

Recent Thoughts
January 2012

The U.S. stock market covered a lot of territory in 2011 but ended the year almost exactly where it started. The S&P 500 closed 2011 at 1257.60, a mere 0.04 points below its 2010 close of 1257.64. A dividend yield of slightly over 2% provided 100% of the total return for the year. The flat market belies the enormity of the events that occurred and the gut-wrenching volatility that investors had to endure during the year.

The year started with the spread of popular uprisings across the Middle East that precipitated the ouster of several prominent leaders and a spike in oil prices. Those events were followed shortly thereafter by a catastrophic earthquake and tsunami in Japan that led to a nuclear disaster. Domestically, we saw one Federal Reserve program end (QE II) and another begin (Operation Twist). Both were designed to keep interest rates very low and thereby stimulate the economy. Our elected representatives in Washington engaged in a bitter debate over the appropriate level of national debt and the future course of spending, all the while overseeing the loss of the country's AAA credit rating. And in Europe, officials continued to negotiate a viable solution to the fiscal mess in which they find themselves.

During the fourth quarter, we witnessed the end of several eras outside the world of finance. Steve Jobs, one of the greatest technology visionaries of our time, died in October following a long battle with cancer. Apple, having temporarily achieved the status of the world's largest company by stock market capitalization, lost a charismatic, if at times mercurial, leader in Jobs. Globally, Kim Jong Il, the reclusive leader of North Korea, died, and Moammar Gadhafi's four-decade reign as leader came to an end when he was killed amidst the uprising in Libya. As had been expected, December also marked the official, and controversial, end to the military campaign in Iraq.

All ten sectors of the S&P 500 posted positive results for the fourth quarter, with the economically sensitive Energy, Industrials, and Materials sectors performing particularly well (18.2%, 16.5%, and 15.4%, respectively). For the full year, however, the economically sensitive sectors did not fare as well. In fact, Industrials, Materials and Financials were all negative for the year. The defensive sectors of the market (Utilities, Consumer Staples, and Health Care) each generated double-digit returns for the year ranking them in the top three spots for the overall market.

Large-cap stocks outperformed medium and small stocks in 2011. This marks the first year since 2007 that the large-cap index outperformed both the small and mid-cap segments of the market in the same year, as measured by the Russell indices. As noted in previous letters, this is a trend

that, if sustained, should benefit the portfolios managed by Eads & Heald relative to styles that favor the smaller capitalization segments of the market.

The congressional super committee tasked with identifying measures to reduce the deficit by \$1.2 trillion over the coming decade failed to reach a consensus and thus set in motion a process through which spending cuts will automatically occur. It appears that congress will now spend the year attempting to undo the automatic cuts that are scheduled to begin in 2013. It is likely that bickering over the expansion of the debt ceiling and a comprehensive plan to reduce the deficit will pollute the political landscape for some time to come. Short-term fixes in policy, rather than long-term solutions, seem to be the norm.

The debt crisis in Europe continued to make headlines during the quarter. The world's major central banks coordinated to provide liquidity to European banks. Furthermore, the European Central Bank implemented a program to provide multi-year loans to the banks in the region. Both programs attempt to relieve the stresses building up in the European financial markets but do little to address the underlying problems of excessive debt and spending. Much work remains to be done to cure the region's ills. It seems likely that forthcoming plans aimed at returning stability to the euro zone will continue to make headlines and cause volatility in global markets over the coming quarters.

Push aside the headline grabbing stories out of Europe and Washington for a moment and what emerges are some glimmering signs of hope for the U.S. economy. Earnings growth for the S&P 500 looks like it will come in around 16% for 2011 and the current consensus calls for 2012 growth of 11%. Both are very respectable rates of earnings growth. Remember the one truism in investing (one that we have driven home many times in the past): stock prices go where earnings go. Prices and earnings do not move in lockstep each day, month, quarter, year or even every couple of years. However, over time, prices will ultimately follow earnings. If the 2012 consensus growth rate is realized and earnings continue to grow in subsequent years (even if at a rate lower than 2011 and 2012), attractive returns for stocks should follow.