J.J. BURNS & COMPANY, LLC

4th Quarter Newsletter, December 2011

REVIEW AND 2012 OUTLOOK

HAPPY NEW YEAR TO ALL! On behalf of our entire team and associates, we wish good health, joy and success for you and your loved ones.

Looking Back

It's hard to believe that it has been nearly six years since the U.S. housing market peaked. This set in motion one of the worst financial crises since WWII. The housing/credit bubble deflated and brought with it a globalized world of economic problems. In the U.S., cracks began to appear in home prices. By 2007, the financial system started to show strains which quickly infected the broader economy. By early 2009, the financial system was on life support and the Great Recession began. Aggressive policy actions helped prevent a complete financial meltdown. With some of the problems addressed and easing programs nearly exhausted, we are left with an economy on a fragile path to recovery. The recovery is 2 ½ years old and has been modest at best. As a whole, the medicine and policies applied have been inadequate to repair the damage done by the financial crisis and recession. With the help of my friends at Deutsche Bank, The Federal Reserve Board of St Louis, and Chief Economist, Dave Rosenberg, I can point to a few metrics which can give a sense of the economic damage. Real GDP (Gross Domestic Product) has just recently gotten back above its pre-recession level, which is nearly three times longer than it typically takes following a recession. Restoring economic output to where it was prior does not mean the losses from the recession have been recouped. Output of goods and services, and the income generated in the production of such has now been restored to some degree. The sum total of output produced (which is income earned) over the past four years is well below what it would have been absent the recession. To give more perspective on this, even if output had stayed flat at its pre-recession level, it would have summed to about 2% per year; its cumulative sum since the peak of the last business cycle would have been about 6 ½% more than what was actually produced. To put this in real dollar terms, in 2011, this translates into $4 Trillion of "missing output" as a result of The Great Recession. Looking at this from the consumer's perspective, the total "hit" to household wealth has been roughly 25% between equities and home values. When you adjust these figures to reflect inflation and population growth, net worth is still about 25% below its peak, and has not increased for about 10 years.

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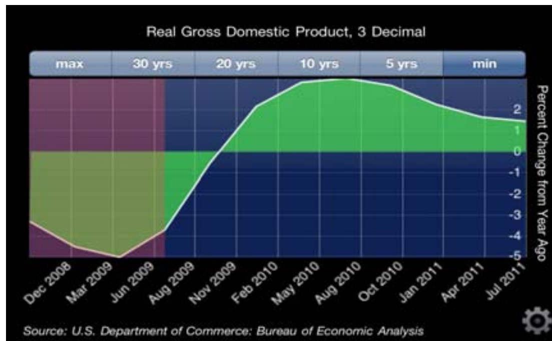

Real GDP represented as year over year. Purple section represents recession (negative GDP)

LABOR MARKETS REVIEW

The toll on the labor market has also been significant. Nearly 9 million jobs were lost in the recession, and only 2.5 million jobs have been restored. This leaves about 6 million people off the payrolls or 4 ½ % below its pre-recession peak. However, these figures underestimate the level of damage to the work force.

A year ago, in our 4th quarter 2011 newsletter, we wrote about Roller Coaster Rides. We discussed the 2010 year as being volatile. We reviewed strategies which were aimed to preserve capital and ones that could participate in slower growth environments. We proposed that 2011 would grind along and that we would implement wealth preserving strategies where stocks would tend to be underweight. The events that played out consistently confirmed our expectations. Europe is quite a mess and cannot seem to face the fact that they must do more to solve their problems rather than trying to monetize their debts with short term loans. There are significant structural design flaws that need to be addressed. The markets know this and will not show any signs of improvement until the proper medicine is taken. The U.S. is not much better in managing its own fiscal issues. Politicians continue to demonstrate their dysfunctional behavior. Our elected officials show no signs of changing.

The last twelve months have been quite a ride in terms of volatility and interest rate levels. The bond markets saw their own roller coaster ride as Europe and America could not pull their respective acts together. On the stock market side, we saw almost $6.3 trillion of equity market valuation lost last year. Even with the U.S. market flat, the world stock market was down more than 12%. We started the year at 1,257 on the S&P 500 and ended at 1,257. In 34 market sessions last year, the S&P 500 moved 2% or more in either direction. In fact the high/low figures were 1,099 and 1,363. In the third quarter we saw the S&P decline nearly 15% on the year. What worked in stocks was broad diversification to maintain wealth and sometimes a "push" is a "win." Specifically, utilities (+14%), consumer staples (+10%), and health care (+10%) outperformed other sectors in the S&P 500 in 2011. This indicates investors are more committed to defensive-type industries which tend to have predictable earnings. Companies such as Procter & Gamble, Con Ed, and Johnson and Johnson, carry dividends better than 3%.

