January 5, 2012

<u>FTI™ Sector Overview for December</u>

<u>Financials</u> – In the Financial sector, U.S. Bonds and U.S. Notes were slightly higher for December (we were long both for December and remain long for January). Despite a lack of new Federal Reserve activity, yields continue to drop slowly. Institutionally, money is still being moved from European banks into U.S. Treasuries. The FTI™ was short the Swiss Franc, the Japanese Yen, the British Pound and the Euro for December (we remain short all four for January). The Japanese Yen saw some drastic intra-month one-day swings, but finished December at its highs, while the Euro moved lower throughout December. The Pound and Franc were both choppy and more reactive than proactive. The Canadian Dollar and Australian Dollar followed the down-and-up pattern, finishing the month close to unchanged (we were short both for December, and remain so for January). We believe that the European debt crisis, Iranian developments, unrest in other nations, Russian protests, global economic growth, Federal Reserve policy and any major moves in equity and commodity markets remain the primary factors influencing the Financial markets.

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1139 South Main Street, Grapevine, Texas 76051

Opinion, News Interpretation and Outlook

2011 was a year that was more difficult than any year I can remember. It was a rare paradox: volatile markets which still managed to trend sideways. The forces driving those markets have shed much of their historical patterns and correlations. For example, there seems to have been a complete disconnect between GDP and corporate earnings. At the beginning of 2011, the consensus projection for U.S. GDP was +3.4%, and globally +4.7%. U.S. GDP is now predicted to be +1.8%, and global GDP is now estimated at +3.8%. Meanwhile, earnings for the S&P 500 were originally projected to be $94 a share, but those estimates have been raised closer to $97. Lower GDP but higher earnings; this is not the normal state of affairs. By way of further example, the commodity markets, of late, are highly correlated to both GDP and the equity markets. The Dow Jones UBS Commodity Index (DJUBS CI) has a correlation to the S&P 500 from June 2008 of 87% (based on rolling 12-month periods). Meanwhile, the S&P 500 has outperformed the DJUBS CI by a big margin since June 2008: the S&P 500 has lost -1.06% while the DJ UBS CI TR has declined -10.05%.

So what happened to the markets in 2011?

- The S&P 500 was unchanged for the year, while most other U.S. equity indexes were down (the Dow Jones Industrial Average being the major exception).
- The Dow Jones Global ex-U.S. Index in Dollar terms was down -16.3% for the year.
- Commodity markets were down[1] for the year.
- Ten-Year U.S. Treasury Notes ended the year with a yield of 1.88%, and Thirty-Year Treasury Bonds finished the year with a yield of 2.89%, after starting the year at yields of 3.30% and 4.45% respectively. Reflecting these falling yields and rising bond prices, the Ibbotson Long-Term Government Bond index was up an estimated 26.7%!
- Inflation in the U.S. was projected to be only +0.5 (as measured by the core CPI) and came in at +1.7.

In summary, inflation was worse than expected, equity markets were generally down, and commodity markets did poorly, while the bond markets performed the best by far. Corporate earnings did better than expected, but the equity markets still performed poorly overall. GDP was weaker, but the S&P 500 did well by breaking even. 2011 was a year where it appears nearly every market or asset class performed in its own private universe, unaffected by the rest of the financial world (or at least not affected as it historically had been).

Outlook for 2012:

2012 looks like it will experience a weak first half economically, and the second half depends on whether President Obama is re-elected or not. Another term for the current President would likely include the lapsing of the "Bush tax cuts," and such an event would in my view lead to a depression. The precedent to this is 1931, the worst year for all markets in U.S. history. The keys to the second half of 2012 are the poll results between the two candidates as the election draws closer. If the Republicans win (or the polls suggest as much), I believe the U.S. stock and commodity markets will boom while bonds should decline (or even crash). I believe the markets will decline until the April 24th and 25th FOMC meeting, after which I expect the U.S. Federal Reserve will announce “QE3.” It is unlikely such a program would do anything visible to help GDP or unemployment, but that won’t stop “Helicopter Ben” from giving it a whirl.

I do find it interesting that world commodity and FX markets are nearly all in downtrends coming into the New Year. U.S. GDP is now estimated to come out at +3.0% or better in the 4th quarter, but the downtrends may be signaling a weaker outcome than predicted, as has been the case with GDP growth and unemployment rates since the President was elected. In all, this is not new, for equity markets are still thought to be in a bear market by this writer since August 2011, which almost always portends a recession.

The gold market is currently reflecting a recession in Europe. The ECB found a way to print money by making an end-around its own rules. However, this liquidity (i.e. loans) will not solve the debt problems nor help sustain growth. All it really does is “kick

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[1] Using the DJUBS CI TR as a proxy, which was minus -13.37%

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the can down the road" a bit longer. It is my strong view that the Euro cannot survive given the mentality of the leaders in Europe today.

What this means has to be boiled down to the nitty-gritty:

The S&P 500 is doing comparatively well because corporate earnings are at all-time highs while the percentage of taxes those corporations pay is at an 11-year low. Profits as a share of GDP are coming in at 14.7% of GDP in 2011, but taxes are estimated to be only $181.1 billion (or 1.2% of GDP)…yet in 2000 those same corporations paid $214 billion!

The equity markets have been very adept at doing well in spite of all the economic problems. Obviously, campaign cash continues to earn the corporate world government favors and pseudo-partnerships with the world's central banks. In this regard, I believe that exposure to the equity and commodity markets will provide the greatest potential for later in 2012, assuming a change in political power in the U.S.

In my view, the major apparent risks of the coming year remain the end of the Euro or the partial break-up of the European Union, oil prices shooting towards $200 due to heightened tensions with Iran, and another recession in the US.

In the end, inflation has to occur. The only real question is when, and the answer remains when the central banks start printing in earnest. Good luck in 2012!

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