ANDERSON HOAGLAND & COMPANY

News & Market Analysis: 4Q 2011 | January 13, 2012

European Crisis Poised to Define 2012

A year of volatile price action in the stock market culminated with a strong fourth quarter which pulled full year returns slightly into positive territory. High quality sectors of the bond market performed well in 2011 as investors took shelter from "headline" risk and benefited from unprecedented monetary stimulus. This letter includes our assessment of current conditions and discusses our investing strategy for 2012.

STOCK AND BOND MARKET RESULTS

	First 9 Months	4th Quarter	Year 2011
S& P 500 Stock Index	-8.7%	11.8%	2.1%
Intermediate 1-10 Yr. Treasury Bond Index	6.0%	0.7%	6.8%
Merrill Lynch 5 to 10 Year AA-AAA Corp. Bond Index	6.2%	1.9%	8.2%
Merrill Lynch 3 to 7 Year State Muni G. O. Index	5.4%	1.3%	6.8%
Merrill Lynch 7-12 Year State G. O. Muni Index	9.9%	3.5%	13.7%

OUR VIEW OF THE EUROPEAN CRISIS, 2012's MOST PRESSING ISSUE

From a high level of abstraction, the solution to Europe's self-inflicted fiscal mess seems pretty clear. First they need to create and fund a vehicle with enough fire power to buy and hold sovereign debt of the weaker EU members so they have time to deleverage. Secondly they need to add capital to their banking system so it can absorb the expected level of bond market and loan related losses without becoming insolvent and curtailing all lending. Any progress on these two fronts is likely to help stock markets around the globe in 2012 because the fear of "contagion risk" has become the prime driver of market volatility. The long-term question for Europe is how to become more competitive and improve their trade balance without resorting to currency devaluation.

Equally obvious, however, are the structural impediments to a speedy resolution for Europe's problems. The EU is a seventeen country monetary union, not a fiscal union like the 50 United States, so each step towards closer economic integration is subject to political debate by each member and the resolution of cultural biases. The capital markets have focused on developments in Europe because the health of the EU block is crucial to an integrated global economy. A failure to address their problems would harm not only the developed world, but also developing countries like China who sell 35% to 40% of their exports in Europe. If the European banks are not recapitalized, losses will likely spread to US bank balance sheets and damage our recovery.

During the fourth quarter six central banks from around the world provided European banks with a facility for swapping euros into dollars and obtaining short-term funding so that their liquidity problems did not escalate, but this is not a permanent solution. On the fiscal front, Spain reacted to December forecasts of a higher deficit by raising taxes and curtailing government spending. The conclusion we draw is that "austerity" is highly likely to sweep across Europe and cause a recession to begin in the fourth quarter of 2011 and intensify in 2012. The data already shows that manufacturing activity in Europe declined in December for the fifth straight month.

WHAT LIES AHEAD FOR THE US ECONOMY?

Compared to a recessionary outlook for Europe and Japan's apparent inability to deal effectively with its earthquake/tsunami/ nuclear disaster, the US appears to be the strongest part of the developed world economy as we enter 2012. One major difference is that we are three years past the collapse of our housing bubble whereas Europe's public and private sectors are just beginning to address their leverage problems. The US economy could "de-couple" from Europe and Japan in 2012 and start to look like the best horse in a very slow race.

The consensus 2012 economic forecast is for 2% real growth in the US, and the bond market is reflecting inflation expectations of 2% versus the trailing 12 months core CPI of 2.2%. As you know from reading our previous quarterly letters, we are forecasting a multi-year period of suboptimal growth until consumers manage to deleverage their balance sheets down to a more reasonable level, a process that could easily take another two years.

On the positive side of the ledger, US data released in December show a rise in consumer confidence, increased housing starts and new home sales, a pickup in several manufacturing indices, improved auto sales and a decline in unemployment to 8.6%. With capacity utilization running below 78% there appears to be plenty of room for the domestic economy to rebound before hitting any constraints on growth or causing an inflationary impulse. Barring external shocks, our economy is past the worst and poised to do better, but ultimately the federal government must also deleverage, and that could further dampen future growth prospects.