The Big news is on the Bond Market Side: U.S. Treasury yields closed below the 1.9% on the 10 year bond. The bond market is indicating that 2012 may continue to be a challenging year for the economy.

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The Deflation Theme Still Alive

More economists are using the "deflation" term. Certainly, JJ Burns and Co. has been espousing this term for quite some time throughout the credit bubble bursting in the U.S. economy. *Deflation* is a general decline in prices, often caused by a reduction in the supply of money or credit. One prominent economist Paul Krugman explains it best, "There are actually three different reasons to worry about deflation, two on the demand side and one on the supply side.

1. When people expect falling prices, they become less willing to spend, and in particular less willing to borrow. When prices are falling, just sitting on cash becomes an investment with a positive real yield – Japanese bank deposits are a really good deal compared with those in America – and anyone considering borrowing, even for a productive investment, has to take account of the fact that the loan will have to be repaid in dollars that are worth more than the dollars you borrowed. If the economy is doing well, all this can be offset by just keeping interest rates low; but if the economy is not doing well even a zero interest rate may not be low enough to achieve full employment.

2. Falling prices worsens the position of debtors by increasing the real burden of their debt. Therefore, debtors tend to cut their spending while creditors are not likely to increase their spending by the same amount."

3. Deflation exerts a depressing effect on spending by raising debt burdens. In the U.S., deflation pressures are surfacing in many areas. There were massive discounts this holiday season. Stores like J. Crew and Bloomingdales were reportedly offering post Christmas price cuts of 75% or more. There is more excess capacity on the retail markets today; perhaps this is why Sears recently announced closings of 100 of their stores. 47" plasma Televisions are now selling under $1,000.

The deflationary message from the bond markets are as follows:

- Less than 1% yield on the 5 year Treasury Note
- Less than 2% yield on the 10 year Treasury Note
- A 3% yield on the long bond 30 year Treasury Note

This is not a matter of whether the bond market is overvalued at current levels. The market flashing signals are awaiting another round of QE (quantitative easing) from the Federal Reserve. Furthermore, on the European side, Germany is showing a breakdown in consumer prices. The message is: The state of the US Economy is fragile.

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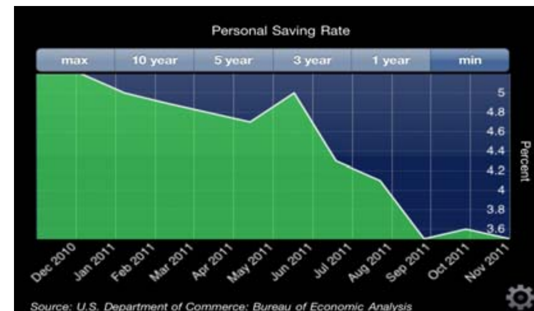
Mixed Signals?

The Consumer Confidence data improved to an eight month high in December 2011. Sales were up this year. Internet based sales did very well. ShopperTrak (shoppertrak.com, counts people, analyzes data and tracks retailers and mall owners) announced a surge in buying. The reason why the average consumer had more money to spend this year had little to do with getting a job or a pay raise in the United States. There were few jobs created. The jobs which were created have been in low paying industries. Real incomes are stagnating. The spending improvement had more to do with the price of gasoline, as prices declined at the pumps by 70 cents/gallon. So how much does the price of gas declining put in consumers pockets? $100 Billion is what a decline of 70 cents/gallon at the gas pumps does for consumers collectively in the U.S. These dollars are a direct infusion into our economy.

The U.S. economy needs to be creating new jobs. A recent WSJ (Wall Street Journal) article noted that "US factory jobs have increased but shrunken pay for newcomers. On average 12- 19 dollars an hour versus 21 -32 dollars an hour for longtime workers – threatens to undo the middle-class status of even the best-paid blue collar jobs still left in manufacturing."

Employment growth has been primarily in retail and leisure industry. These are lower paying sectors in the job market. Wages and salaries fell 0.1% in nominal terms in November and have been flat or down in five of the past eight months. This is terrible. Even with the benefits of lower prices, real after-tax personal income stagnated in November and has also been flat or negative in four of the past five months. In other words this is a "wage-less jobs recovery."

