

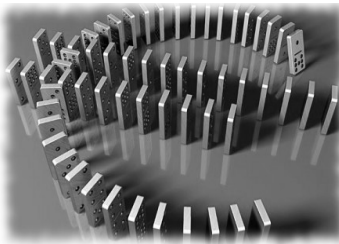
Perspective

JANUARY 2012 • VOL. 28, NO. 1 • A QUARTERLY REPORT ON INVESTMENT AND ECONOMIC TRENDS

WHO'S HOLDING THE BAG?

"Words pay no debts" – William Shakespear

During the fourth quarter, investors took comfort in a pledge made by European leaders to implement a "comprehensive plan" to resolve the ongoing debt crisis. The daily baying and yelping about the euro crisis that had bombarded investors throughout a big portion of 2011 came to an abrupt end in early November. At the same time, fears last autumn that market turmoil would cause the U.S. economy to wither away did not materialize. In fact, most economic indicators and recent forecasts have since been revised upward. As a result, stocks around the world shook off one of the most tumultuous stock market environments in the last sixty years, and rallied to end the year on a high note.



As noteworthy as we thought the market's daily reactions were to news out of Europe at the end of last summer (after all, how much of the daily news was genuinely actionable?), we are equally puzzled by the instantaneous calming effect of the EU's latest "blend and extend" short-term solution.

The market wants to believe that it doesn't matter, or that it will resolve itself. The market uses short term fundamentals or budding trends as evidence that "it's different this time." However, in the end, the world needs to deleverage or it will be stuck in an environment of perpetual fits and starts, sub-par economic growth, and haphazard reaction to crisis.

Total nonfinancial debt in 18 OECD countries grew from 167% of GDP to 314% between 1980 and 2010, an increase of almost 5% of GDP per year over three decades. This trend has brought us to the point in many of these countries where debt levels are stifling GDP growth in some of Europe's largest economies. It's not a matter of discrete liquidity flare-ups, but a lack of confidence in sovereign solvency. EU actions are not changing the dynamics of ongoing structural issues, but only deferring them.

Stock markets in both 2010 and 2011 started off strongly with predictions of vigorous economic growth, but halfway through each of those years the economy stalled and worries of a double dip recession emerged. As a result, the Fed was compelled in 2010 to intervene with QE2 and then again in

2011 with "Operation Twist." The economy has recently strengthened once again, but given the strong financial links between the U.S. and Europe, fears linger surrounding the euro crisis.

During the first half of this year it will likely become obvious whether the fallout from Europe will halt the U.S. and global economic recoveries, or whether recent evidence of renewed U.S. economic acceleration is for real.

While the stock and bond markets will continue to be impacted by European developments throughout 2012, we are encouraged that most companies around the world are doing better than their governments. We believe the U.S. economy will continue to persevere.

Market

Market Measures*	% Change	% Change	% Change
	4Q Ending 12/31/2011	6 Mo Ending 12/31/2011	1 Yr Ending 12/31/2011
Dow Jones Industrial Avg	12.67%	-0.31%	8.14%
S&P 500 (Cap Wtd)	11.75%	-3.75%	1.91%
NYSE Composite	10.09%	-10.12%	-6.11%
NASDAQ Composite	8.21%	-5.51%	-0.77%
Russell 1000 Large Cap	11.84%	-3.64%	1.50%
Russell 2000 Small Cap	15.47%	-9.77%	-4.18%
Russell 1000 Growth	10.61%	-3.92%	2.64%
Russell 1000 Value	13.11%	-5.22%	0.39%
S&P CitiGroup Growth	10.81%	-2.00%	4.65%
S&P CitiGroup Value	12.98%	-5.43%	-0.48%
Lipper Large Cap Value Fd	9.67%	-6.57%	-1.74%
Barclays Capital Int Bond	0.84%	3.25%	5.80%
U.S. T-Bills (90 days)	0.00%	0.03%	0.16%
Consumer Price Index	-0.19%	0.33%	3.32%

*Total Return

Since bottoming on October 4th, stock markets staged a powerful rally to end the year. The S&P 500 closed the year down a fraction of a percent, its smallest annual move since at least 1970. The Dow industrials closed the year up 5.5%, and the Nasdaq Composite closed the year down 1.8%.

