KEATING INVESTMENT COUNSELORS, INC.
REGISTERED INVESTMENT ADVISORS FOR INDIVIDUALS, RETIREMENT PLANS, TRUSTS AND FOUNDATIONS

INVESTMENT STRATEGY
JULY 2011

After gaining 33% from July 2, 2010 to April 29, 2011, the S&P 500 experienced its first correction, declining 7.2% from April 29 to June 16. In comparison, the European Index dropped 13% and the emerging market index declined 9%. As we have previously mentioned, it is natural for markets to consolidate after such a sharp and sustained gain before continuing onward. During this modest correction, some of the leading cyclically sensitive sectors like energy, technology, and materials have pulled back the most from their market leading gains, while defensive sectors have exhibited strength. As always, there are plenty of negative headline issues and worry lists. Despite these concerns, we believe the fundamentals are still very positive, especially for large, high-quality, dividend paying stocks.

One issue currently getting too much attention is the notion of a formal U.S. Government debt default. This has produced headlines because politicians are using the current need to raise the U.S. debt ceiling as an opportunity to push for specific spending cuts and tax increases. We see two likely outcomes regarding the U.S. debt situation. First, we believe the U.S. debt ceiling will be increased before the August deadline. It would be both irresponsible and unthinkable to do otherwise. This forthcoming action should quickly nullify the doomsday scenarios being peddled.

Second, we see no realistic scenario where the U.S. would formally default on its debt. The dollar has a unique and privileged status as the global reserve currency. Most commodities, like oil, are priced in dollars as are many contracts and currencies. No other currency is large enough nor trusted enough to replace the dollar in the capacity of the reserve currency. Due to this envious position, it is likely the U.S. will allow the dollar to slowly depreciate since all our debts are denominated in dollars and largely owed to entities outside the U.S. Besides spurring exports, this will reduce the debt burden because we will pay back debts with dollars that are worth less than originally borrowed. In the past, most countries that defaulted on their debt got into trouble because they owed debts not denominated in their own currency. Currently, some peripheral countries in Europe are struggling with the opposite situation. Greece, in particular, has its debt in Euros, but they do not control the Euro currency and therefore are unable to devalue it. As a result, Europeans must decide to help Greece pay off their debts or Greece may be forced to re-adopt their own currency.

Although we do not believe the U.S. will formally default on its debts, there will be long-term ramifications from the debt the U.S. has accumulated since the surpluses of the late 1990s. Over the past decade, U.S. debt has doubled from two wars, excesses in domestic spending, and from backstopping the financial system after the recent major financial crisis. The first issue to be addressed is the sizable yearly budget deficit the government is currently running. This budget deficit has been necessary to offset the damage the financial crisis caused and it likely averted a complete financial collapse and depression. Despite the recent large shortfalls, it is important for the deficit to be trimmed down methodically over several years instead of attempting to balance the budget abruptly. This latter mistake was made during the

777 EAST ATLANTIC AVENUE, SUITE 303 • DELRAY BEACH, FLORIDA 33483 • (561) 278-7862 • FAX (561) 265-1055

mid-1930s as the economy began to recover from a severe financial collapse. Sharp budget cuts and tax increases led to a second economic collapse in 1937, which only ended with World War II.

Over the next 5-10 years, the budget deficit will need to be reduced through a combination of greater economic activity, lower spending, and higher tax revenues. Greater economic activity is the best way to solve our budget deficit because it naturally results in both higher tax revenue and lower outlays to deal with unemployment. However, some very tough decisions need to be made to lower discretionary spending as well as increase tax revenues. When it comes to lowering spending, the elephants in the room will continue to be defense and healthcare. Although these are important subjects, both have grown to a size that is unsustainable and must be reduced.

