

Knowledge is Power in Making Investment Decisions
Participate in opportunistic strategies combined with protection strategies in uncertain times

January 2012 - Investment and Economic Update

2011 was a great year for U.S. corporations. Earnings at S&P 500¹ companies rose about 13.5% (with 4th qtr. 11.4% growth estimate as of 1/6/12 down from 16% growth in 3rd quarter) to a new record high. Earnings in 2012 are expected to still increase, yet at a slower pace. S&P 500 companies have now beaten Wall Street profit estimates for 11 straight quarters, have increased profits by double digits for 9 quarters in a row, continue to hold a record amount of cash, and have a relatively low tax burden due to various tax measures.

The 2011 U.S. market, while basically flat, was one of the best performing of world market indexes. However, Brazil fell 18%, Hong Kong fell 20%, Shanghai fell 22%, India fell 25% and most of Europe was down substantially. Only Ireland and Venezuela beat the U.S. market. Despite strong earnings growth the U.S. stock market acted strangely, as often fear and panic took over – retail investors fled, locking in losses. In contrast, Warren Buffet went on a \$20 billion stock buying spree.

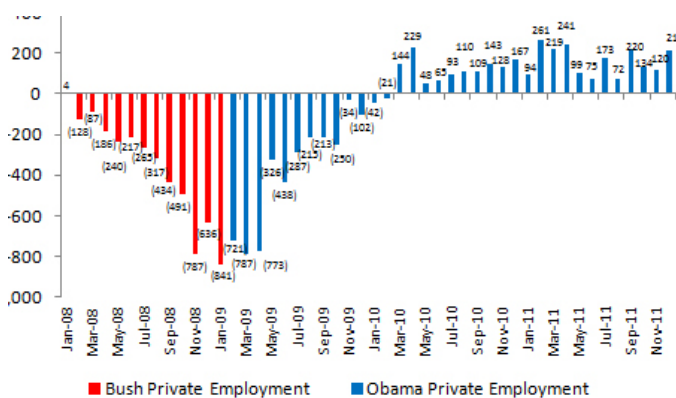
In 2011 the private sector added the most jobs since 2005. Private sector job creation under Obama in 2011 was larger than 7 out of the 8 years Bush was president, even with Congress blocking Obama's jobs plan for badly needed job creating funding.

Economic expansion with lots of positive data

The economic “recovery” turned to “expansion” over a year ago - at the end of 2010 - GDP grew to beyond its pre-recession level.

1.9 million private jobs were created in 2011 offset by about 300,000 government job losses as the stimulus funds to local governments expired. The unemployment rate fell to the lowest level in nearly three years, in a fresh sign the economy is picking up as businesses are more willing to hire.

Private Employment Chart with Dec 2011 data



Change in Total Private Employment (in thousands), Source: U.S. Bureau of Labor Statistics

"Factories Hum as New Orders Jump" Wall Street Journal (WSJ) 1/4/12 December ISM manufacturing index had the largest gain in six months and has expanded for 28 consecutive months (WSJ) The main subcomponents (new orders, employment, and production) are all showing expansion. The ISM

Services Index also expanded again - It has showed expansion for 25 straight months since the end of the recession.

U.S. consumers have reduced their debt for 13 consecutive quarters (Fed Reserve) *The Conference Board Consumer Confidence Index*[®], which had improved in November, increased further in December. (conference-board.org)

"Holiday Sales Reflect growing Wealth Gap" (CNN Money 1/5/12) reported December same store sales at high end stores like Saks and Nordstrom had strong gains while "the shrinking middle class is really showing up in retail -- retailers that cater to the middle class got hurt." (Their sales relied on heavy discounting to get increased sales but less profit).

2012 Outlook

MarketWatch 1/2/12 "Your major risk in 2012 is missing the upside. While I know doom and gloom sells, it always has, the reality is that most of today's predictions of financial apocalypse and aftershocks rely on markets and governments not knowing what the dangers are. I find it much harder to believe we allow a crisis to develop than believing that we gradually help the problems heal."

While many small investors are out of the stock market, large investors are buying the shares of companies beaten down and that may rebound in the next few years.

