



Roxborough Capital Management

Private Wealth Advisors

"With great wealth comes great responsibility"

Global Economic and Markets Review

December 31, 2011

Problems cannot be solved by the same level of thinking that created them. – Albert Einstein

When the ball finally dropped in Times Square at midnight on the 31st, domestic stocks, as measured by the S&P 500 Index, were exactly where they were at the start of the year. Fitting, in our opinion, because after the ball dropped, we didn't really have any more clarity about the future direction of the U.S. economy than we did at the start of the year.

<u>Equity Indices:</u>	<u>12/31/11</u>	<u>9/30/11</u>	<u>12/31/10</u>	<u>Qtr Change</u>	<u>YTD Change</u>
Dow Jones Industrial Average	12,218	10,913	11,578	12.0%	5.5%
S&P 500 Index	1,258	1,131	1,258	11.2%	0.0%
Nasdaq Composite Index	2,605	2,415	2,653	7.9%	-1.8%
Russell 2000 Index	741	644	784	15.0%	-5.5%
MSCI EAFE Index*	1,413	1,373	1,658	2.9%	-14.8%
MSCI Emerging Markets Index	916	880	1,151	4.1%	-20.4%

*Europe, Australiasia, Far East

Granted, the employment data during the fourth quarter was encouraging, and manufacturing, retail sales, and consumer confidence appear to be rebounding from multi-year lows. These all point to an ongoing, albeit modest, economic recovery in the U.S., similar to what investors expected at the beginning of the year. However, many of the same problems remain unresolved; overly indebted nations worldwide and the subsequent pockets of insolvency within the global banking industry, lackluster wage growth, and persistently weak housing prices all render supportive monetary and fiscal policies mute. The global economy is not any closer to a sustainable rebound than it was at the start of the year. And it all seems to hinge on Europe.

Unfortunately, European technocrats continually fail to develop appropriate policy solutions, preferring instead to address the situation as if it were a liquidity issue, one that can be resolved with more money (debt). This is the same level of thinking that trapped Japan in the 1990's. Unless European leaders are willing to embrace a new level of thinking, one that allows for the failure of insolvent governments and banks, and the enactment of structural governmental and business reforms, the euro-zone may collapse under its own weight, plunging European economies into a deflationary trap more dire than the one Japan is still experiencing.

Looking forward, the key questions for investors during 2012 will be whether the U.S. economy can withstand the European recession, whether the U.S.' fiscal austerity will happen in 2012, an election year, or be pushed into 2013, and whether China's government will be able to successfully steer its centrally planned economy through the global turbulence. Welcome to 2012.

The Worldwide Economy – Fighting Against Deflationary Forces

With few exceptions, economic growth around the world slowed in the fourth quarter. The as of yet unchecked deflationary forces in Europe are now dragging the continent and most of its member-states into recession, which is having knock-on effects in Asia and emerging markets around the world. The U.S. appears to be one of the few economies bucking the trend, as consumers disregard their own falling inflation-adjusted incomes and ramp up personal spending.

				Qtr	YTD
	12/31/11	9/30/11	12/31/10	Change*	Change*
European Euro	1.30	1.34	1.34	3.4%	3.1%
British Pound	1.56	1.56	1.56	0.5%	0.3%
Canadian Dollar	1.02	1.04	0.99	-2.1%	2.2%
Japanese Yen	76.94	77.10	81.14	-0.2%	-5.2%
Chinese Yuan	6.30	6.38	6.59	-1.2%	-4.4%

* US Dollar % change versus the currency

In all, 2011 may be the high water mark in terms of global growth for the next few years. Most economists are lowering, once again, their expectations for worldwide growth in 2012 and 2013. The Organization for Economic Cooperation and Development (OECD), which tracks 34 industrialized nations around the world, now expects growth for its member-countries to be 1.6% in 2012, down from its previous expectations in May 2011 of 2.3%. Central banks around the world are confirming the pessimism; no fewer than 11 central banks have reversed course and are now providing monetary stimulus. In addition to the 11 central banks lowering rates, China lowered its bank reserve ratio, a move that often signals additional stimulative moves on its part.