The market's final score inconspicuously masked what was actually a very bumpy road for investors throughout the year. Optimism in early 2011 was later replaced by renewed economic concerns in the U.S. and worries about Europe.

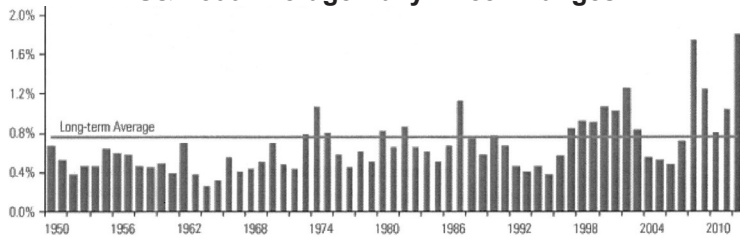
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It then took a 20% rise in October, the best since 1974, to bring stocks back into the black.

Volatility was particularly acute from July until the middle of November, while anxieties about the European economy held the global financial markets hostage. Daily price changes in the S&P 500 during that five month period averaged 1.8%. That is higher than 2008's and double the annual average percentage for the last 60 years.

S&P 500 Average Daily Price Changes



Source: Oppenheimer Investment Strategy Group

Note: 2011 data refers to period from July to mid-November

Recent volatility aside, it is clear investors are still skeptical of stocks. Corporate earnings continue to exceed all expectations and are well above 2007 levels, yet a commensurate move in stocks has fallen somewhat short. This is largely explained by the fact that over the last three years mutual fund flows have shown a net decrease of almost \$150 billion out of stock funds, and an increase of over \$725 billion into bond funds.

A stock represents a claim on a company's future cash flows. As long as the company produces increasing cash flows, an iron clad relationship dictates the price of the stock will ultimately catch up even though short-term disconnects occur. Consider that there were 12,586 trading days in the 50 years that spanned 1961-2010 that produced an annualized return of 9.7%. If one removes the 50 best days from that calculation, then that annualized return drops by more than half to 4.5%.

Euro Debt Crisis

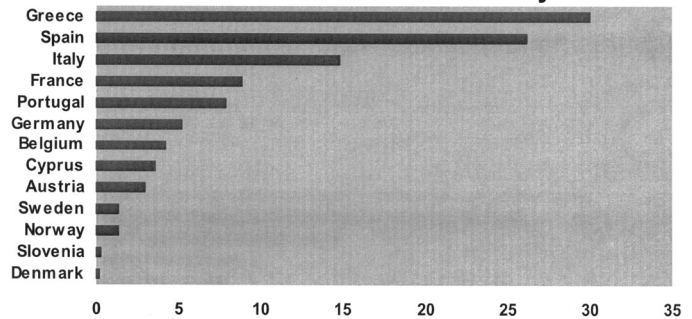
Demographics have finally caught up with the European social welfare state. European governments made promises they can't keep and now we're witnessing the bursting of the entitlements bubble. Some progress has been made regarding the crisis, but in spite of the market's positive reaction, the euro zone finds itself in much the same position starting 2012 as it did in 2011.

Once sovereign yields climb above the likely GDP growth rate, the debt burden will climb to the point where it eventually crushes the state. By this measure, all of the so-called PIIGS (Portugal, Ireland, Italy, Greece and Spain) are already above the sovereign yield danger zone. At the same time, the euro zone is sliding into a second recession, compounding unresolved sovereign debt problems of the "periphery" countries.

The simple math indicates the periphery writes down its sovereign debt, but that is not seen as a palatable option. In response to increasing anxieties, the EU along with the ECB has implemented a strategy whereby banks must shore up their balance sheets in return for short-term 1% loans. It is

estimated that it will take about €106 billion to shore up the European banking system.