CNN Money - The U.S. seems to have the best comparative outlook for 2012 according to a panel

six leading analysts in a CNN Money presentation 12/29/11 - "U.S. & Brazil: 2012's Breakout Stars."

Their positive outlook even assumes no more than a mild recession in Europe. U.S. stocks and selective high-yield bonds are favored by most on the CNN panel. Brazil also has good rebound potential.

CNN points out that investors seemed to be ignoring how well the U.S. economy is doing relative to most of the world. Many economists believe the euro zone with its budget cutting - resulting in more unemployment - is already in recession and that their economies will stagnate in 2012.

Investors worry that Italy and Spain will have to keep refinancing borrowings at unsustainable levels as old bonds mature in the first half of 2012, which could escalate the crisis. But this should have a minor effect on U.S. corporate profits since only about 14% are European dependent.

More significant may be the slowdowns in China and India, yet they should still have the highest economic growth, but down to about 7-8% in China and maybe 5% in India vs. 2-3% in the U.S.

RBC Research - "The (European) recession is expected to be relatively shallow and short lived, with policymakers expected to make sufficient headway in resolving the sovereign-debt crisis to alleviate some of the downward pressure on the economy." There is concern however that Europe could fall into a worse crisis – the risks in the U.S. seem much less and its outlook much more positive.

Marketwatch 1/1/12 - "Stock funds have nowhere to go but up - Investors don't like equities, but that will change. Investors riveted by the market's ups and downs can lose sight of the fact that stocks are pieces of real businesses. These companies sell real products and services, and produce real profits from which real dividends are paid. The anxiety that has gripped the market has created valuations well below average, so those real profits can be obtained cheaply.

"No matter how much they dislike stocks, whatever the price, young people will still have to retire one day and meet other financial goals." (Dave adds: many older investors need returns to meet their retirement needs with potentially 20+ years of active retirement. Low bond yields and money markets offer zero or negative real returns after even relatively low 2-3% inflation.)

"With or without these buyers, stocks can still go up. This is not the first time that the market has been out of favor. Stock ownership was not as prevalent a

century ago as it is now, but the mania that led to the crash of 1929 and the Great Depression were sufficiently significant social phenomena to keep small investors away from Wall Street for decades. Even so, share prices advanced fairly relentlessly.

"The widespread shunning of stocks has been remarked upon so thoroughly that it recalls the famous 1979 BusinessWeek magazine cover proclaiming 'The Death of Equities'. That preceded one of the most almighty rallies in history, in which the Dow Jones Industrial Average went up by a factor of almost 20 in about 25 years.

"A similar move may be too much to hope for, but with hope of any kind so hard to spot, you wouldn't want to bet against it, either."

Recommended Strategies

1) Recovery strategy to help maximize the potential market rebound over the next few years.

2) "Participate yet Protect" strategy especially for longer-term funds to help minimize the effects of future market crisis.

3) Alternative opportunities without stock or bond market exposure for more cautious investing in what we believe are timely opportunities.

The three strategies can be combined within a portfolio, depending on your objectives.

For our recovery strategy, we do not recommend just index¹ returns but funds that have historically consistently outperformed the "dumb" indexes or ETFs with positive Alpha (outperformance vs. risk taken).

CHARTS ON NEXT PAGE

DISCLOSURES

¹Investors cannot directly invest in indices

Additional risks are associated with international investing (especially in developing countries), such as currency fluctuations, political and economic stability, and differences in accounting standards. Past performance does not assure future results. There is no assurance that objectives will be met.

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S&P 500 Index: Current Market Snapshot

Daily closes from 10/9/2007 - Present

17 Months to low at -56.8%, 51.0 Months Elapsed to date

dshort.com
1/9/2012



S&P 500 from 2007 peak

Back at the 2007 peak, the market was considered fairly valued, not in a bubble like in the 2000 tech bubble.

