COHO PARTNERS, LTD.

2011 Annual Commentary

"been down so long, seem like up to me"

Bluesman Furry Lewis, "Turn Your Money Green"

"There is no economy in the world, whether low-income countries, emerging markets, middle-income countries or super-advanced economies that will be immune to the crisis that we see not only unfolding but escalating."

Christine Lagarde, IMF Managing Director

After a year characterized by dramatic events from the Japanese Earthquake and Tsunami, escalating and rolling European crises, global political upheaval, the U.S. debt ceiling debacle, social inequality protests, etc.., the U.S. economy enters 2012 with growing momentum as recent economic releases have consistently exceeded expectations. We have long postulated that a cyclical recovery would hinge on the interconnectivity and improvement in the primary domestic areas of employment and housing. Within these economic lynchpins, the fourth quarter data has sown the seeds of optimism for many investors and economists. While the escalating credit crisis in the Eurozone has dominated headlines and elicited extreme market volatility, improving jobs reports have buoyed the spirits of consumers and spurred many economists to eschew material concerns of a recession amidst increased optimism that the United States can avoid any contagion from across the pond.

After 31 consecutive weeks of new unemployment claims above 395K per week, the 4-week average of such claims has now dropped from over 420K in September to under 375K, a level consistent with positive payroll growth and the lowest reading since June of 2008. The December non-farm payroll jobs report confirmed this recent strength with a gain of 200K jobs and a reduction in the unemployment rate to 8.5%. We entered 2011 with an unemployment rate of 9.4% and have now enjoyed 6 consecutive months with over 100K new jobs created and an average for the year of 137K per month. The private sector has now enjoyed 22 consecutive months of positive payroll growth and almost 30% of the almost 9 million jobs that were lost during the recession have been recovered.

This improving data along with the plunge since August of gas prices at the pump (down from $3.96 per gallon to $3.28 in December), has engendered a huge boost in the spirits of consumers. Indeed the Consumer Confidence index released by the Conference Board showed a record 2-month increase in December to 64 from a near cycle low in October of 40.9. While final data has yet to be reported, it appears that consumer spending continued at a solid pace during the holiday season.

On the housing front there appears to be a consensus building that a bottom may have been reached as new housing starts, new single family sales and existing single family sales all experienced their highest volumes since January of 2011 in the most recent data from the National Association of Realtors (the same organization it should be noted that in December 2011 revised the originally reported sales data from 2007-2010 down over 14%). The National Association of Home Builders index has increased for 3 consecutive months from a level of 15 to the current reading of 21 noting improved traffic.

Manufacturing data points of Industrial Production, Capacity Utilization and the ISM indices (Institute for Supply Management) have exhibited modest increases since August and, along with the above data, collectively point to a fourth quarter GDP that should exceed 3%, the highest for the calendar year after 3 consecutive quarters of sub 2% growth. Armed with this information, we anticipate many economists will be inching up GDP growth projections for 2012 in the weeks ahead.

We believe that among the greatest challenges facing economists, strategists and investors is discerning the cyclical from the secular; the noise from the trend. Markets trade violently off news releases that prove to be woefully inaccurate in hindsight and revisions of which are often buried on page 6. For a few years we have all acknowledged how dreadful the home sales data has been since the housing bubble imploded. Yet, in December, we found out that it was actually *overstated* by 14% by the NAR. Lest we pick solely on the NAR and their agenda-driven output, the Bureau of Economic Analysis that reports the GDP figures may even be worse. In late July they revised the data from the "Great Recession" of late 2007 to mid-2009 down over an additional one-half of one percent. Additionally, they even restated 1Q 2011 GDP figures that had just been released and finalized 35 days prior from 1.9% to 0.4% growth. As Maxwell Smart might say while holding his thumb and forefinger slightly apart, "missed it by that much".

As expounded upon in our 3Q 2011 Commentary, we feel we are still in the early to middle stages of a post-financial crisis environment. Events in Europe that are currently holding the global markets hostage are an aftershock of the 2008 financial meltdown and a product of excess leverage and debt accumulation in the developed world that was three decades in the making. The Eurozone as currently constituted lacks a central fiscal policy, thus the downturn there is expected to be more severe. It is critical to understand the characteristics of such an environment in order to have a more accurate perspective on the probability of future outcomes.