Estimated Billions of Euros Needed by Banks

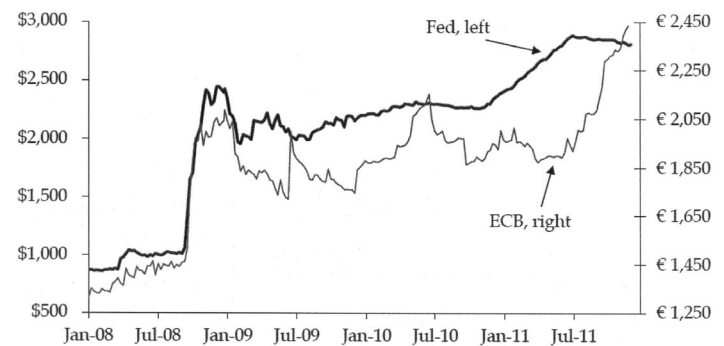


Source: Charles Schwab

In theory the loans will be used as a capital buffer, as well as, to purchase newly issued sovereign debts. The anticipated result is a restoration of confidence and a decline in sovereign yields. Indeed, since the middle of the fourth quarter, anxieties have diminished. However, with roughly \$1 trillion of sovereign debt to be rolled over in the coming year, half of which by Italy, we believe worries will flare up again in 2012.

Up to this point, the ECB has refused to be the lender of last resort mainly because such an effort runs the risk of generating complacency among the peripheral economies about the need to carry out fiscal and structural reforms. Ironically, implementing those reforms impairs the immediate ability of countries to service existing debts, and a vicious cycle ensues. Therefore, we believe the massive exposure of French and German banks to peripheral sovereign debt will ultimately sway the ECB to give in and "hold the bag." As can be seen by the expansion of the ECB's balance sheet over the last six months, the foundation has been laid.

Fed Balance Sheet vs. ECB Balance Sheet in Billions



Source: Strategas Research Partners, LLC.

Interest Rates

One of the most noteworthy stories of 2011 was the continued strength of U.S. treasuries (lower yields). The yield on the 10-year treasury started the year above 3%, only to make a record low in September of 1.7%, and finish below 2% for the first time in over 30 years.

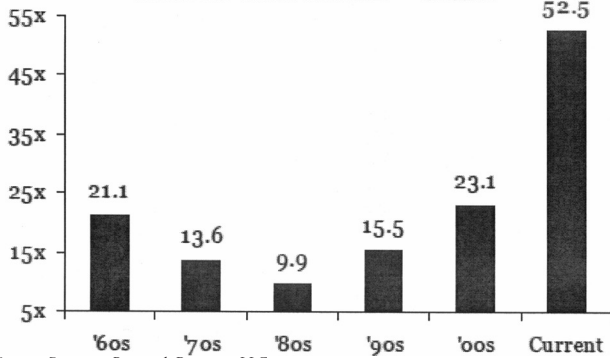
Naturally, problems in Europe created a short-term "lifeline" in the U.S. as investors moved out of risk assets and into safe haven U.S. treasuries. However, the Fed's commitment to maintain low interest rates on the long end of the curve via

“Operation Twist”, and its pledge for near zero interest rates into 2013 on the short end, have also had an impact on all borrowing rates.

While the Fed’s intended consequences of a low interest rate environment include an increase in lending and encourage spending, success has been debatable. What’s undeniable, however, is how expensive treasuries are. The 10-year treasury yield is currently two standard deviations below its 5 year average (3.49%), and when adjusted for inflation, has a negative real yield. Investors are literally paying for the privilege to lend instead of making a return.

For all their wear and tear, stocks are as attractive as they have ever been when compared to fixed income. Both the dividend yield and the earnings yield of the S&P 500 exceed the 10-year treasury yield by margins as wide as any during the last 50 years. In fact, while the S&P 500’s P/E ratio (inverse of earnings yield) is in the mid teens, the inverse of the 10-year treasury yield is above 50.