The easily identifiable culprit is Europe. Caught in a stubbornly challenging debt trap, growth for most members is falling. Even Germany, the champion of European growth at the start of 2011, contracted in the fourth quarter. Fiscal austerity throughout the continent and rapidly rising borrowing costs for the Spanish and Italian governments are creating a self-sustaining feedback loop, threatening the solidarity of the euro-zone itself and Europe's banking system.

Euro-zone members must refinance €1 trillion of maturing debt in 2012, the equivalent of 10% of the euro-zone's economy. But would-be investors are balking. Banks, which were coerced into buying Greek debt based on the premise that doing so would prevent Greece from defaulting, are now facing losses that could exceed €100 billion, or 80% of the Net Present Value of Greek debt they hold; Greece needs those concessions in order to ease its crushing debt burden and keep it in the euro-zone. This in turn motivates banks and other investors to require higher yields for highly indebted nations like Italy and Spain. In essence, both countries are being forced to pay more for their debt at a time when both are struggling to bring debt service payments down.

But there's an even more insidious side to having to pay higher interest rates. Higher borrowing costs pressure Spanish and Italian politicians to cut government outlays even deeper, which tends to weigh on economic growth even more. It's a catch-22; how can a government improve its solvency by cutting outlays, which subtract from economic growth, while simultaneously stimulating the economic growth that is required to pay off its existing debt? This is the quintessential nature of a deflationary trap and, unfortunately, its seeds have already been sewn.

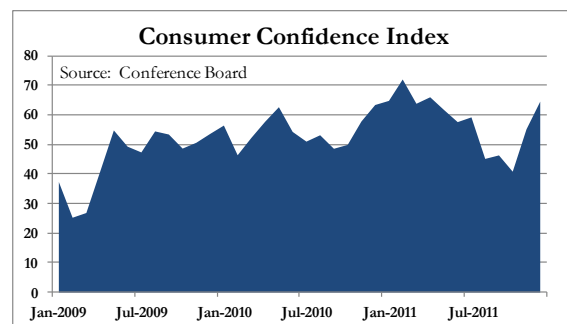
Moreover, the insolvency of certain nations translates into the insolvency of European banks, which are unprepared for losses of this magnitude. This "counter-party risk" threatens the entire banking system with collapse, forcing the European Central Bank to step in and lend money to European banks as a lender of last resort. Sound familiar? This is exactly what happened in the U.S. in 2008, and it happened in Europe during the fourth quarter; the ECB lent an unprecedented €489 billion to European banks at ultra-low interest rates, an amount that shocked most observers.

While lending that amount of capital may alleviate the liquidity risks, it can't address the underlying issue – the long-term solvency of nations and their banks. For their part, European banks have pledged to shrink themselves, by selling assets and lending less, by almost €1 trillion in the next two years. As ambitious as those pledges may appear (they would have dire consequences for the European economy), they may not be enough to ensure banks' survival.

When one steps back and evaluates the situation on the whole, it's hard to feel optimistic about Europe's near-term direction. It also explains why the Economist Intelligence Unit (EIU) expects the 17-nation bloc that uses the euro currency to contract 1.2% in 2012. It also explains why the EIU assigns a *40% probability to the breakup of the euro-zone within the next two years*. In such a scenario, the global economy would certainly fall into a recession, one that would likely surpass the Great Recession of 2008.

To understand why, one just needs to look at Asia. During the quarter, most of the key Asian manufacturing nations experienced a marked slowdown in manufacturing and export activity. South Korea has now turned in five straight months of manufacturing decline, while Taiwan has now turned in seven straight months of manufacturing decline. China is even starting to show signs of manufacturing and export sluggishness, which is not a welcome situation considering the government is sticking to its plan to blunt residential real estate speculation, one of the primary growth drivers of its economy. As a result, growth rates for China's economy are likely to come down, and may even fall short of the country's 8% growth rate target in 2012. The only bright spot in Asia is likely to be Japan, which will get a boost as the nation continues to rebuild after last year's earthquake and typhoon. But even then, economic activity is likely to be tepid.