The actions of the European Central Bank (ECB) in establishing the Long Term Refinancing Operation (LTRO) in concert with the expansion of U.S. dollar swap lines and the easing of collateral rules effectively reduce the current risk of a systemic banking system failure in Europe and across the globe. However, they do little more than buy time. The Federal Reserve and other global policy makers continue to backstop the system with greater liquidity in an attempt to lower the cost of debt and ignite increased economic flows. During a typical inventory-led recession, this is precisely the correct call. Currently, we fear they may be reading from the wrong playbook. In a major deleveraging period, a change in the pricing of debt does not serve to spur demand and represents a classic liquidity trap.

The current period is still characterized by excess capacity in housing and labor. In such a period, deflation and not inflation would be the primary concern despite increases in reserves and the money supply. As the demand for credit continues to wane, stagnant wages are not sufficient for sustained spending increases which, in turn, are needed for a continued increase in hiring. A major by-product of such a period is a shorter economic cycle and much greater economic volatility without the smoothing effect that credit expansion provides. It is precisely during periods such as this, that it becomes most challenging to separate the noise from the trend.

In employment for example, we are witnessing modest headline job growth concurrent with a quickly declining unemployment rate giving the hope for a sustainable increase. However, the Labor Force Participation rate (those still counted as part of the labor force) has declined to a 27-year low of 64%. If this rate were held constant to the level (65.7%) when President Obama took office, the unemployment rate would actually be 10.9%. While some economists argue that this rate would be expected to decline within our aging population (more retirees not counted as part of the denominator), they ignore that within the 25-54 age groups which is not impacted by such demography, we have witnessed a decline from 80% participation in 2007 to 75% currently. In addition, in 8 of the last 10 recessions payroll employment growth was positive in the very month that the recession began with an average of 200,000 new jobs and 500,000 in total over the prior 3-month period . With 5.6 million Americans out of work for at least six months and 3.9 million of them unemployed for more than a year, it is far too early to view the recent data as more than a cyclical uptick.

Importantly, the quality of the new jobs does not augur well for future consumer spending. Our long-term decline in manufacturing was obfuscated in the early 2000s with the construction boom that offset the loss of many of those higher paying jobs. The large majority of recent job growth has been found in the categories of healthcare and hospitality. Many of these employ low-skilled workers at low wages or are seasonal and run the risk of rolling off in the next quarter. Job growth is critical but mostly to the extent that it corresponds with increasing wages. This has yet to occur and the prospects for 2012 are not yet encouraging.

For the year, Average Weekly Earnings as reported by the Bureau of Labor Statistics is up 2.66%. Real Disposable Personal Income data per capita (adjusting for the 3.4% increase in the Consumer Price Index) is actually down -0.9% over the one year period ending in October. According to the Census Bureau, average household income adjusted for inflation is down -6.4% from the levels of 2007 and actually now back to the level of 1996! Flow of Funds data for the end of 3Q 2011 show that Household Net Worth suffered the largest quarterly loss in more than 2 years down more than 4% and cumulatively down 14% from pre-recession levels of 2007. In concert with the deleveraging theme is data revealing that total credit outstanding has now declined for 13 straight quarters (a very strong November report notwithstanding) and is down 5% from the 2008 peak. This welcome increase in frugality has now reduced the consumer debt burden as measured by the Household Debt Service Ratio (includes mortgage and consumer debt) to levels as a percentage of disposable personal income not enjoyed since 1994. However, consumption fueled by a decline in the savings rate from 5.3% to 3.5%, without material wage and employment gains, is highly unlikely without commensurate credit growth to engender a sustainable expansion. We anticipate the savings rate to rise in 2012 and consumer spending to be impacted accordingly.

