

# QUARTERLY ECONOMIC UPDATE

JANUARY 1, 2012

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and risk tolerances.

## The Year in Review

The past year was indeed a difficult period to be a long term investor. Overall performance of our clients' portfolios was less than desirable. The following headlines illustrate the mood that seemed to persist through 2011:

*"A Wave of Worry Threatens to Build on Itself"* – New York Times, 8/19/11

*"The Recession and Death in Europe"* – Wall Street Journal, 10/4/11

*"The Economy Stinks... Everywhere"* – Washington Post, 8/5/11

Negative sentiments drove the markets in 2011, yet stocks closed the year roughly where they started. Bond yields fell substantially, especially in the Treasury markets as investors sought the safe haven of the U.S. The key issues remain: how bad is it out there and have markets reacted appropriately?

The U.S. economy at times reached near stall speed while serious attempts to rectify fundamental problems were stymied by gridlock in Washington. The United States lost its AAA bond rating. Employment and housing remained very weak while local and state governments restricted spending to meet budget shortfalls. European economies also grounded to a near halt – if not outright recession – as a result of the sovereign debt crisis

(continued)

## Economic Statistics

	4th Qtr (12/31/11)	3rd Qtr (9/30/11)	% Change	1 Yr Ago (12/31/10)	% Change
S&P 500 Index	1,257.60	1,131.42	11.2%	1,257.64	0.0%
10 Year Treasury Yield	1.88%	1.92%		3.29%	
Gold Spot (\$ / oz)	\$ 1,563.70	\$ 1,623.97	-3.7%	\$ 1,420.78	10.1%
WTI Crude Oil (next future)	\$ 98.83	\$ 79.20	24.8%	\$ 91.38	8.2%
GDP Qtr / Qtr	N/A	1.8%		2.3%	
CPI Y / Y	3.4% (Nov)	3.9%		1.5%	
Unemployment Rate	8.5%	9.1%		9.4%	

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and responses taken by governments and institutions. Additionally, last year witnessed the devastating impact of a tsunami on the population and economy of Japan.

This broad picture doesn't tell the whole story. It is true that the housing market is in trouble, and we do expect it to remain so. Further, on net the government sector hasn't been much of a help to the economy. Irrespective of whether the spending has been efficient, the growth in Federal

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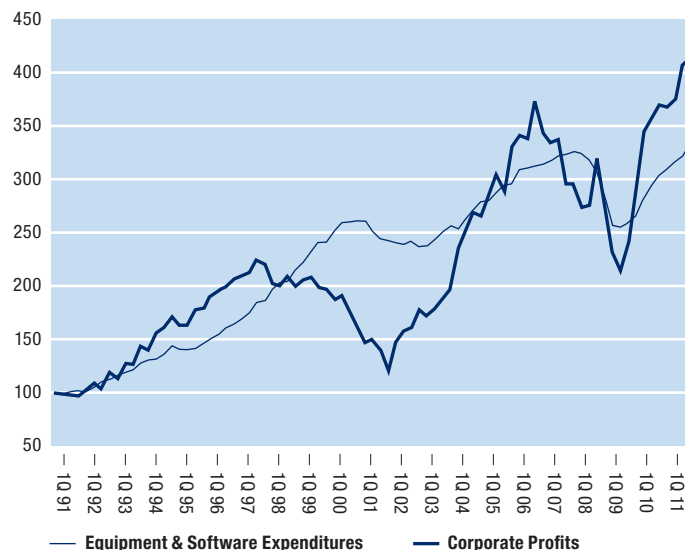
government expenditures has been offset to a large extent by contraction at the state and local levels. But housing and government aren't the entire economy.

It has been well documented that the economic rebound from the recession has been anemic. However, when we exclude government spending, residential investment (housing), and nonresidential structures (commercial construction), we get a more positive picture. Real GDP, by this measure, has expanded 8.3% from the trough as compared to 5.5% for the economy as a whole. Though perhaps not as strong as we would like, this expansion has been solid, and something positive is clearly occurring in broad swaths of the economy.

Drilling down further, we see the consumer has held up relatively well. Real consumption expenditures have increased 5.5% from the trough through November 2011 and are now 1.8% higher than the prior peak. Preliminary numbers also indicate that the Christmas season was fairly strong. Despite high unemployment, consumers as a whole have reduced debt and managed to spend. You probably won't find that in the headlines! The star of the domestic economy, though, has been the corporate sector. By the third quarter of last year, corporate profits were 10.5% above the 2006 peak. This profitability has been driven by modest final U.S. demand, gains in productivity (which tend to constrain employment), strong spending on machinery and technology, and strong export growth. U.S. real exports in the third quarter were 23.2% higher than the recession low. We believe exports will continue to remain robust going forward.