The U.S., on the other hand, appears to be a bastion of hope. Manufacturing activity is showing signs of life, inventories are lean, retail sales rebounded in the fourth quarter, consumer credit is rapidly expanding, and consumer confidence has bounced off of multi-year lows, owing in large part to better than expected employment data.



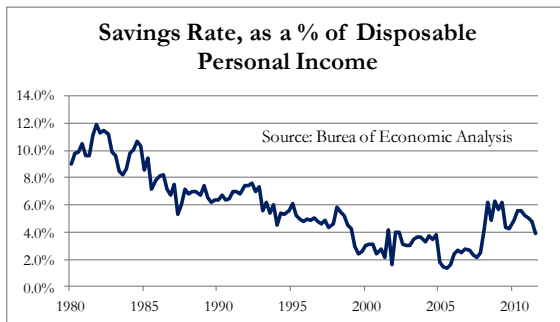
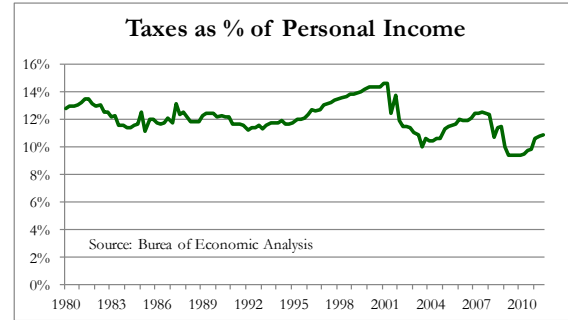
Private employers added 155 thousand employees per month on average during the quarter, in line with what's required to maintain a flat unemployment rate (which tells us the drop in the unemployment rate to 8.5% during the quarter is symptomatic of disgruntled job-seekers leaving the workforce, who are no longer counted as "unemployed", not an overall improvement in the actual number of unemployed). The ranks of the long-term unemployed have probably peaked, and workers appear to be moving from part-time positions to full-time positions. Overall, the U.S. economy appears to be stabilizing, which in turn supports a more balanced outlook for financial markets.

Investors can't get too optimistic about the economic recovery however. Manufacturing and retail sales are not strong, only improving (in the case of retail, primarily because of huge price discounts). There is no question that small-business owners remain cautious, and that the prospects of the economy reaching "escape velocity" are still a long way off, especially when one considers that consumer spending, which grew 6.5% in 2011 and represents 70% of the economy, has been artificially supported by two temporary factors: a reduction in the percentage of personal incomes allocated to taxes, and a marked decline in the household savings rate.

As is common during a recession, politicians attempt to stimulate the economy by easing the personal income tax burden, and 2008 was no exception. As a nation, we entered 2007 paying 12.5% of our personal income to the government, and exited 2009 paying 9.5%.

At the risk of alienating our Republican audience, we can confidently predict that higher personal income taxes will be part of the fiscal deficit solution; they have to be. There is simply no way the U.S. can cut its way to fiscal balance without plunging the economy into a deep recession. Government spending is an asymmetrical factor that provides marginal economic stimulation when rising, but significantly detracts from economic growth when falling. Various European nations emphatically prove this point. While one might argue that taxes won't change much during an election year, in fact, taxes, as a percentage of personal income, are already rising; at the end of 2011, the rate was 11%.