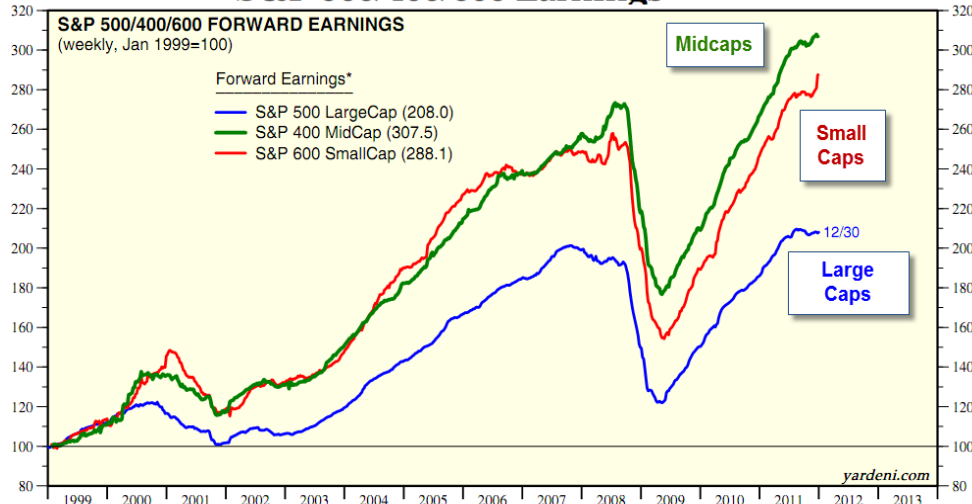
Corporate earnings are at record levels, yet the market seems relatively cheap and has not even recovered to Spring 2011 highs, before the Summer decline.

The 20% decline line separating the green shading from pink indicates a "bear market" which means a 20% decline from the October 2007 high.

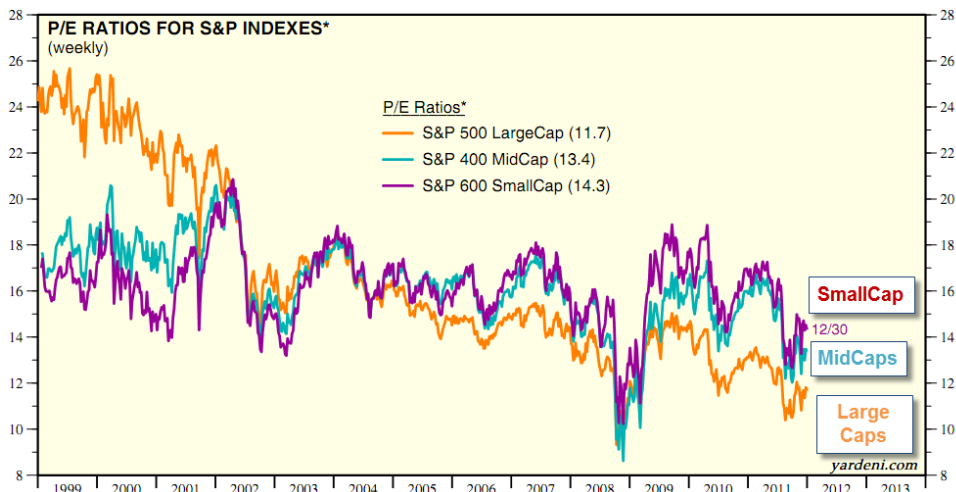
The 2nd chart isn't of earnings, as obviously the **S&P500 index** of the 500 largest stocks has higher total earnings than the **small companies**. The chart is relative earnings increase compared to the January 1999 base of 100 (left scale). So **Midcap earnings** at 307 have grown to 307% since 1/1/1999, the most earnings gain vs. **large** and **smaller companies**

Large companies typically historically have lower earnings growth in expansions than smaller companies. But in a recession earnings of smaller companies often fall faster than large caps.

S&P 500/400/600 Earnings



* 52-week forward consensus expected operating earnings per share. Time-weighted average of the current year's and next year's consensus forecast. Source: Thomson Reuters.



* Price divided by 52-week forward consensus expected operating earnings per share. Source: Thomson Reuters.

P/E Ratios Chart

Large caps are "cheapest" relative to earnings. Smaller and Midcaps historically have had higher P/E's since they can have faster growth in expansions.