As we have been fond of pointing out, the economies of Brazil, Russia, India, China, Turkey, Chile, S. Korea, Vietnam, etc. have been humming for some time now. The irony is that much of these nations' growth over the past decade was led by exports; but exports are no

U.S. Corporate Health (1Q '90 = 100)



longer the name of the game. In recent quarters, the U.S. has on net been importing less while Europe has on net been exporting more. With this scenario, one would think the developing world economies would implode due to a lack of global markets. Despite weakness in their exports, the developing world is still growing faster than the developed world. This is because the countries of the developing world have relatively sound balance sheets, they've been moving towards free market economies, and their middle classes have reached a level where demand has been sustained internally. Clearly this is another bright spot in the broad economic picture.

Why, then, haven't markets reflected these trends? It is our contention that investors are emotional beings. As a result, price movements in the short run can be strongly influenced by the two emotions which impact investors most – fear and greed. These can create their own momentum, which might at first make investor behavior seem prescient. But eventually emotions create havoc with portfolios. To illustrate, according to the Investment Company Institute, between 1996 and 2010 the largest inflows into equity mutual funds occurred in early 2000 at the end of the dot com bubble. This inflow occurred in a year in which the S&P 500 lost 10.1%, followed by losses of 13.0% in 2001 and 24.2% in 2002. Similarly, the largest equity fund outflows occurred at the end of 2008 as investors panicked. The S&P 500 then gained 23.5% in 2009 and 12.8% in 2010. Investors were clearly zigging when they should have been zagging!

It is also our contention that emotional investing is driving the investment environment today. Simply put, the European debt crisis is frightening investors. There's no question that the peripheral economies such as Greece and Portugal are in trouble. Their economies will be crippled for years to come. Spain and Italy also have unsustainable debt levels, though there is still hope. We are not looking for robust growth in Europe, and recession is a distinct possibility. The questions are: can the rest of the world prosper in the face of Europe's issues, and do security prices already reflect negative events? For starters, exports to the European Union total about 20% of U.S. exports, or less than 2.5% of GDP. Certainly recession in Europe will have an impact on the U.S., but in and of itself, a European recession shouldn't be devastating.

surprised to see continued volatility, both on the upside and the downside. Ultimately, investors need to focus on their own time horizons and risk tolerances. For us at Pinnacle Capital, it is more important than ever to stay focused on our investment disciplines.

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The star of the domestic economy has been the corporate sector.

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## Equity Strategy

As 2011 unfolded, we anticipated many of the developments discussed above. Among our expectations were that the consumer side of the U.S. and European economies would remain weak while the exporting side of these economies would remain relatively healthy. Further, despite the level of concern in the markets, we did not believe the U.S. would soon slip back into recession. Overseas, we were skeptical regarding the strength of the exporters in many of the emerging nations. However, it was also our belief that many of these nations' middle classes had reached a level where internal demand could sustain economic growth. We expected generally promising results for companies that served the consumer side of emerging nations. In addition to our positive view on certain sectors of the global economy, we also believed that equity valuations were very favorable.

As a result of this outlook, we maintained our investment posture with an overweighting in industrial and technology stocks. Among other factors, we expected companies such as Caterpillar (CAT), Timken (TKR), Intel (INTC), and IBM (IBM) to benefit from both strong exports and domestic spending by corporations. Portfolios were less exposed to the consumer durable sector of the U.S. economy, as we expected this sector to face the head wind of deleveraging balance sheets among consumers. Most of clients' exposure to consumers was in the form of food companies such as Kraft (KFT) and Kellogg (K) in the U.S., and Embotelladora Andina (AKOB) and Brasil Foods (BRFS) in Latin America. To position portfolios to benefit from modest to rising inflation, we maintained investments in Apache Corp. (APA), a U.S. based energy company, as well as in Market Vectors Agribusiness ETF (MOO). Finally, we kept weightings in financial companies low. Such exposure consisted of Aflac (AFL), an insurance company, and the financial arms of industrial companies such as General Electric (GE). At no time during 2011 did

## European Debt

Country	Gross External Debt as of 6/30/11* (\$BN)	Net U.S. Exposure as of 12/31/10# (\$BN)
Portugal	\$ 548	\$ 46
Italy	\$ 2,684	\$ 269
Greece	\$ 583	\$ 41
Spain	\$ 2,571	\$ 41
<b>Total PIGS</b>	<b>\$ 6,383</b>	<b>\$ 535</b>

Data sources: \* Bloomberg, L.P. and World Bank  
# BIS Statistical Annex 6/11

A greater issue is the impact of a European recession on banks. As of mid year, the gross external debt of Portugal, Italy, Greece, and Spain (the PIGS) was approximately \$6.4 trillion. On the other hand, according to the most recent BIS Statistical Annex, total U.S. exposure – including both direct investment and derivatives such as credit default swaps – totaled approximately \$500 billion. This latter figure is as of yearend 2010, and we believe the exposure has been reduced significantly through 2011. Meanwhile, equity capital of U.S. banks has grown to \$1.6 trillion as of mid 2011. Certainly, European defaults will impact the U.S., but it appears to us that there is sufficient capital to absorb all but the most extreme losses.

