INVESTMENT QUARTERLY

THE BIG IF. . .

A former co-worker at the old Arlington Trust Company of Lawrence, Mass was fond of the saying " If I had some ham I could have some ham and eggs, if I had some eggs." In a way, this puts the current economic situation into perspective. There are so many critical variables at work in the outlook for the world's economic future that it is hard, if not folly, to try to predict the outcome at this time. The forecasts are so diverse and dependent upon the occurrence of specific future events and outcomes that are unquestionably assumed by the forecaster that the operative qualifier, usually missing from the analysis, should be IF. In this environment it is prudent to fall back on the words of the famous philosopher, Yogi Berra, who said, " It's tough to make predictions, especially about the future." With this caution in mind, this quarter's piece will give our thought and concerns about some of the major issues facing our economy and the markets.

Confidence is still the overriding drag on both the economy and the markets, although the stock market has performed better than the economy to date. Confidence is impacted by the job market, the housing market, the polarization of our political leaders at home, and worries that Europe's ability to work in harmony is even more unlikely than our domestic situation. Conditions will not get significantly better until a broadly based confidence returns. We see the results of this confidence deficit every day. Federal Reserve and government efforts to revive the moribund consumer (70% of our economy) have not been successful to date. The volatility in the stock market reflects reaction to the daily news, as there is no underlying confidence to put the daily events into longer-term perspective. Lost in the concern of the market's volatility is the understanding that this volatility is the result of activity by only 10 to 15 percent of the investment world. Retirement funds, trust accounts; and major institutionally managed accounts generally do not create short-term volatility. The volatility is brought about through actions of hedge funds, short term and program traders and ineffective stabilization by market makers. Many of the new trading initiatives over the past 30 years have seemingly increased volatility while proclaiming that they are necessary to maintain liquidity and stabilize the markets. Additionally there is little underlying confidence that the longer term outlook for common stock is positive enough to override the short term concerns. And this lack of confidence is reflected in other areas, beyond the stock market, as well. Corporations are still hoarding their cash. The velocity of money is still weak, and despite lower prices and mortgage rates, housing is still mired in the mud.

Real Estate continues to be one of the major drags on the economy. With foreclosures on the rise now that the legal logjam has been cleared, the immediate prospect for pricing

improvement is non-existent. The natural demand for housing, without the easy money of the past, the expectation of continually unreasonable pricing gains, and the loan to value lock-in many are facing with upside down mortgages and less income because of job losses, will make it hard, if not impossible, to create the incremental demand needed to bring a significant increase in housing prices, jobs, and spending in this market. While the outcome is still a toss-up, logic would imply that there will be meager help from this sector at best in the near future.

Despite the latest statistics on jobs, there is still much to be overcome. Without significant economic recovery job growth will be modest at best. After dissecting the latest monthly figures it looks like the gains were neither of high quality nor sustainable. Economists project that we need at least 300,000 new jobs each month just to handle the growth in population. Where are they going to come from?

The financial sector, better but not yet at a sustainable level of recovery, is facing new pressures from links to the Euro zone crisis. The eventual outcome here is too tough to call. Certainly the sovereign debt crisis in Europe hasn’t been resolved, only delayed as a result of the liquidity provided by the ECB. If we can’t find unanimity in our congress, how can we expect sovereign nations with nothing in common and a proud electorate pressing for their own priorities to subrogate their needs for those of the Union. If the contagion spreads or any of the politicians who are now leading together, like Sarkozy, are turned out in elections, this situation could return to the front page. Nobody wants austerity that impacts their lifestyle or is even willing (see Greece) to accept it for the short term if it is necessary to save their country’s financial wellbeing.

Corporate earnings are likely to be challenged next year after a period of strength. The treat of a recession in Europe could hurt exports. At home it appears that a reduction in the savings rate spurred consumer spending at year-end. One has to wonder how many rabbits can be pulled out of one hat. We can’t see where the argument for sustainable increases in consumer spending can come from. Of course, it is an election year and we all know that getting elected is more important than serving the needs of our country. The election campaign couldn’t lead to another Quantitative Easing could it?

We hope and expect that we will muddle through 2012 and that a European derived crisis does not become a reality. But one has to be vigilant and monitor how the “**IF**s” are playing out. “Who can kick the can furthest down the road” seems to be the game of the era

For the year the S&P 500 returned 2.13%, reflecting its dividend, as growth was flat. The Dow Jones Industrial Average was better at 8.38%. Bonds, due to the continuing Federal Reserve attempts to lower intermediate rates, showed a return of 6.50% for the Barclays Intermediate Government Index. All in all a better year than the economy might have implied. Thank God that there are 4 quarters to the year.

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