



INVESTMENT STRATEGIES

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Looking Back and Looking Ahead

A recap of 2011 and our thoughts for 2012

Last January, we published our outlook for the year, and our major thesis was that we would see slightly more volatility in 2011 than in 2010, although not the amount experienced in 2008 and 2009. On average, strategists predicted the market as measured by the S&P 500 index would end at 1371, or a 9.1% gain. We expected the index would end at 1280, or roughly where we began the year.

Well, we ended 2011 at a little under 1260, which was close to our estimate, and flat year over year on a price basis, although there was a roughly 2.1% total return including dividends. In fact, the index ended the first day of the New Year right around 1280, so we consider our forecast to be a win! We were also pretty accurate in predicting swings; we'd expected an early year move up to 1350 (we actually went to 1370) and then a pullback into year end.

Interestingly, our forecast for the S&P 500's 2011 earnings was actually much too conservative. The number is likely to be around \$97, up 12% and well above our \$92-\$93 expectation. We were also looking for \$98-\$99 for 2012, but have raised our estimate to \$103 since earnings have been reasonably strong.

On our sector calls, we had some winners and losers. Our negative call on Treasuries once again did not come to pass. With the yield on the 10-year now below 2%, we will sooner or later have to be right on this call! However, we were correct on municipals and corporate bonds.

Our predictions were decidedly mixed on the individual sector front. We suggested overweighting the pharmaceutical, health care, consumer staples, all of which outperformed the S&P 500.

But we also suggested overweighting financials (once again), emerging markets and commodity shares, which underperformed. Our forecast for financial shares starting to raise dividends significantly did come to fruition, though.

Our suggestion to underweight utilities and REITs did not do as well, as they outperformed the market. Underweighting the precious metal stocks did, however, work out as this group did not do as well. We also were generally right in underweighting precious metals themselves, with the exception of gold, which again had a good year. We had anticipated commodity prices might move higher, which did not occur.

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We anticipate 2012 will be more trend oriented. We see the early year upside trend driven by improving investor sentiment around earnings numbers coming in at or above expectations and early year excitement normally seen around the "January effect" and just the normal optimism that comes with turning the page to a new year.

After an early year move higher we anticipate investors will become more pessimistic about the market and the economy. While we see the housing market showing some signs of improvement, overall we anticipate strategists will be proven too sanguine on their expectations for earnings in 2012. The current expectation for 2012 S&P 500 earnings is a little over \$106 per share, which we find way too bullish.

We believe the issues in Europe will result in earnings from multinationals coming in below expectations. Also, populist rhetoric in the Presidential campaign, which will be perceived as anti-business, could result in corporate investment staying below expectations while management teams retain a much higher level of cash than typical. We also anticipate some wage pressure for high performers.

Currently profit margins sit at all-time highs. This is a figure that could ultimately revert to the mean (when margins are high, new competition comes in, eventually reducing margins due to higher costs and lower prices) and is very cyclical.

As a result, as mentioned earlier, our expectations for S&P 500 earnings are \$103. In general, we believe we could see \$110 in earnings from the S&P 500 for 2013, which in itself is a large discount to the average projection of \$121.

Should these issues come to light and investors become more pessimistic, we anticipate the market will drop to the 1100-1150 range moving towards the November election with investors pushing down the overall valuation metrics, and eventually willing to pay less than 12 times earnings.

Following the election, we anticipate investors will become much more constructive, driving the markets up towards our 1295 year end price target, or 11.8 times our expectation for year ahead numbers based on the 2013 estimate. Once again we are below the average strategist's expectation at 1334, although we are seeing a lot more realistic level of projections, in our opinion.

We expect to see some multiple expansion around the eventual election outcome; we currently think the President will win re-election and the Republicans will take control of the Senate while retaining control of the House. Gridlock is generally good for the markets, in our experience, and we anticipate it will drive the markets significantly higher into the end of 2012 and carry over into a very strong market in 2013.