**Avg. Bond “P/E” by Decade
(100/10-Year Treasury Yield)**

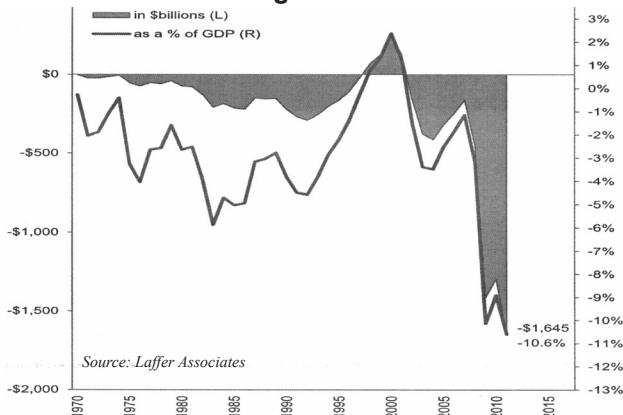


Source: Strategas Research Partners, LLC.

The current situation in bonds is unsustainable. Inflation by itself will make it tough for the Fed to hold rates down - even more so if GDP surprises on the upside. We have witnessed such periods both in 2010 and 2011, just to see the optimism fizzle and rates move lower as the sustainability of the economic recovery proved elusive each time. We suspect that 2012 will be similar. However, absent geopolitical calamity or additional Fed intervention, we believe market forces will drive rates higher off the bottom.

Economy

Federal Budget Deficit % of GDP



Source: Laffer Associates

If the investment-led recovery falters, the U.S. has little more ammunition from either a fiscal or monetary policy standpoint to re-stimulate the economy. In fact, it’s just the opposite. The country is running a \$1.6 trillion federal budget deficit with little stimulative effect.

Consumption and government spending cannot provide the fuel to run our economic engine anymore. In the five and half decades from 1947 to 2000, the economy grew at an average annual rate of 3.5%. However, since 2001, GDP has grown at only a rate of 1.6% annually. The loss of almost two GDP growth points a year since 2001 may not seem like much, but such a loss is actually severe because for every additional GDP growth point our economy generates annually, we create one million new jobs. In the four years from June 2007 through June 2011, the number of unemployed doubled from 7 million to 14.1 million.

Initial jobless claims continue to recover and are returning to mid-2008 levels, with the most recent 4-week moving average around 385,000. Below 400,000 signals an improving jobs picture and the average since 2000 is 390,000.

In spite of heightened economic fears last summer, nonfarm payroll employment increased every month last year. Since the July lows, payrolls have accelerated to 200,000 in December and the National unemployment rate dropped to 8.5%.

The ISM manufacturing index, the best indicator of the investment led recovery and a good predictor of corporate earnings, registered a 53.9 in December. With a reading of 50 representing the demarcation line between expansion and contraction, this was the 29th month of growth and a 6 month high.

Housing

The housing market continues to bounce along the bottom from the end of the recession. New home sales for the year were the worst on record dating back to 1963. They are currently at a seasonally adjusted annual rate of 315,000, less than half of the 700,000 needed to sustain a healthy market.

Existing home sales are around 4.4 million per year. That remains below the 6 million economists say is consistent with a healthy market, but it is up about 12% over the last year, and 34% above the mid-2010 low point.