The other side of the balanced budget equation is collecting higher tax revenue. As mentioned, greater economic activity is the key to increasing tax revenue but it is also likely that additional tax increases will be enacted. It is difficult to predict how taxes will change after the current tax agreement ends in 2012. However, the majority of new taxes will likely focus on personal consumption rather than higher income, property, or corporate taxes. Higher consumption taxes may come in the form of a European-style value added tax (effectively a sales tax) as well as fees for using formerly free public services such as roads, bridges, and parks. Many companies and households are already noticing large increases in fees for many services such as registrations, inspections, and licenses. As for investors, it is probable that dividend and capital gains taxes will be increased to perhaps 20% from the current all-time low of 15%. However, we would not expect increases beyond these levels because it would be counterproductive as higher tax rates would discourage greater investment and reduce economic activity.

The second issue is how to pay down or reduce the large debt we have already accumulated. As previously mentioned, this has historically been accomplished by stealth devaluation through the compounding effects of higher inflation. Over the past twenty years, we have experienced below average inflation of approximately 2.5% annually. The historical trend over the past century has been annual inflation of 3.1%. It is likely the government will find 3% to 4% annual inflation acceptable in the future in order to reduce the real debt burden. Over time, this has a dramatic effect. At 3.5% annual inflation for twenty years, $1 in goods today will require $2 to purchase in the future. In comparison, 2.5% annual inflation increases $1 in goods to $1.64 in twenty years. In either case, inflation significantly reduces the real cost of repaying the debt. The likely inflationary policy slant going forward will be very beneficial to debtors, especially Uncle Sam, but also benefits underwater homeowners and over-indebted municipalities. However, it is devastating to savers and retirees on fixed incomes. Historically, the worst contemporary example of inflation in the U.S. was from 1966-1991 when inflation averaged 5.8% per year.

What is most important for investors, and especially for retirees, is how best to protect the purchasing power of their assets and income from inflation. The most dangerous asset to hold if inflation rates increase is longer-term fixed income securities. The fact that interest rates on these securities are currently so low makes these securities even more unattractive. As we have mentioned in prior Investment Strategies, we are purposely avoiding long-term fixed income securities and replacing called bonds with fixed income securities that mature in 2-7 years. These intermediate-term securities will do a far better job of protecting portfolios from inflation because, as interest rates increase, we will be able to reinvest matured bond proceeds at higher interest rates.

Common stocks and income producing real estate have historically done the best job of protecting wealth and income against inflation. For equities, companies that have pricing power fare the best in an inflationary environment. Generally, dominant companies that produce differentiated or essential products have the greatest pricing power. As a classic example, Coca-Cola has historically had no problem increasing prices to offset inflationary pressures because of the company's unparalleled brand loyalty and marketing scale. We believe it is also beneficial to own companies that generate a large share of their revenue outside of the U.S. This helps protect portfolios against declines in the value of the dollar.

One of the most important benefits of a company's pricing power and diversified revenue stream is its ability to raise dividend payouts along with, and often ahead of, the rate of inflation. This maintains the true value of the income produced by a portfolio. Even for investors not living off this income, dividends have historically provided about 45% of the total return from holding stocks. Traditionally, companies paid out 45% of earnings as dividends, while, over the past decade, this average has dropped to 30%. We believe income-starved investors and the retiring baby boomers are going to demand dividend payouts be increased back to 40% or more. Consequently, most dividend paying companies are going to increase dividends faster than earnings and inflation.

By owning stocks that yield 2.5% to 4.0%, our client portfolios are structured to benefit greatly from this trend. At the same time, portfolios are broadly diversified across global economic sectors with quality emphasized. To mitigate risk, we have deliberately kept commitments to the financial sector (banks and investment firms) below average. In contrast, less economically sensitive sectors like consumer staples, healthcare, and telecommunications have been over-weighted. In summary, due to the inflationary policies the U.S. is likely pursuing, we continue to believe owning shares of dividend paying, high-quality multinational companies is the best strategy for long-term investors.

Truly yours,

Keating Investment Counselors, Inc