



***Market Review***  
***Fourth Quarter 2011***

Much like all of 2011, this quarter was emblematic of market participants' lack of sustained conviction in any economic outlook. While the fourth quarter was in the right direction, wild shifts in investor temperament have created a quarter-to-quarter roller coaster of hope and despair, based on little new economic input. Perception rather than fact continues to dominate. By the end of the third quarter, the belief was that Europe would fail and take the U.S. economy with it. Midway through Q4, simple acknowledgement by European officials that aggressive policy action was needed was enough to send the U.S. markets on a buying spree. Sentiment is now to the point where U.S. investors have become complacent with Europe's problems. The current rationale: U.S. exports to Europe have a small impact on overall U.S. GDP, so a disruption won't move the American economic needle much; we are a self-sustaining economy. Reality, as usual, is somewhere in between.

Justifiably, adding to investor optimism was gradual improvement in employment, and building evidence that GDP this quarter might reach 3%, eliminating double dip worries. Consequently, commodity-oriented stocks (think Energy), economically-sensitive businesses (think Industrials), and the higher-risk names that had been so badly battered in the first nine months of 2011, fired their afterburners and led a powerful close to the year. Risk on.

As poorly as they had done, it was no surprise to see a snap back in industrial and commodity stocks. What was impressive was that the banks participated in this run. There have been many voices in the marketplace, including a few here at RHJ, which proclaimed that America could not have a sustained economic recovery without bank participation. Loan growth has been slow, but it has improved; could it finally be? Let's hope so.

In 2011, the banks' general reluctance to lend was matched by cash-rich corporations' reluctance to hire. Few business leaders had confidence enough in the economic outlook to take that bold step forward. In contrast, management comments regarding the economy seem a bit more upbeat of late giving us hope they will be more aggressive in 2012. There are reasons to be bullish, but we are by no means out of the woods. Unemployment, while improving in the private sector, is nowhere near where we would like to see it. Corporate balance sheets are healthy and indications suggest that this upcoming earnings season will be robust, but corporate margins are near record levels, leaving little of the upside leverage to earnings that we like to see in a sustained expansion. Perhaps most importantly, new hopes of a workable plan to bailout Europe have grown in the U.S. markets, but the fact remains that Europe still faces the potential of a Lehman-like debt crisis, with subprime sovereign debt rather than subprime mortgage debt the root of the cause. No, we are not out of the woods, but we are on the right path.

In closing, we need to at least address the persistently high levels of consumer and government debt and the necessary continued deleveraging. As consumers increase their savings rate rather than credit card debt, as government stimulus wanes, spending cuts appear, and ultimately taxes increase, economic growth will be impaired. If engineered properly, no recession need appear, but if growth in a normalized economic cycle is 3.5%, then perhaps we will see 2-2.5%. Exciting? Not particularly, but still an environment where we feel money can be made. In such an environment, we believe that revenue growth will be a relatively scarce resource and our focus will be finding those high quality companies where stable organic growth can be achieved in spite of a slow growth economy.



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