The positively received housing statistics pertain more to levels of sales that have stopped declining. Still high prices, excess inventory and slower household formation are still critical overhangs to a rebounding market. Both the Case-Shiller and Core Logic home price indices depict an annual decline of about 4% in home values in 2011. Core Logic also estimates that 10.7M or 22.7% (down from the 2Q 2011 figure due to increased foreclosure sales) of all homes with a mortgage are in a negative equity position with another 2.4M homes possessing less than 5% equity. Though new foreclosures have now declined for multiple quarters (due in part to the robo-signing litigation), the duration of the average loan in foreclosure is now a record 631 days. Bank of America Merrill Lynch forecasts nearly 8 million homes will be liquidated by the end of 2015, in addition to the 6 million we have already seen. The current discussion of a foreclosure disposition plan by the administration of GSE and FHA owned properties for rental opportunities might reduce further price declines and accelerate a return to a more normal market. As most all of these are single-family homes, the logistics and management of such an endeavor would be extremely challenging. Excess inventory remains an overriding concern.

As far as the demand side of the equation, new household formation has been declining since the start of the recession. Recent data from the Census Bureau indicate that 6 million Americans ages 25-34 are living with their parents up 27% from 2007. With 1.8 million 25-29 year olds unemployed (up 111% in four years), we are reminded of the circular link between employment and housing.

What is clearly a trend and not just noise are the rolling credit concerns and declining economic fortunes of developed Europe. With virtually all major countries in Europe exhibiting slowing and even contracting growth rates, the question is not if or when the Eurozone enters recession but rather the magnitude of the downturn. While the market cheers any news of the ECB or other facilities backstopping European sovereign debt, the underlying issues of excess indebtedness remain. There are some estimates that foresee a deleveraging of the European banks by over $2 trillion euros in 2012 while facing $200 billion euro of rollover debt issuance on the calendar for Italy and Spain before April. This forced delevering of the banks may have widespread credit implications across the globe.

Europe represents over 20% of the revenue of S&P 500 companies and an even greater percentage from the emerging markets. Representing almost 20% of global GDP, this area is systemically critical to global growth. Without fiscal unity, credit strains will worsen. Forced austerity in many peripheral countries increase unemployment and economic malaise. A recession turns into a small depression. In the last year alone, seven governments in the EU have been voted out of office with other regimes facing peaceful and less peaceful uprisings. Further global instability is one of the greatest risks for 2012. It is a challenge to foresee a decoupling of the United States from this global turmoil.

Though the investment community has recently moved away from fears of a domestic recession, consensus GDP growth estimates for the coming year are still trending in the 2%-2.5% range with unemployment moderating to below 8%. The International Monetary Fund (IMF) forecasts global GDP growth to achieve 4% in 2012. The U.S. is projected to grow at 1.9% and the Eurozone at 1.1% while Emerging and Developing markets slow to a still robust 6.1%. If it were not for the escalating concerns in Europe and a concurrent expected slowdown in China and the emerging economies, our outlook for the U.S. might be more optimistic. However, we see a significant recession in Europe and additional fiscal headwinds creating downside risks that should be most pronounced in the first half of the year. More importantly, the symmetry of the possible outcomes does not present a positive skew as the historical world superpowers have never been more uncertain. These risks are no longer unthinkable and must be accounted for as a possible outcome. We continue to foresee a high level of recession risk in 2012.

A growing concern and a large distinction from the global downturn of 2008 is the slowing in Asia. With the Shanghai Composite index off almost 30% since April, many fear a major slowdown in China. If it were to materialize, it would most likely be led by rapidly falling property investment under aggressive government constraints and a worsening European debt crisis impacting both credit and exports. An additional risk would be the impact these softening economies might have on potential currency wars.

Emerging markets are always more volatile and sudden outflows into the U.S. dollar (ironically but expectedly still viewed as a safe haven) have hit stocks and bonds denominated outside the U.S. dollar very hard in the second half of 2011. With a recession in Europe (the largest export destination for emerging markets), many emerging countries will be more challenged. Regardless, these are economies with debt to GDP ratios of less than 33% compared with over 100% in the developed world, with more attractive demographics and natural resource abundance. The MSCI Asia ex-Japan index is currently valued at less than 1.5 times book value, which is not far from the extreme lows of 1.3 times realized during the depths of 2008.

