INVESTMENT STRATEGY
JULY 2012

After gaining 24.5% in the six months from September 30th through March 30th, the market underwent a correction, declining nearly 10% during April and May. This was followed by the best June since 1999, as the market gained 4%. At the mid-way point, 2012 has played out much like the last two years with strong economic numbers through the winter, but tapering off starting in April. In addition, the European debt crisis is once again a focal point for the media and frightened investors. In contrast with Europe, U.S. growth has been firmly positive, but frustratingly slow. Importantly, the U.S. housing market has clearly stabilized in most markets and activity is finally beginning to pick up. A healthier housing market could become a major positive force for the economy and employment. Another positive factor is much lower commodity prices. Commodity prices have reacted to slower growth in Asia, most importantly in China. Overall, investors continue to gravitate to U.S.-based assets because of a healthier economic outlook and greater safety during uncertain times.

For the third consecutive summer, the European debt crisis has dominated headlines. Over the past two years Europe has patched problems as they arose, using billion dollar handouts from various stability funds in return for strict spending guidelines by the countries accepting the low interest rate loans. Unfortunately, these strict spending requirements have forced governments to quickly slash spending and increase tax revenues. These actions have resulted in even deeper economic recessions, making repayment of loans even more difficult. For example, Greece's economy is effectively in a depression after declining for five straight years. This should be a warning to American politicians arguing for similar austerity measures in this country.

Up to now, the strategy to hand out low interest rate loans to some of the smallest countries in the Euro zone has managed to stabilize the crisis for short periods of time. Unfortunately, more recently Spain and Italy have begun to come under pressure. These countries are far too large to stabilize with a few loans. Europe is nearing the point where it must decide to create a true fiscal union or their stopgap efforts will fail. The creation of a true fiscal union will require a higher governing body that controls budgetary policies, a unification of banking regulation and tax policy, and some form of mutually issued debt securities to lower the cost of funding for over-indebted countries. Putting this framework in place will be one of the greatest political challenges ever. Nonetheless, we believe the alternative is more menacing than the sizable hurdles European leaders have in front of them.

While Europe's growth has stalled due to brutal austerity, Asia's growth has slowed as China tightened lending and as their massive stimulus projects reach completion. We have been expecting China's growth to slow because the country has been trying to contain a substantial credit bubble they created with their stimulus spending during 2008 and 2009. During this bubble, housing became greatly overpriced, companies borrowed far too much

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money, and developers started too many commercial and high-end residential real estate projects. We expect sizable bank losses in the years ahead in China. However, we do not expect a sharp recession like those experienced by the U.S. and Europe a few years ago. The Chinese government's #1 priority is pacifying their massive population. As a result, the Chinese have the means and the will to prop up sectors of their economy to ensure "full" employment and "progress" within their society. Of particular focus is the build out of China's healthcare system with new modern hospitals across the country. Current portfolio holdings such as Thermo Fisher Scientific, General Electric, and 3M are benefiting from this initiative.

An extremely positive byproduct from the slowdown of Chinese growth is a significant reduction in commodity prices. During the past few years, China has stockpiled commodities to fuel their enormous development projects and this has led to much higher commodity prices. In fact, China consumed 53% of all cement, 48% of all iron ore, and 40% of all coal produced worldwide in 2011. This huge demand sparked the largest mining boom in thirty years which will result in significant new supplies of raw materials coming to the market over the next several years. We believe the combination of new supplies and reduced demand sets the stage for lower commodity prices over the next 2-3 years.

The most obvious benefit from lower commodity prices is cheaper products for consumers and higher profits for some consumer and industrial companies. Most importantly for consumers is that oil prices have declined 23% since March. This is during a period when oil prices usually rise in accordance with the summer driving season. Over the past twelve months, we have also seen price declines of 56% in cotton, 27% in aluminum, 35% in steel, 28% in sugar, 19% in copper, and 7% in corn prices. In combination, these declines in commodity prices should make a significant difference to consumers' pocketbooks heading into the fall. Meanwhile, profit margins should increase for many of the companies held in client portfolios.

While lower commodity prices will certainly help the economy, the real difference maker will likely be the stabilization of the housing market in the U.S. Over the past year, U.S. home prices rose 3%, the sale of existing homes rose 10%, and the sale of new homes increased 19.8%. Looking forward, pending sales of previously owned properties are up 15.3% compared to a year ago. Meanwhile, the number of homes for sale has dropped by 20% over the same period and unsold inventory of new homes is at its lowest point since the early 1960s. These factors should result in renewed construction activity which is being confirmed by the major home builders. For instance, Lennar Corporation, the third largest homebuilder in the country, has seen orders jump 40% compared to last year and their backlog is up 61%. Although these are the early stages of a housing recovery, this positive momentum should have a large and growing effect on employment and consumer confidence.

The potential upside surprises to the U.S. economic outlook further solidify our belief in the value of U.S. dividend paying, multinational companies. As we anticipated, U.S. stock markets have outperformed international markets over the past year. For perspective, the S&P 500 Index has gained 3.1% over the past twelve months. By comparison, the European large cap index is down 30.5%, the German index declined 24.4%, the Japanese index lost 7.7%, and the Chinese index retreated 12.9%. In fact, in dollar terms, no other major stock index advanced over the past year.

While U.S. companies have already outperformed over the past 12-18 months, we expect the trend to continue for the foreseeable future. With the amount of turmoil in Europe and growing uncertainty in Asia, the U.S. is once again being looked to as the preferred choice for conservative investors. Thus far, the majority of these investment flows have found their way into fixed-income investments, notably Treasury securities and corporate bonds. As we discussed in our last Investment Strategy, we believe fixed-income securities have become extremely overvalued because of these investment flows.

Apart from the flood of investment money into fixed-income securities, there has been a very modest flow of money going into dividend-focused equity mutual funds over the past twelve months. In fact, $27.4 billion has moved into dividend-focused equity funds over that period. These figures are very impressive considering the fact that money has flowed out of equity mutual funds in general for 13 consecutive months. It is our belief that these investment flows are likely to accelerate as investors search for greater returns and higher income.

Although the past three summers have been mentally confusing and emotionally draining as the media rehashes the same story lines, good things have come to investors who focused instead on the record profitability and growing earnings of high-quality U.S. companies. These companies are now flush with more cash than needed which should result in greater dividends to shareholders. In addition, with instability growing overseas, investors are now putting a premium on dollar-denominated assets. Taken together, we believe high-quality, dividend paying equities are the most likely area for significant investor money to flow into. Meanwhile, if events in Europe or China have an outsized effect on the global economy, we think our clients are best served by being invested in the highest-quality, best-financed companies in the world. Early indications show that other investors are slowly coming around to this viewpoint, so we urge our clients to stay the course while global events unfold.

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Keating Investment Counselors, Inc.