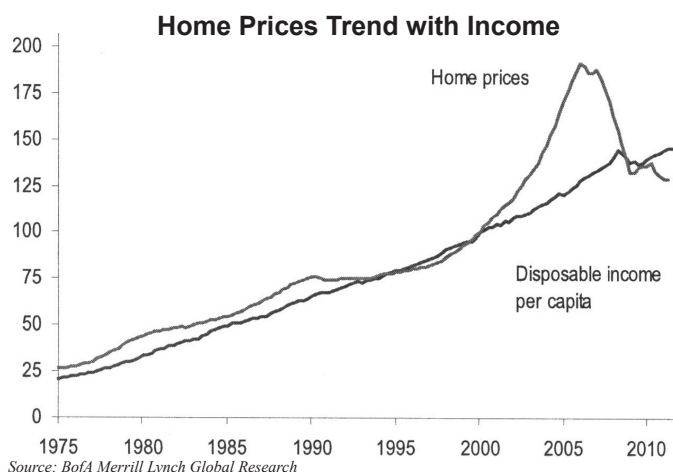
In selling new homes, builders must compete with foreclosures and short sales on existing homes — when lenders accept less for a house than what is owed on the mortgage. With a glut of foreclosures on the market, existing homes have been selling at a deep discount to new homes, and the difference between the median price for new homes versus existing homes is three times greater than the long-term average. This has made it extremely difficult for builders to compete and helps to explain why new home sales are at record lows.

In response, homebuilders have cut the supply of new homes

hitting the market. New home construction is only about one third of the 1.5 million needed per year to keep in line with population growth and scrappage. However, we believe prices of new homes will need to come down further. While there have been roughly 6 million loans liquidated since 2007, there are an estimated 8 million left to be liquidated through 2015. Even if estimates prove incorrect, it's clear there will be continued pressure on new home prices in the intermediate term.

A bright spot for housing is that, as prices have come down, homes have become affordable again. Comparisons that measure the cost of renting to buying, or income levels relative to home prices have fallen back down to earth from their peaks of 5 years ago.

In December, the average rate on a 30-year fixed home loan dropped to 3.75%, the lowest rate ever. With mortgage rates at all time lows, the prices of homes becoming more affordable, and new construction trailing population growth, we believe the seeds of an eventual recovery are now being sown.



Outlook and Conclusion

The following is a summary of some of the indicators that guide our equity investment policy:

Commodity Prices	Turning
Earnings Growth	Positive
Fiscal Policy	Negative
Earnings Momentum	Turning
Inflation	Positive
Interest Rates	Positive
Monetary Policy	Positive
Yield Curve	Positive
Price to Book	Neutral
Price to Dividends	Neutral
P/E Ratio	Neutral
Volatility	Negative
Technical Outlook	Neutral

To summarize our current thoughts:

- Inflation outlook still positive in intermediate term
- No economic contraction, but sub-par growth
- Unemployment making progress
- Corporate profits still growing
- Volatility persists as Europe remains unresolved
- Treasuries are overvalued
- Dollar to remain strong
- Price of oil to test upper boundaries
- Budget deficit expanding

One thing seems reasonably certain. The global economy is going to continue enduring a significant deleveraging cycle throughout 2012 that affects most if not all parts of the developed world. EU interventions up to this point have been effective at calming markets in the short-term, yet Europe remains at a tipping point.

Interventions for the sovereign debt crisis cannot remain haphazard. Unless the ECB ultimately decides to backstop “periphery” country debt, Greece and Italy will both default in 2012, and core European banks will be left holding the bag.

In the meantime, imposed austerity is crushing periphery countries’ economies and Europe is sliding into a recession. In order to get out of this vicious cycle, any solution for deleveraging will be accomplished by some combination of default and write-downs, debt repayment and rising savings rates. We anticipate additional market volatility while the issues or the solutions run their respective courses.

With failed stimulus spending and all the regulatory chaos that has been created in the U.S., it has been reassuring to see just how resilient corporate America has been. Notwithstanding the wild ride stocks had in 2011, the underlying companies of the S&P 500 have never looked better. Good companies exhibit fiscal discipline while governments do not.

Over time, the best investing results are achieved largely by purchasing strong companies at attractive prices. Regardless of what the world throws at investors in the short-run, or how it impacts a company’s stock price, great businesses still grow value even in a tepid economy.

In a world where safety, predictability and income are at a premium, quality matters. We will continue to invest in companies we believe will deliver healthy returns, with reasonable risk, in the face of current macroeconomic challenges.

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