# COMMENTARY 2012 Q1

**Inverness**
Counsel

**As we stated in our 3Q11 commentary, *"We think the state of the global economy and outlook for equity markets are not as bleak as some have indicated."* We viewed the summer correction as an opportunity and increased our exposure to growth-oriented sectors. During the first quarter of 2012, economic conditions continued to improve, helping to lift equity markets. Overall, we continue to think the environment for equities looks positive through the end of the year.**

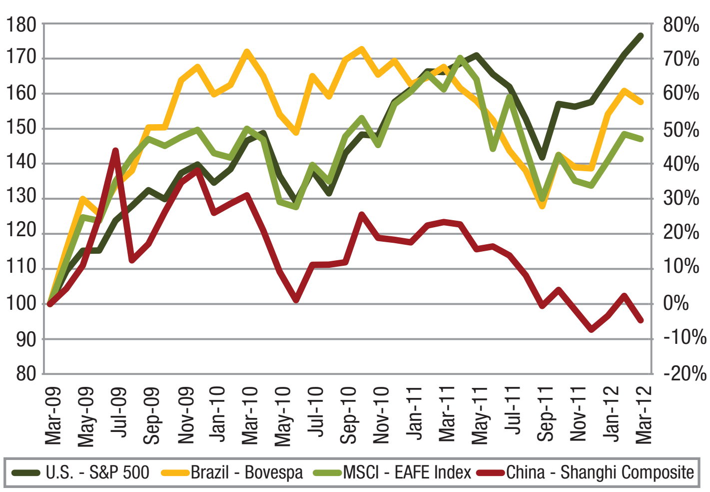
For the quarter, the S&P 500 gained 12.6%, marking the best first-quarter return since 1998. To date, the S&P 500 Index has recovered nearly all of the losses from the 2007–2008 financial crisis and is down just 0.5% on a total return basis (including dividends) since the market's prior peak in October 2007.

During the quarter, we benefited from our increased exposure to growth-oriented sectors (Technology, Consumer Discretionary, and Industrials), which outperformed the broader market as investors moved into securities that are leveraged to improving economic fundamentals. Defensive sectors (Utilities, Telecommunication Services, and Staples) underperformed the index.

### Increased Liquidity Reduces European Fears

The European Central Bank's (ECB) long-term refinancing operation (LTRO) program has provided European financial institutions with increased liquidity through access to capital at extremely low interest rates. Thus far, the ECB has extended over €1 trillion ($1.33 trillion) in loans to European banks. This action has reduced contagion fears across the region, resulting in strong gains for the major European indices as concern about a liquidity crisis recedes.

**Figure 1. Global Equity Market Returns (March 2009–March 2012)**
***** Index values are standardized as of March 2009*****




*Source: Bloomberg*

Greece was finally able to reach an agreement with neighboring Eurozone nations for additional funding in order to avert formally defaulting on its debt. Subsequently, yields on Italian and Spanish government bonds declined significantly, easing contagion fears across the region. The underlying economic conditions in Europe appear to be trending slightly better than expected; however, we still think the region will face a challenging 2012 as austerity measures are fully implemented and governments struggle to find new initiatives to drive economic growth.

### The U.S. Continues to Lead the Global Economic Recovery

Just over three years ago, equity markets bottomed following one of the worst economic downturns in recent history. Since then, the U.S. has been one of the leading nations behind the resurgence of the global economy. Over the past six months, expectations for the U.S. economy have considerably improved, resulting in a strong market rebound.

Since the market low in early October 2011, the S&P 500 has appreciated nearly 25%. Although this rally has resulted in higher equity valuations, we continue to find many of the fundamentals compelling. After several attempts, the housing market appears to have stabilized and should improve as we enter the traditionally active spring selling season. In fact, Jamie Dimon, CEO of J.P.Morgan has stated that housing is nearing an inflection point and may be already having a positive impact on the economy. Consumer confidence is at its highest level in four years, and job creation has accelerated, with approximately 650,000 jobs created during the first quarter.

The outlook from corporations also remains strong, with robust earnings growth and expanding profits. M&A activity should also begin to accelerate, as corporate cash balances are at record levels and equity valuations are still below their historical averages, trading at 13.9 times forward earnings versus the 10-year historical average of 15.4 times.

