

Congress Asset Management Company



Economic and Market Outlook

First Quarter, 2012

Few will mourn the passing of 2011 into the financial history books. From an apparent economic recovery at year end 2010 and high optimism in the financial markets, a succession of natural disasters, economic disappointments, and government failures led to the most volatile year in stock market history. Today there is broad skepticism that the modest improvements in the domestic economy can be sustained in a global banking system that is clearly troubled. “Fragile” has become the most common description of our positive economic momentum as we exit 2011.

The largest single threat to the global financial system and the U.S. economy remains the European debt crisis. Despite numerous “summits” European leaders have proven incapable of forging a believable rescue package for its heavily indebted members. Until late October the crisis centered largely on the failure to stabilize Greece’s finances. Since then, the crisis spread rapidly to Spain, Italy and most recently, France. Europe is now faced with an acute systemic debt crisis which threatens the solvency of their largest banks and therefore, the global financial system. What heretofore was a debt crisis affecting a few small members on the periphery of the Union has become a twin crisis holding the financial system of the industrialized world in its grip.

The catalyst for the rapid deterioration of Europe’s debt crisis was the failure in mid-October to construct a comprehensive program to contain the spreading crisis. It became painfully obvious that the European Financial Stability Facility, created in 2010 to guarantee debt of Greece, Ireland and Portugal, simply did not have the resources to support the debt of Italy and Spain also. In addition, Italy and Spain were original contributors to the EFSF, and would effectively be guaranteeing their own debt. Rating agencies and the bond markets quickly rejected the plan. Interest rates rose on all European debt except Germany.

Many economists believe that for the monetary union to survive in its present form, the European Central Bank will have to purchase government debt as a lender of last resort. With good reason, the ECB has resisted this controversial step. Monetization of the debt is potentially inflationary, anathema to Germany, and reduces the incentive for countries to discipline their financial management. The economic and financial deterioration is ongoing. It is clear that there is absolutely no way for Greece and others to meet their interest payments, let alone pay back their debt. Furthermore, the severe austerity measures and tax increases forced upon them have plunged the weaker nations into deep recessions, and the gap between the prosperous and poorer nations continues to widen. The probability of a breakup of the Eurozone in some fashion is increasing. An exit by one or more countries or a breakup of the Union itself, would likely lead to a series of defaults and write down of assets by European banks. Until recently it was hard to see how the European Central Bank would let this happen, but the possibility is increasing as time goes on.

The unfolding train wreck which is Europe today is the primary cause of the volatility in the financial markets especially the stock market, and the aversion to all risk based assets generally. Despite extreme statements by some observers about the threat to U.S. banks and financial base from the sovereign debt crisis, for many reasons we believe the vulnerability of our banks to the crisis is minimal. U.S. banks are in far stronger financial position today than before the housing collapse of 2008. The exposure of U.S. banks to European sovereign debt is very low, and the extent of bank lending to European businesses including banks is extremely small, if at all. With respect to the much feared threat of credit default swaps, we find it hard to believe that U.S. banks would again engage in dangerous levels of cross border insurance with the painful memory of 2008 still fresh, thereby

mimicking the folly of American International Group. Also, in many ways the Federal Reserve has made known its vigilance and concern about the crisis in Europe. Recently, six central banks led by the Fed agreed to provide cheaper access to European banks for swapping euros into dollars, a mainstay of trade finance arrangements. While none of this precludes another MF Global situation it does provide some comfort that the debt crisis in Europe can be contained.

By contrast, the U.S. scene appears almost tame. The U.S. economy is entering the new year on a moderate uptick. Estimates of Gross Domestic Product growth have been consistently ratcheted up and now center around 3.5%. If so, the fourth quarter will be the strongest of the year. While the trend is welcome, some sectors remain depressed and are holding back a more robust recovery. Single family homebuilding, usually an important early contributor to a recovery, remains at low levels, and housing prices generally have not recovered. The excess of houses for sale and reduced level of household formations have kept a lid on a positive turn in housing. The deterioration in housing appears to be over, however, in the light of recent trends. Both housing stocks and permits rose in the latest month. Importantly, single family starts have improved for two months. If confirmed in coming months even a modest upturn in housing will have a noticeable impact on our economy. At some point, the low level of home construction relative to demographic demand will impel housing to stronger growth. This will occur only gradually as joblessness is reduced and family formations rise.

The labor market is clearly on the mend. New jobless claims have declined steadily for several months and private sector jobs are growing. The employment numbers have been revised upward in each of the past six months. The silver lining in rising employment is that national income also increases. The improved employment and income pictures are confirmed by rising tax receipts, which are up 4.8% in the third quarter, and healthy retail sales over the Christmas holidays. The effect on the

average consumer of an elimination of the temporary payroll tax deduction is substantially mitigated by the sharp decline in retail gas prices, in our view. Other indications of economic stability and moderate growth are evident in rising production levels, strong manufacturing trends, positive international trade and exports, and improving consumer and business sentiment surveys.

The year 2011, soon to be history, has had more than its share of extraordinary natural and man-made havoc. The greatest failure of government domestically is the inability of several Super Committees to agree on even modest reductions in government spending, or to take any steps to address unsustainable increases in entitlement programs. Faced with a national election in 2012 no solution to these long term critical weaknesses will be agreed to this year. Aside from possible small fiscal steps and continued aggressive monetary policy, government policy will be quiescent in 2012, despite heated rhetoric. Economic growth in the U.S. will continue at a moderate scale into the new year, and accelerate later in the year as housing and employment continue their modest uptrends. Supported by historically low valuations, rising earnings and dividends, and fortress balance sheets, U.S. stocks will again be favored over foreign markets, including those of emerging Asia, as was so evident in 2011.

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