The Eurozone presents additional investment challenges and opportunities despite how gloomy the economic prospects appear. Market valuations clearly reflect much of this weakness with many countries in the Eurozone selling for less than nine times trailing earnings. While the economies may be challenged, we need to remember that many of the great companies within these borders are global. The Eurostoxx 50 (Europe's leading Blue-chip index for the Eurozone) currently sports a 2012 price/earnings ratio estimated at 8 and a dividend yield in excess of 5%. At some point even such weak economies are valued too inexpensively to ignore. Though we feel now to be a good time to establish longer term positions in foreign markets amid good valuations, weakening currencies and turmoil in Europe should continue to work against these markets over the next few quarters.

One thing from which our markets have clearly not been able to decouple has been the macro-driven volatility. The spectre of the European debt crisis spurred a nearly lock-step correlation between individual stocks and the overall index. According to Birinyi Associates, this correlation peaked at 0.86% in October, fully 74% higher than the average of the prior 30 years. While the S&P 500 entered 2011 at 1257 and closed at precisely the same level (though with dividends it was up 2.1% for the year), the year was anything but serene. From a low of 1099 to a high of 1363, the index experienced no less than 34 separate up or down moves of 2% within a single day.

Following a fourth quarter where most domestic indices returned in excess of 10%, some managed to finish the year in slightly positive territory. As noted, the S&P 500 finished up 2.1%, with the Nasdaq and the Russell 2000 small cap index off 1.8% and 4.1% respectively. International stocks as indicated by the MSCI EAFE index declined 11.7% with Emerging Markets off over 18.1% (Brazil and India were each down in excess of 30%). 2011 was clearly a year to stay defensive. Higher dividend-paying, more defensive companies were clearly the outperformers as Utilities, Healthcare and Consumer Staples sectors in the U.S. all posted double digit gains. The top 100 S&P 500 companies ranked by dividend yield returned over 3.7% for the year while the bottom 100 declined more than 10%.

2011 was again a year of strong U.S. corporate profitability. Total U.S. corporate profits as a percentage of GDP (a proxy for profit margins) broached 10% at the end of 3Q approaching the record of 10.2% in 3Q 2006. We have often pointed out the lack of sustainability of this metric that inflates current earnings thus creating the appearance of value by traditional price earnings metrics. Recent data indicate a moderation in productivity gains which may soon show up in reduced margins. While the full year estimate for S&P 500 earnings is for a 15% gain to $96, we do not foresee that continuing in 2012 with the results for the 4th quarter of 2011 probably representing the first sequential quarterly decline since 2009. Consensus estimates for S&P 500 earnings in 2012 have declined recently from over $113 to below $107. Foreseeing a greater probability of a mild recession, our outlook is well below consensus in the range of $85-$95.

Despite the anticipated modest inflationary increase in 2011, we remained very constructive on fixed income which continued to post strong returns. For the year, the best performance was in the least loved asset classes of long term U.S. Treasury bonds (up 29.3%) and municipal bonds (up 10.7%). With the continued government intervention (financial repression) into the fixed income markets and expected economic weakness and moderating inflation, we maintain our somewhat positive stance on fixed income. However, from current yield levels the return outcomes are not favorably skewed and return expectations are much lower.

There are very interesting dynamics taking shape for 2012 that seem to benefit the United States as perhaps the best house in a bad neighborhood. Relative to the global economies, our financial system is well capitalized, our economic growth both in absolute and relative terms is superior to much of the developed world, our corporations are in excellent fiscal health, and we maintain (for now) the reserve currency of the world. Collectively, we find many legitimate arguments that favor our stock market in the year ahead at the expense of alternative markets and investments. While finding solid long-term value now for the first time in a few years in international equities, we continue to suggest an overweight of U.S. equities. What we cannot ignore, however, is the global risk that would increase correlations among most all asset classes. The survival of the Eurozone, the stability of European banks and the international monetary system, government and consumer debt issues in the U.S., and our political quagmire all represent very high stakes risks and potential extreme outcomes. It is these outlier risks that continue to suggest a defensive positioning focused upon capital preservation and safe income strategies. Despite the increase in the crowd around us, we continue to favor high quality, dividend paying and growing companies as the most attractive value in the prospective environment.