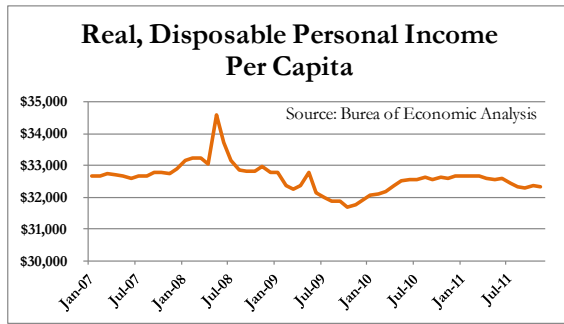
If the nation were to return to the long-term average of 12% in 2012 (the best case scenario in our opinion), \$130 billion of additional taxes would be paid, and, all else being equal, consumer spending would decline by a like amount. This translates into a 0.9% headwind to GDP growth in 2012, which may not sound like much, but when the economy is expected to grow 1.3% in 2012, a 0.9% headwind brings GDP growth dangerously close to zero. If we were to move to the average rate during the Clinton era (perfectly reasonable given our ballooning debt and structural deficit) over the course of three years, GDP growth could face a 0.9% headwind every year for the next three years.



Higher taxes, however, are just one component that points to weak consumer spending for the next few years. After peaking at nearly 6% in 2010, consumers drew down their savings in 2011, bringing the household savings rate close to pre-recession levels in the low single digits. Some interpret this as an indication that consumers are confident about the future (unlikely in our opinion given the dismal public opinion polls we've referenced in previous Reviews), or as an indication that

consumers have recession fatigue and are willing to spend, even if it means dipping into their savings and jeopardizing their ability to retire when and how they want (a mentality we encounter all too often in our line of work). If consumers were to return to the average savings rate of the last 30 years, 5.8%, by our estimation nearly \$225 billion of consumer spending would evaporate, or the equivalent of about 1.5% of GDP. This could be spread out over a year or two, which means that a higher savings rate wouldn't, by itself, push the U.S. into a contraction. But it would be enough to exacerbate a contraction if taxes rise, as we discussed above.

There is one scenario in which a higher savings rate would not subtract from economic growth; if real (after-inflation) Disposable Personal Incomes (DPI) rise fast enough to offset a rising savings rate (about 1.3% for every 1% increase in the savings rate), consumers could maintain their level of spending and save more. Unfortunately, that doesn't appear to be realistic.



Real DPI spiked in May, 2008 when the federal government mailed checks to Americans as part of its initial stimulus program. 2010 was generally a good year, but since then, Real DPI has fallen, erasing the gains of 2010 and the first half of 2011.

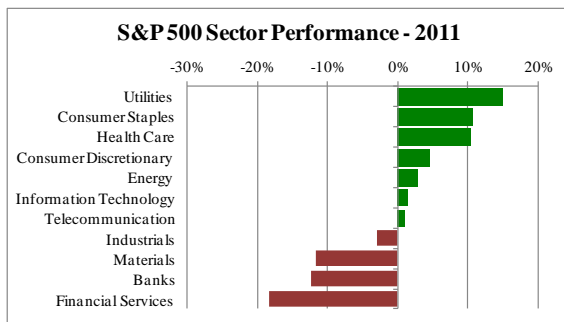
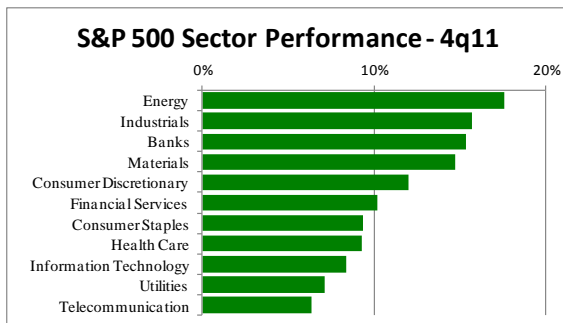
In part, the decline of real disposable incomes can be attributed to a rising tax burden. But, the largest factor, in our estimation, is

attributable to the fact that a high unemployment rate prevents employees from demanding wage increases that keep pace with inflation. In essence, workers are being paid more, but not enough to keep up with broad-based inflation. In the short term, consumers can offset these declines by drawing down their savings and taking on more consumer credit, which they did in spades during the fourth quarter. However, both of these efforts are short-term in nature, and eventually become headwinds to economic growth, as savings are rebuilt and debt is paid down.