In fact, we are looking for a close at the end of 2013 above 1500 on the S&P 500, or up more than 17%, as we see an expansion of the multiple to 13 times on improved economic growth, some type of conclusion to the European debt crisis and the realization that political gridlock may in essence bring some comfort to investors -- legislation negative to business is likely to be wound down to some degree.

Also, while current interest rates argue that valuations are way too low, in this case we believe an **increase** in bond yields could actually result in an expansion of the earnings multiple due to the fact that higher rates would indicate a much improved economic environment.

As such, although current valuations are very cheap in the current interest rate environment, with the S&P 500 trading at 12.7 times trailing earnings, investors are looking at interest rates being kept artificially low and considering what this means in a difficult economic environment, in our view.

With the markets likely to provide rather uninspiring returns for shareholders this year, where can one go to secure solid returns? First, we think the equity markets will continue to provide better total returns than bonds. Bonds, at least Treasuries and high quality corporates, are unlikely to go much higher, in our view, as yields sit near all time lows. While we do not anticipate yields rising much in 2012, we also do not anticipate bond prices to rise. The total return will be from these weak yields only, meaning there will be very little return on high quality bonds in the current year, and probably negative returns in out years.

Further, while investors may need to be more nimble than normal, we believe there is money to be made in equities, especially early in the year. While returns may largely be flat for the full year, some asset allocation changes could provide an opportunity to make money.

We would stay long equities early in 2012, concentrating on pharmaceuticals and health care (a holdover from last year), technology, and financials, which have significantly underperformed over the past few years and, in our view, look attractive, in particular as they begin to ratchet up dividends.

As the market moves up, we would take some money off the table in equities and move that into fixed income, concentrating on municipal bonds and lower rated corporate bonds, where there is still solid yield available. We would also include exposure to preferred stocks in this suggestion.

We would again consider emerging markets, particularly the Asian and Pacific markets early in the year. We expect they will likely have the same issues as the US market as the year progresses; we would initially consider this to be a trade rather than a long-term investment.

We would stay away from companies and sovereigns with heavy exposure to the Eurozone economies. We believe it is highly likely there will be a recession there in 2012. This is expected to also hurt multinationals, part of the reason we are suggesting staying away from some of the sectors we liked last year, such as the consumer staples groups, and some of the technology names with large exposure to those markets.

This is part of the reason that we see the emerging markets as more of a trade -- they too have significant exposure to the Eurozone.

Other areas we suggest underweighting at this point include the electric and gas utilities, which have had a solid run over the past couple of years and trade at large premiums to their typical value versus the market, as well as the REIT sector, which also has seen its valuation move to premium levels. In both of these areas, we suggest sticking with exposure to the higher yielding names. These should receive some yield support and investors should get solid returns from the dividends, even if the share prices fall.

We expect bonds will likely see limited price appreciation/depreciation this year due to the Fed holding rates fast. Most of the return will be from coupons, which is not very attractive from a Treasury/high quality corporate perspective. Should investors wish to add bonds to their portfolios, we would suggest they consider municipals and a diverse portfolio of lower rated corporate bonds, which should offer more stability than we see from equities.

Following a down year for commodities, they could provide some small upside in 2012, although overall we see generally stable commodity prices in 2012. We do, however, see a modest decline in oil prices during 2012 due to the slowing European economy and a beginning move towards natural gas to replace oil in some uses (see our crazy prediction for 2012 later).

We generally anticipate little from precious metals in the year ahead, following last year's declines (with the exception of gold). We do believe we have seen the top in gold and may see a modest pullback this year due to reduced demand from China and India.

We continue to feel sector selection and nimble movements between stocks and bonds could be very important in enabling investors to get above market returns in 2012.

What type of trends do we see occurring in 2012? We anticipate a possible uptick in merger and acquisition activity due to attractive valuations and large amounts of cash on hand, although political rhetoric could create some headwinds before November. We continue to expect the Fed will keep rates largely steady through all of 2012 and well into 2013, though we view the Fed beginning to increase rates as a positive for the markets. Political rhetoric will be more of an issue to the markets than at any time in the past 30 years, in our view.