STOCK MARKET STRATEGY

The S&P 500 Index ended the year at 1258 or 12.3 times the consensus 2012 earnings estimate of $102. We continue to believe that much of the bad economic news has been priced into the stock market and find it generally attractive at today's valuation level. Corporate America came through the most recent recession with excellent returns and strong balance sheets. Corporate cash now equals 7.2% of aggregate company assets, the highest ratio since 1959.

We view this as evidence of management discipline in the face of a weak demand environment and have been impressed that company level returns on capital have remained well above long term averages through the financial crisis and recession of the last three years. There are cyclical factors supporting corporate profitability, primarily labor market weakness, but we also believe that managements have become better allocators of capital. The business school teaching that one should invest in all projects with a rate of return at or above the firm's cost of capital seems to have evolved into a belief that all projects should earn a return well above the cost of capital.

We are looking for investment candidates that demonstrate this understanding and also that have new products, new strategies or new markets which will allow them to grow at above average rates. In a sluggish economy, companies with the ability to grow while generating strong returns on their investments are especially attractive.

In terms of sectors, we are underweight relative to the Index in areas like healthcare and defense that are likely to be negatively impacted by future government contraction and overweight technology stocks and industrials that have stronger fundamentals.

Last month, JP Morgan published an analysis showing that only about 8% of S&P 500 earnings are generated in Europe. NAFTA has led to expanded export trade with Canada and Mexico which now total 33% of US exports versus only 14% with Europe. Our tendency therefore, is to use periods of European headline induced volatility to buy stocks that we think are attractive.

Bond Market Strategy

The ten year Treasury note yield peaked in the first quarter of 2011 at 3.60% and then fell steadily, reaching its low of 1.67% at the end of September and closing out the year at 1.90%. The prospect that the Fed could keep short rates close to zero percent for an extended period coupled with demand for "safe haven" investments clearly trumped the negative news of a downgrade of US government debt from AAA to AA+ in August and the massive supply of bonds issued to fund our $1.5 trillion deficit. At current levels we have minimized holdings of US government debt.

Our taxable bond holdings are concentrated in finance related corporate bonds which we believe have attractive risk/reward characteristics and in Build America Bonds (BABS), which is a taxable sub-sector of the municipal bond market. BABS have varying degrees of their interest obligation subsidized by the federal government. The program which authorized them expired in 2010 after about $180 billion had been issued, and they started to gain market acceptance during 2011. We diversified our holdings across a broad list of issues when we bought them, and we will probably begin to liquidate BABS if they attain our price targets in 2012.

A positive for the BABS market is that 49 of the 50 states--Vermont is the exception--have balanced budget provisions in place, so they have a mandate to cut spending and raise taxes in a more timely manner than the US Congress. The National Association of State Budget Officers claims that they have cut 648,000 jobs and reduced deficits by more than $325 billion over the last four years. We are starting to see reports of improved finances in several states (aggregate tax collections were up 7.3% in the third quarter of 2011) which should help to diminish fears about the creditworthiness of both BABS and General Obligation municipal bonds.

The municipal bond market yield curve currently parallels that of the Treasury market: short-term rates are close to zero, and rates rise sharply as one moves out from five years to ten and from ten years to thirty. In light of our subdued outlook for inflation over the next two years and evidence of improved fundamentals at the state level, we think it is a good time to take maturity risk but avoid credit risk.

Therefore our municipal bond market strategy is to focus on pre-refunded and escrowed issues (which have increasing scarcity value) and "essential" service bonds that are financed with tax revenues on water-sewer services, electricity, transportation and the like. We are generally avoiding bonds that are dependent upon more economically sensitive activities like sports complexes, airports and port authorities. At the beginning of the year financial analyst Meredith Whitney threw a scare into the $3 trillion municipal bond market with her forecast that "hundreds of billions" of bonds would default. Defaults actually declined to $2.1 billion in 2011 versus $2.8 billion in 2010, and in retrospect, the publicity around her pronouncement provided a great time for us to buy bonds at attractive prices.

ADMINISTRATIVE ISSUES

The Securities and Exchange Commission requires that we annually offer to send you an updated copy of our form ADV, like the one that was given to you before the inception of our business relationship. If you would like one, please send us a written note to that effect because the SEC requires two-way documentation of all requests.

We welcome any questions or comments you may have regarding our outlook or your specific portfolio, and we appreciate your confidence as we deal with the investment uncertainties of 2012 and beyond.