We're not claiming with any sort of confidence that 2012 will be the year politicians raise tax rates (they are, after all, politicians), or that Americans embrace the act of saving (we are, after all, a consumption-driven society). As such, the lurking headwinds to the economy may not appear until 2013. Nonetheless, both are possible. If they don't happen in 2012, they're all the more likely to happen in 2013. Accordingly, while we welcome the economic green shoots during the quarter, we're reluctant to endorse anything more than an "eyes wide open" degree of optimism; the global economy and the U.S. still have significant challenges to overcome.

Stock Markets – Focusing on the Positive, Not Europe

For stocks, the ongoing negativity coming out of Europe was eclipsed by improvements in domestic economic activity and domestic earnings reports. After dumping shares in economically sensitive sectors in the third quarter, investors returned to economically sensitive sectors in large numbers during the quarter, fueling gains in all sectors, and mid-teens gains in four sectors. Investors were in a buying mood in general, much like consumers, and even bought shares of traditionally defensive sectors.

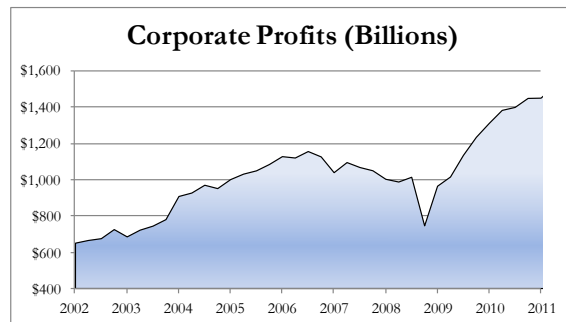


The quarter's advance was not enough, however, to bring every sector into positive territory for the year. Banks and financial services, despite double digit gains in the fourth quarter, finished the year with double digit losses. While domestic financial institutions hold relatively small amounts of European Sovereign debt, they are nonetheless inextricably linked to their European

counterparts. As we discussed above, the global banking system relies to a large extent on inter-bank lending. It is this counter-party risk, which, when combined with ongoing weakness in their domestic loan portfolios and forthcoming banking regulations that will negatively impact profitability, motivated domestic investors to take a cautious stance in both sectors.

Outside of financial services and banks, however, investors have a green light to be aggressive, at least in the short-term. Management teams appear to be downplaying the impact European issues will have on their operations, and for the time being, investors have reason to believe them.

Earnings reports for the third quarter were good (announced in October and November). Government data on corporate profits set a new high water mark in the third quarter, indicating that earnings growth is genuine, which is always a concern of ours when management teams have the ability to manipulate accounting practices and pull other levers to inflate reported earnings.



In general, management teams were positive about business momentum going into the fourth quarter, which supports confidence regarding fourth quarter earnings. Although, for certain companies, the confidence in fourth quarter results may have proven a bit too optimistic. As we prepare for fourth quarter earnings reports, companies are already pre-announcing disappointing results. The ratio of negative pre-announcements versus positive pre-announcements hit its highest point since the fourth quarter of 2008, an unwelcome signal considering that earnings collapsed shortly thereafter, catching many investors flat-footed.

Investors have little mercy for companies that are pre-announcing disappointing results, in many cases dumping shares to such an extent that stocks begin trading the next day with double-digit percentage losses. These “landmines” serve as an important reminder that while stocks may continue to perform well in general, investors will have to remain vigilant, exercise valuation discipline, and be quick to spot risks. Studies indicate that earnings shortfalls tend to be serial, not discreet events, which also argues against the standard “buy and hold” strategy.

Fixed Income

Fixed Income markets were generally subdued during the quarter. Bond investors didn't embrace the new-found economic optimism, preferring instead to use sell-offs in the bond market, and the higher yields a sell-off brings, to add to positions. Rates on U.S. Treasuries barely changed during the quarter, although rates declined significantly for the year.