Volatility may be less an issue from a day to day perspective, although we expect we will see three major up and down moves.

We continue to do well on our "Crazy, Off the Wall" predictions. At the start of 2010, we suggested one of the major credit rating agencies would place the US Treasury bond on credit watch during 2010. This did in fact occur in 2011 along with an actual downgrade by Standard & Poor's.

For 2011 we envisioned a major realignment of the European Union which placed the viability of the Euro in doubt; this is currently ongoing.

For this year we have two "Crazy, Off the Wall" predictions. First, we see the Euro moving to par against the dollar by year end. This would be a much larger drop than has ever been seen in a major currency before, but with the US remaining the giant in the currency realm and with the likelihood of major issues in the Eurozone, we believe there could be more movement here than at any time in the past.

Our second call is that natural gas will finally begin an inexorable move in 2012 to replace gasoline as a transportation fuel in the domestic market. Given our position as the Saudi Arabia of natural gas and its much cleaner environmental profile, we think the complications here will finally be overcome with major government support as the untenable financial fundamentals of renewable energy becomes apparent due to debacles such as Solyndra and the Chevy Volt (General Motors Co.-GM-\$22.84).

What should investors do with this in mind? Since we expect a significant increase in the market early in the year, we would probably hang on to current overweight equity positions in the near term. With the influence we see from the presidential election season, 2012 is probably one of the more difficult years to predict due to fundamentals having much less of an impact than usual.

As we said last month, perception is everything in the markets, and while we believe the markets will go up following the election no matter who wins, the perception is President Obama has put in place an anti-business agenda. As a result, if the polls show that he will win re-election (as we anticipate), we expect the market is likely to be relatively weak; the converse is also likely to be true, so watch the polls to get a better feel of how the markets will react in 2012.

Again, though, no matter who wins we anticipate that the market will move higher after the election. At this point, we believe investors should retain their overweight position in equities early in the year. Investors should then re-position their portfolios as the market moves higher, lightening up on equities and moving more of their assets into municipal bonds and lower rated corporate bonds. Then, later in the year, we believe investors will have an excellent time to move into equities at very attractive prices. While it is impossible to pick an exact point for these moves, slowly take some money off the table as equities rise and move into bonds, and then do the opposite as equities move down.

What could derail our thesis? The election could go differently than we anticipate. While our expectation is that the market ends 2013 much higher no matter who wins, perception is everything. Should the Republican nominee look as if he will win, the market could trade up into the election, rather than down; we expect to end up in the same place no matter who wins.

There could be a disorderly breakup to the Eurozone. Also, energy prices could move up, pushed by demand from emerging economies and strengthening demand from the developed economies. This could increase inflationary pressures and force the Fed's hand, causing them to raise rates more quickly than anticipated. We expect such actions would also likely push the market down, although the strengthening economy would offset that to some degree.

In summary, we suggest initially overweighting equity securities and increasing the weighting in fixed income investments as the year goes on, with a focus on municipals and higher yield corporates and avoiding Treasuries. Later in the year we anticipate there will be an excellent time to increase exposure to equities, especially some more cyclical names. Overall, some nimbleness and attention to how the political

process is unfolding will be needed. Doing such may allow investors to outperform what we believe should be a roughly flat market in 2012.

Additional information is available upon request.

Analyst Certification

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Buy - We believe the stock has significant total return potential in the coming 12 months. **Long-term Buy** - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues. **Neutral** - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.

Underperform - We believe the stock is vulnerable to a price decline in the next 12 months.

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	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
Rating				
Buy	56	29%	4%	96%
Long-term Buy	40	21%	8%	93%
Neutral	94	49%	0%	100%
Underperform	1	1%	0%	100%

As of 9 January 2012

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