Ultimately, it comes down to confidence. The global problems are real, but not unsolvable. The U.S. and many emerging nations are on relatively sound footing. While the margin of safety is not huge, we believe the bond and equity markets are anticipating major setbacks. As long as this high level of fear exists, we wouldn't be

clients hold bank stocks in their portfolios. We believed a need to improve balance sheets, a trend towards reduced leverage across the economy, and increased regulatory burdens would weigh against such stocks.

While the year began in a promising fashion, fears set in and there was a rush to perceived safety. After reaching a high on April 29, the S&P 500 fell 19.4% by October 3 before rebounding 14.4% by year end. Portfolios held several successful positions, including Temple Inland (TIN), which was sold after the announcement of a takeover, and IBM, which performed well for the year. Clients' low exposure to financial stocks helped performance, while exposure to emerging nations – including companies that derive significant revenues from exporting to these markets and those operating locally in these markets – negatively impacted performance. This negative performance occurred despite generally strong underlying financial results. For example, CAT derived over 37% of its revenues in 2010 from Asia, the Pacific region, and Latin America. The company had year over year revenue growth of 41% and 37% for the September 2011 and June 2011 quarters, respectively. Yet the stock price fell from a high of \$115.41 per share on April 29 to a low of \$70.55 per share on October 3 before rebounding to \$95.52 per share at year end. Similarly, Grupo Pao de Acucar (CBD), the largest retailer in Brazil, fell from a high of \$48.00 per share on June 28 to a low of \$30.68 per share on October 3 before rebounding to \$36.43 at year end. This occurred despite the company experiencing year over year revenue growth of 56% for the September quarter and 62% for the June quarter. Despite a strong rebound by many of the stocks in client portfolios between the recent market bottom on October 3 and the end of 2011, equity positions as a whole did not meet our expectations.

We did make several adjustments in 2011. Hewlett Packard (HPQ) was sold as a result of poor underlying business performance. Our positions in MOO were sold in order to reduce our exposure to short term commodity price movements. Pall Corp. (PLL) was added to many accounts that didn't already hold it. We also bought SAB Miller (SBMRY) after the sale of HPQ, purchased CBD during the summer, and increased holdings of several existing positions as we adjusted after the sale of MOO. We sold BRFs as a result of the emergence of several antitrust issues. As these were subsequently resolved, we were able to buy the stock back for many accounts when the stock fell in the market downdraft.

Notwithstanding these adjustments, we believe the long term posture we've staked out is still the proper posture going forward. We believe that equities are in general

very attractively priced. At the beginning of 2012, we do not anticipate radical changes to portfolios. However, our views are subject to change as economic, business, and political conditions change along with security prices.

## Fixed Income Strategy

On the interest rate front, we began the year with the opinion that interest rates were generally too low. Governments would likely print money to ease debt burdens, thereby leading to higher future inflation. It was, and remains, our thought that investors will eventually penalize debt issuers by requiring higher rates of interest. While we recognized that interest rates might temporarily fall if global investors panicked and bought U.S. debt, we believed that it was more prudent to keep durations short and wait for better opportunities down the road. If we were to strive for slightly higher returns, we thought it would be more prudent to take on slightly higher credit risk – i.e., purchase investment grade corporate securities as opposed to U.S. Treasuries – than to extend maturities and take on duration risk.

While we believe our investment posture is appropriate for the long term, as the year unfolded results were disappointing. Markets returned to a state of fear not dissimilar to what occurred in 2008 and early 2009. The 10 year U.S. Treasury yield, which reached 3.73% in early February declined to 1.88% by year end. Likewise, spreads between corporate bonds and U.S. Treasuries widened. As a result, the total return on U.S. government bonds generally exceeded that of investment grade corporate bonds despite the higher absolute yield on corporate bonds. Furthermore, interest rates in general tended to fall more for securities with longer maturities and durations than for those with shorter maturities and durations. Consequently, longer dated fixed income securities tended to outperform shorter dated fixed income securities. The bottom line is that the fixed income portion of most of our client portfolios underperformed the broad benchmark which we utilize for comparison.

Nonetheless, we still believe that interest rates are too low and it makes little sense to extend fixed income maturities at this time. Also, given that we see some strength in the economy, it makes even less sense to switch our corporate bond or corporate bond fund positions into Treasuries. As is the case with equities, going into 2012 we don't anticipate major changes in our outlook. And also as is the case with equities, we must always add the caveat that our views are subject to change as economic, business, and political conditions change along with interest rates and spreads.