Personal Savings Rate and Income



Consumers will not lead the recovery on a consistent basis. However looking at the data it's clear to us that most of the consumer spending came at the sacrifice of personal savings. The last reported data which includes November shows a decline to 3.5% from 3.6%. The personal savings rate is the percentage of after-tax income that's not spending. As of June 2011, households were socking away about 5% of their earnings (see personal savings rate graph above). With the decline in gas prices and the decline of savings the consumer added to the influx of retail sales (inclusive of web purchasing). Also, the temporary extension of payroll tax cuts and Federal jobless benefits helped to increase this spending. Families still carry a significant amount of debt while others constrain their spending because of

depressed home values. Economies improve because of organic growth in jobs, and higher wages. I recently had the pleasure meeting and speaking with Patrick O'Keefe former Asst Secretary-US Labor Department under President Ronald Reagan's Administration on a CNBC Worldwide program (see link below). I agree with Patrick's analysis of job growth. I think his perspective on how he would guide the current Obama administration is equally interesting. (Go to jjburns.com, click "in the news" – Jan 12th)

Core Themes for 2012 Outlook

1. Fragile Economy
2. Global Deleveraging will continue to be the backdrop for economics, finance and politics for 2012
3. The Chinese/Asian Growth Story

Fragile Economy

Global Deleveraging will continue to be the economic backdrop for finance and politics in 2012. It took more than three decades for the developed world to borrow too much money and it will take years to pay it back. Furthermore, this is a problem which is global. The U.S. is only partially through this deleveraging cycle and the rest of the world has just begun. Balance sheet recessions are typically followed by a slower grinding and below-trend recovery. Lower standards of living and high unemployment will be the hangover.

The dysfunctional behavior is likely to continue among our elected officials. This will all take place against a backdrop of clashing priorities for Western democracies between the need for austerity, the need to support economic growth, and the need to provide for rising outlays on entitlements. The clash between baby boomers and the younger generations about who will be paying the bill will be an ongoing debate.

Sub Prime Crisis #2

The weakness of the European banking system surpasses that of their U.S. counterpart. The potential of European policy errors and inaction could put many more sovereign nations in jeopardy. Martin Wolf, editor of the Financial Times put it this way, "the welfare of many nations cannot afford to have the proverbial 'can kicked down the road' to solve these serious problems."

Chinese/Asian Growth Story

China is the growth engine of the global economy. It's nearly a certainty that China's GDP will surpass that of the Western world within the next few

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years. China is embarking on slowing down their cycle as their growth has been on "a tear." There is a strong likelihood China will have a soft landing. Currently, other emerging markets regions may experience their own credit bubbles, which we believe there maybe too much emphasis placed on these parts of the world for investment opportunities at the present time. That said, longer term China and the emerging markets will likely be significant growth engines, and suitable for investment opportunities which could exceed allocations higher than U.S. equities.

Conclusion

With U.S. Gross Domestic Product (GDP) likely finishing under 2% for 2011, this spells "Fragile." It was a year where little went right in an economy that still badly needs to recover from the Great Recession of 2007-2009. We do think however, there are a few preliminary figures showing some signs we are on a path of recovery. However, I stress that the "patient is still quite ill." Significant risks still remain, which is why we will watch the progress accordingly and further why we continue to underweight stocks in our portfolios at the present time. There is a lot more data coming out in the next few weeks which I plan to update you on, furthermore, the continuing Euro debt crisis. In the meantime, the following represents our preliminary thoughts looking at 2012:

- Capital Preservation: own higher quality corporate bonds, shorter term high yields and limited term bond portfolios
- Income Orientation: in stocks, focus on larger cap growth and consistent dividend paying history. With aging baby boomers, we see a strong shift to safety and income at a reasonable price. The new "norm" is: "I'll be ok, and will take less income for more stability."
- Focus on middle class, especially in Asian consumer markets. The rise of the middle class and the products they desire
- Alternatives: minimize volatility utilizing strategies to provide growth, in a low growth world and protection otherwise.
- Broad asset class diversification, along with alternatives which include precious and industrialized metals, currencies and commodities
- The continued theme of "Frugality." People spend differently in economic downturns. Focus on sectors which benefit, for example, home improvement, gardening, board games and entertainment, discount stores
- Non Cyclical: non correlated investments with the economic cycle: defense and healthcare, liquor/beverages/movies/home entertainment

Our team has been meeting with many of our investment policy committee members and portfolio managers. Analyzing their respective styles and recent purchases to be certain they represent our core theme of preservation of capital and uncovering opportunities for growth.

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There is significant news coming from many media sources. Furthermore, we wish to know what you are thinking. Therefore, we welcome your comments, and questions regarding any financial issue or news story. Your thoughts are important to us.

Again on behalf of our entire team at JJBCo we wish you a Happy New Year!

Respectfully and with warmest wishes,

JJ Burns, CFP
President and CIO

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