be addressing the structural problems in the economy and working through the dysfunctional political environment. Ultimately, clarifying issues such as tax policy, healthcare reform, regulation, and Europe will provide strong catalysts for equity price performance.

In general, we expect earnings to trend lower through the year and continue to view the equity market as range bound between 1100 and 1300 on the S&P 500 until the critical structural problems are addressed. We see good relative value investing in well managed companies that demonstrate consistent growth in free cash flow over long periods of time including the shares of Microsoft, Honeywell, United Technologies and Kohls.

We are not constructive on the stocks of the major banks. First, we believe that investing in a business model where the company pays the employees 40% to 60% of the revenue earned is simply a bad investment – period. However, the banking industry is struggling to find new fees to attack customers with in order to replace lost revenue from mortgage lending, securities lending and other parts of their businesses. At the same time, many of the banks, led by Jamie Dimon at JPMorgan, believe they have too much capital and should be buying back their own stock. We disagree. Given the uncertainty in financial regulatory reform, we are underweight equity investments in the major banks until there is clarity in regulation, the economy and compensation practices.

Long time readers know that we are generally not supporters of stock repurchase schemes – since they are typically short sighted, lack strategic initiative, and don't work in sustaining a company's stock price at a higher level. Investors should be watching closely whether management utilizes cash balances for business investment or stock buy backs.

We remain concerned that the stewardship over publicly traded companies is poor given the list of silly business decisions and egregious compensation of many executives. Investors only have to look at the recent initiatives by several major companies to ambush customers with new fees. These short-sighted decisions include AT&T's ill-conceived attempted acquisition of T-Mobile, the chairman of Nabors Industries receiving $100 million for retiring, Verizon's attempt to charge customers two dollars a month to pay their bill electronically, Netflix's decision to increase monthly fees, or the major banks, led by Bank of America, to attempt to charge five dollars a month for clients to use their debit cards. Stupidity is not a crime. But, make no mistake - these are warning signs of earnings problems still to come. Whenever a company grasps at nontraditional sources of fee income to support revenue, chances are there is an earnings disappointment over the horizon.

Investment Grade Fixed Income

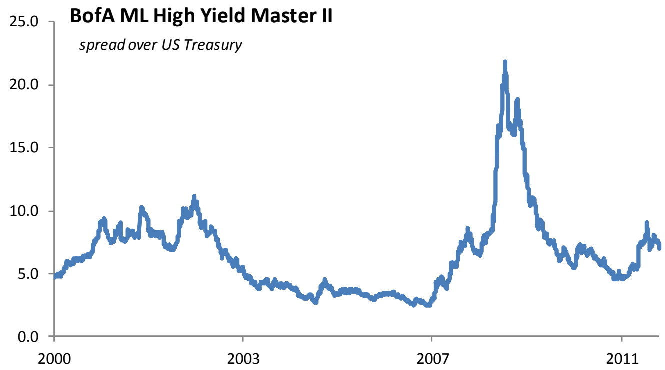
The level of interest rates in today's markets is completely controlled by the Federal Reserve. This totally distorts the efficient pricing of risk. We believe that the risk to interest rates is toward higher rates over the next 12 to 18 months. However, spreads on corporate credits are fairly wide particularly in the bank and finance sector. We continue to see excellent investment opportunities in banks including: JP Morgan, US Bank, Wells Fargo and Citigroup. Morgan Stanley is a weaker credit and offers investors excellent relative value in short maturity debt.

Preferred Stocks

We continue to find value in the preferred stock market, particularly in the regulated banking and utility industries. Capital ratios of the major banks are at their highest levels in over 50 years. Much of the Trust Preferred structures that were issued during the Financial Crisis had high dividends and are likely to be called starting in 2013. However, there is good relative value in some of the large European bank preferred stocks including Deutsche Bank, Barclays, and Credit Suisse.

High Yield Bonds

One of the consequences of the Federal Reserve's easy monetary policies is that the capital markets are very liquid for those companies that can access them. The result is that borrowing costs for issuers are lower and investors are scooping up deals because they offer more yield than other fixed income investments. Even though spreads have tightened from peak levels in 2008, we still believe there is good relative value in certain high yield issues.



One of the anomalies that exist in the markets today is that the rating agencies rate a security based on where it falls within the capital structural regardless of its maturity. As a result, the bonds of Ford Motor Credit (Ba1/BB+) maturing in two years get the same rating as the bonds maturing in 30 years. However, we believe the risks are very different since the company has enough cash on its balance sheet to mature all of its near term debt. In today's market, we see good relative value in high yield issuers with strong cash flow and solid balance sheets including CMS Energy, AES, Ally Financial, CIT and HCA. We expect the high yield market will be volatile in 2012 with an increasing number of bankruptcies.

Municipal Bonds

Municipal bonds have been one of the best performing asset classes in fixed income following the Financial Crisis. The good news is that revenue for municipalities is rising over the past two years. However, the bad news is that we still have a massive $2 trillion unfunded pension liability in the public sector that needs to be addressed.

There are still wonderful investment opportunities investing in municipal bonds. While we believe that general obligation bonds and essential service revenue bonds are some of the safest investments, we expect problems in municipal credits down the road. The problems will be concentrated in projects, tax increment finance districts and economic development zones that have poor structures and insufficient revenues relative to projections to fund debt service, over the next several years.

Last year we experienced several large bankruptcy filings of municipalities including the largest bankruptcy filing of a municipality in history as Jefferson County, Alabama filed for protection from its creditors after a $3 billion sewer project went bad. We expect to see more restructurings in 2012 including potentially Detroit, Michigan which is in danger of being taken over by the state appointed manager before it runs out of money. While tax revenues have increased in general over the past year, there are many inferior municipal bond issues that will require restructuring. The municipal market has become a much more of a "buyer beware" market.

This report is published solely for informational purposes and is not to be construed as specific tax, legal, or investment advice. Nor is this document intended as a solicitation or an offer to buy or sell securities or related financial instruments. The report should not be regarded by recipients as a substitute for the exercise of their own judgment. The comments are based on current market conditions. Different market conditions and assumptions could have materially different results. Neither Winthrop Capital Management nor any of its affiliates, directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this report. WCM or its clients may own the securities of Morgan Staley, Citigroup, US Bancorp, Wells Fargo, Ford Motor Credit, Ally Financial, HCA, Kohls, Microsoft, Honeywell, United Technologies, Deutsche Bank, Barclays, Credit Suisse CMS Energy, AES, and International Lease Finance. Certain clients of WCM use Schwab or Fidelity as their custodian.