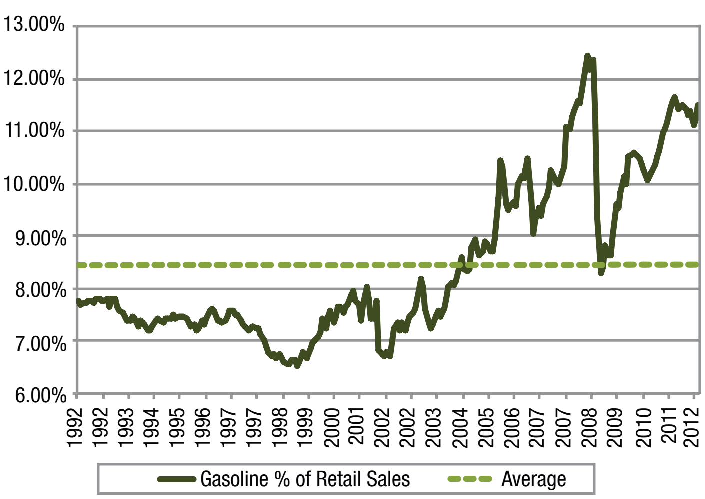
Equities are still under-owned as an asset class, with significant cash balances on the sidelines. According to Lipper, U.S. equity mutual funds reported $50 billion in net outflows in 2011 ($66 billion over the final nine months of the year), marking only the second year of net redemptions since the firm began tracking such data in 1992. Hedge funds have also been considerably underweight U.S. equities, and their performance has suffered over the past six months. As the economy continues to improve, investors will likely begin to demand higher returns on their investments, potentially driving further market appreciation as additional capital flows into equities.

### Rising Fuel Costs and a Slowing China May Curb Growth

The price of Brent Crude has climbed to $123 per barrel, up nearly 16% year-to-date and over 30% since the end of September. Demand for the commodity has rebounded, while geopolitical tensions in the Middle East have continued to escalate. As a result, the price of gasoline at the pump has steadily risen and is closing in on the psychologically important $4.00 per gallon level.

In periods when the national average price of a gallon of gasoline exceeded $4.00, we experienced subdued growth in consumer spending, which accounts for close to 70% of total economic activity. Today gasoline sales account for nearly 11.5% of total consumer spending and may soon approach the 12.5% peak level reached in July 2008. According to David Rosenberg, Chief Economist and Strategist at Gluskin Sheff, every $0.01 increase at the pump drains approximately $1.5 billion of household cash flow into the gas tank. So $4.00 a gallon gasoline is an approximately $100 billion annual drag on the economy.

**Figure 2. Gasoline's Percentage of Total Consumer Spending**




*Sources: U.S. Census Bureau; Inverness Counsel, LLC*

If U.S. refining capacity declines while the geopolitical situation in the Middle East—particularly in Iran—intensifies, we could see meaningfully higher gasoline prices. The combination of these events could create a prolonged period of reduced consumer discretionary spending. On a longer-term basis, recent advances in the discovery and extraction of oil and gas could offset these factors and provide some relief for consumers as well as U.S. based manufacturing.

We also continue to monitor the developments in China, as economic growth appears to be decelerating. Chinese manufacturing activity has slowed over the past several months, and further declines would reduce global demand for input materials. Although the prospects for additional monetary easing in China have improved, a marked slowdown of the Chinese economy would undoubtedly impact U.S. economic growth, particularly companies in the Industrials and Materials sectors.

### Course of Action

Given the improving outlook for the housing market and the positive results from the Federal Reserve's latest round of stress tests, we increased our exposure to the Financials sector. We also reduced our exposure to Industrials and Materials, as recent price movements now reflect the fair value of the assets.

As long-term investors, we often find similar themes across many of our investments. Themes we are currently focusing on include the possible resurgence in American manufacturing, the impact of social networking in a constantly connected world, and the downstream implications of record U.S. corporate cash balances.

Another key theme in which we are investing is the emergence of a middle class in countries such as China, India, and Brazil. Incomes in these nations have reached a level where many people can now afford discretionary goods and services. Products ranging from beef and poultry to designer clothing and accessories have experienced a sharp rise in demand. At the same time, services such as cable television, mobile phones, and the Internet are seeing rapid global adoption. We believe this global consumer transformation is still in the early stages and should provide compelling investments over the next several years.

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