Fixed Income (Yield):	12/31/11	9/30/11	12/31/10
U.S. Treasury 2 Year Note	0.25%	0.25%	0.61%
U.S. Treasury 5 Year Note	0.83%	0.96%	2.01%
U.S. Treasury 10 Year Bond	1.89%	1.92%	3.30%
U.S. Treasury 30 Year Bond	2.57%	2.66%	4.13%

We find investor appetite for U.S. Treasury securities surprisingly strong when one considers that on an after-inflation basis the 10-year Treasury yields a -1%, and the 30-year Treasury yields a -0.5%. Investors are signaling that inflation is likely to fall, which supports the notion that in the

end, inflation-adjusted returns are likely to be higher than what current yields would suggest. But they are also signaling that with the euro-zone struggling, inflation risks take a back seat to default risks. Despite the ultra-low yields on Treasuries, expectations for a third round of quantitative easing, in which the Federal Reserve buys Treasuries and other bonds in the market in an effort to bring down interest rates and incentivize lending, are growing. Some investors now put the odds of such an effort at 50% during 2012.

Municipal bonds had a great year; as an asset class, municipal bonds returned 10%, one of its best years on record. This is due in large part to paltry yields on U.S. Treasuries, the low level of new bond issuance (as municipalities reduce their own spending), and expectations that tax rates will go up, making tax-free income all the more attractive. And yet, municipal yields relative to Treasuries are still highly attractive, which means if Treasury rates hold steady, or even decline somewhat, municipal bonds could have another banner year in 2012.

Commodities

Commodities were all over the map during the quarter, driven by the underlying dynamics of their own markets, rather than a general sense of economic optimism or pessimism. Crude oil advanced as tensions in the Middle East, and in particular, Iran, flared up. Natural Gas is in freefall due to historically large supply gluts that can only be fixed with equally large demand growth (which may happen over time, but not enough in the short term). Copper's strength is primarily attributable to optimism about the continuation of China's economic growth. Wheat was the beneficiary of some unfavorable weather, although crop reports from the USDA have since quashed those gains.

Commodities	12/31/11	9/30/11	12/31/10	Qtr Change	YTD Change
Gold	\$ 1,567	\$ 1,622	\$ 1,421	-3.4%	10.3%
Crude Oil	\$ 98.83	\$ 79.20	\$ 91.38	24.8%	8.2%
Natural Gas	\$ 3.02	\$ 3.67	\$ 4.41	-17.7%	-31.6%
Copper	\$343.60	\$315.20	\$443.95	9.0%	-22.6%
Wheat	\$ 6.52	\$ 6.09	\$ 7.94	7.1%	-17.9%
CRB Index	305	298	333	2.4%	-8.3%

We wouldn't be surprised to see a high degree of dispersion within the Commodities sector in 2012, and the individual dynamics of each market dictate how various commodities perform.

Conclusion

Overall, 2012 could be a decent year from an investment perspective. If there is one thing we've learned over the course of our careers, it's that financial market performance can decouple from the underlying fundamentals for short periods of time. Investors are notoriously short-sighted, and tend to allow their emotions to dictate more of their actions as a result.

But that doesn't change the medium-term outlook. The euro-zone is struggling for its survival, the U.S. has little margin for error, and Asia must find a way to stimulate domestic demand to offset sagging exports. The medium and long-term fates of the global economy and global financial markets depend on the ability of its leaders to develop and implement new "levels of thinking". It starts with the conclusion that more money (debt) will only make things worse, and ends with the acknowledgement that failure, at a national debt level as well as a company level, is a real and necessary aspect of commerce. Will it be painful? Absolutely. But it's the only feasible path to medium- and long-term recovery. The same level of thinking can only lead to a deflationary trap like the one that still dominates Japan's politics, consumer mindset, and economic vibrancy.