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

INVESTMENT STRATEGY
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It has now been five years since Lehman Brothers collapsed, unleashing a severe global financial crisis and an economic recession worse than anything since the 1930's. This period was one of the most traumatic events in contemporary history and has left an indelible mark on our society. Perhaps the worst after effect from this event is the loss of the unwavering optimism that previously defined America. Regardless, the economy has slowly recovered and the financial system has stabilized. Accordingly, the U.S. stock market has just reached a new all-time high. In spite of these achievements, investors are still pessimistic regarding America's future and are anxious about a drop in share prices. We believe both the short-term and long-term prospects for America are much brighter than generally perceived and this will lead to better than anticipated results for those with the courage to remain invested in the most innovative and dynamic economy in history.

We find it peculiar that the majority of investors are still so skeptical about the current economic expansion. We are now four and one-half years into an expansion that began in the spring of 2009. At this point in the economic cycle, investor psychology has traditionally already shifted from being apprehensive about another crisis to confident in a long-lasting expansion. This time around investors are still very uneasy and concerned about any number of low-probability events. Even worse, they are under invested in stocks. We believe this negative psychology is actually a bullish sign for stock prices. Bull markets do not end when investors are fearful, but rather when they are overly exuberant.

The immediate prospects for the U.S. economy continue to improve as the housing market recovers and domestic spending picks up. For instance, new home construction bottomed at roughly 500,000 new homes a year from 2009 through 2010. Currently, we are on a pace to build about 900,000 homes over the next year. Normally, the U.S. has required approximately 1.5 million new homes built each year just to satisfy basic demand. The recovery in new vehicle sales has been even stronger than in housing. After bottoming at roughly 9.5 million new vehicles in 2009, the U.S. is now on a pace to sell 16 million cars over the next twelve months. Before the crisis, there were roughly 17 million new cars sold each year. As a result of this rebound in activity, the number of non-farm jobs has actually recovered to nearly the pre-crisis peak.

Looking internationally, the developed economies in Europe have finally stabilized. Spain, the hardest hit large economy in the Euro area, recently announced their recession ended this summer. Germany, the most important member of the union, just reported the strongest growth in Europe and reelected their Chancellor to a third term. This should keep Europe's efforts to become a more unified coalition on track. Thankfully, the Europeans have also come to realize that aggressive austerity results in greater economic hardship. Europe is not likely to boost worldwide economic growth, but it will no longer be a drag.

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Emerging markets are beginning to suffer the consequences we described in our July strategy. As you will recall, rising U.S. interest rates are likely to suck investment dollars out of the emerging markets. This will result in weaker currencies, slower economic growth, and disappointing investment returns in these markets. There is also the potential for a political or credit crisis as a result of economic and currency weakness. Over the past quarter, money has moved rapidly out of several emerging markets faster than even we anticipated. The currencies of Brazil, Indonesia, South America, and India have all weakened by 10% or more against the dollar. Due to huge investment inflows, investors and governments have become complacent as emerging markets averaged 5.9% annual growth from 2000-2012, compared to U.S. growth of 1.8% annually. Going forward, growth rates are more likely to resemble the period from 1980-2000 when emerging markets grew 3.7% per year, compared to 3.2% annual growth in the U.S. As discussed in our last strategy, investors are highly likely to be disappointed by slower growth and poor investment returns in emerging markets over the next few years.

Given the worldwide economic landscape, we believe investors should be far more optimistic about the U.S. equity market over the next 12-18 months. The U.S. economy is likely to keep expanding while the fallout from the emerging markets stays relatively contained. Investment dollars should continue flooding into the U.S., resulting in higher stock prices, faster economic growth, and lower inflation. These investment dollars will also find their way into many emerging innovations that could revolutionize entire industries and the economy as a whole. At the end of the day, what has made America exceptional is our willingness to pursue difficult long-term projects that have the potential for enormous returns. America’s unwavering optimism is what has allowed us to successfully chase these dreams and change the world in the process. It is these revolutionary advancements that power economic growth and create new jobs. For instance, the development of the smartphone has been ground-breaking over the past five years. Entire new industries have sprung up overnight to service this new technology. Apple, creator of the iPhone, has gone from the brink of bankruptcy in the late 1990’s to being the most valuable company in the world.

It seems the average American investor and citizens in general have lost the belief that better days are around the corner. We’ve been overwhelmed by pessimism following the traumatic financial crisis of five years ago. The ubiquitous 24-hour news media has only reinforced these anxieties by warning us about any number of new potential calamities. Only a few years ago, the media was warning us that oil prices were set to skyrocket upward. The media claimed this would cause economic devastation and hopelessly indebt America to the Middle East. As it turns out, new innovation completely reshaped America’s energy outlook for the next thirty years. The advent of 3-D geological imaging and directional drilling combined with old-fashioned “fracking” has unlocked huge new oil and natural gas supplies within the U.S. and created hundreds of thousands of high-paying jobs.

We believe similar revolutionary advancements are likely in the foreseeable future. Investors should understand that innovation is accelerating thanks to flourishing fields of knowledge, more powerful tools, and clear needs that offer huge rewards to whoever finds a solution. For instance, the price of sequencing DNA has plummeted over the past few years. In 2007, it cost around $1 million for an individual to sequence their entire genome. Currently, an individual can receive this data for a few thousand dollars. As a result, an explosion of new research projects are being initiated to study various genetic abnormalities that could one day develop into targeted treatments to cure diseases we never thought feasible. Research of this type was impossibly cost-prohibitive just a few years ago. The price of energy generated by solar panels has taken a similar path over the past few years. Today, under ideal conditions, a solar panel can generate energy on par with traditional power plants. If a better storage device were developed (battery), our nation's energy infrastructure would be turned on its head.

Innovation itself may also be revolutionized in the foreseeable future. IBM believes that the next revolution in computers will be ones that learn and think for themselves. This means that computers will no longer just be powerful tools that assist humans in processing data and making decisions. Computers will recognize problems and find solutions without our assistance. This has the potential to rapidly accelerate innovation to levels unimaginable to most people.

These are just a few of the exciting advances researchers are exploring, but there are many more primed to be the next giant breakthrough. The great thing about innovation is that it often comes from unexpected places. For instance, none of the major oil companies were initially involved with the recent energy revolution in the U.S. They were investing in giant projects in exotic locations and completely missed the great opportunity in their own backyard. Rather than making predictions, we are trying to point out that most investors have become overly pessimistic about America's future. This is not surprising following the crisis five years ago, but it could lead to very poor investment decisions. Over the past few years, the media has featured several prominent and pessimistic portfolio managers (primarily bond managers) that believe the U.S. has entered a "new normal" marked by slower growth and lower equity returns. Although worldwide growth may slow from what we became accustomed to over the past century, equity returns benefit little from high economic growth, much more important is positive and persistent growth. The key to the strong equity returns generated by developed markets over the past century has been the stable rule of law and property rights, combined with innovation and low expectations. These factors still hold true today. Therefore, we believe America's best days are ahead and investors will be richly rewarded for being on board.

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