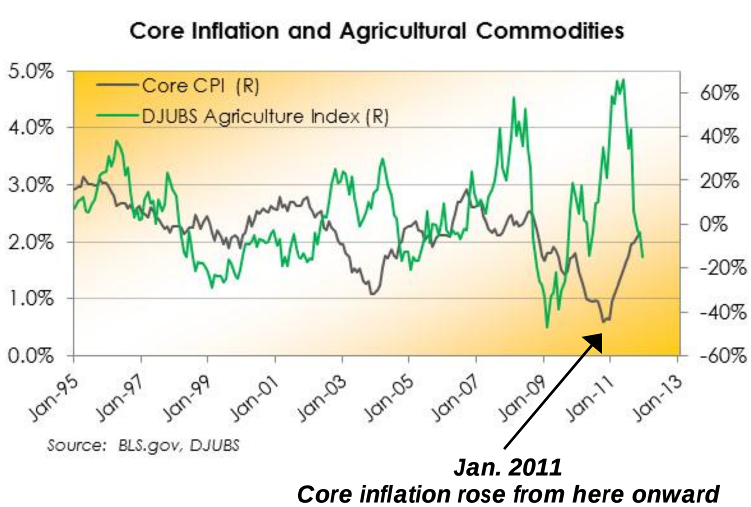
As we move into the new year, we like to look back on some of the topics we wrote about during 2011. This month we simply review the timeline of Miracle Mile Research publications in 2011, and see how our views played out in the months that followed.

Q1 2011 – Inflation

The beginning of 2011 found us focused on inflation. The Federal Reserve had just embarked on its second round of quantitative easing, which we believed would prove inflationary to the global economy and dampening to world equity markets. In January 2011 we wrote the following:

> A debate has raged over the last few years between those who believe that the stimulus poured into markets will eventually ignite inflationary pressures versus those who believe that anemic growth makes deflation the greater risk. The Fed has routinely fallen into the "deflation risk" camp, and has openly pursued an aggressive campaign to stimulate growth. Throughout the worst of the recession in 2008-2009, the weakness in global economic activity seemed to warrant these aggressive tactics. In recent quarters, however, the landscape has changed. Growth in Asia and the rest of the developing world has picked up to the point where central banks are raising rates to contain inflation. Renewed global growth – as well as a depressed dollar resulting from both the Fed's easing measures and the euro's troubles – have helped fuel a run-up in commodity prices. Despite the flow-through impact that many of these commodities have on the cost of food and energy, the situation is not sounding alarm bells for the Fed. Policy makers in the U.S. focus only on "core" inflation – the general price level excluding food and energy. In this week's post-meeting statement the Fed commented, *"Although commodity prices have risen, longer-term inflation expectations have remained stable, and* ***measures of underlying inflation have been trending downward****."*



As of January, core CPI was still declining, but we anticipated that it was only a matter of time before higher commodity prices – fueled by dollar-depressing Fed stimulus – would make its way into core goods through raw materials. We did not have long to wait. Growth in core inflation moved higher in every month of the past year, and equity markets began to stall in the spring.

We now see a reversal in this trend. Commodity prices have retreated significantly since late summer, and we anticipate this positive tailwind to flow into *lower* core prices in the months to come. This should prove a boost to equity markets as well.

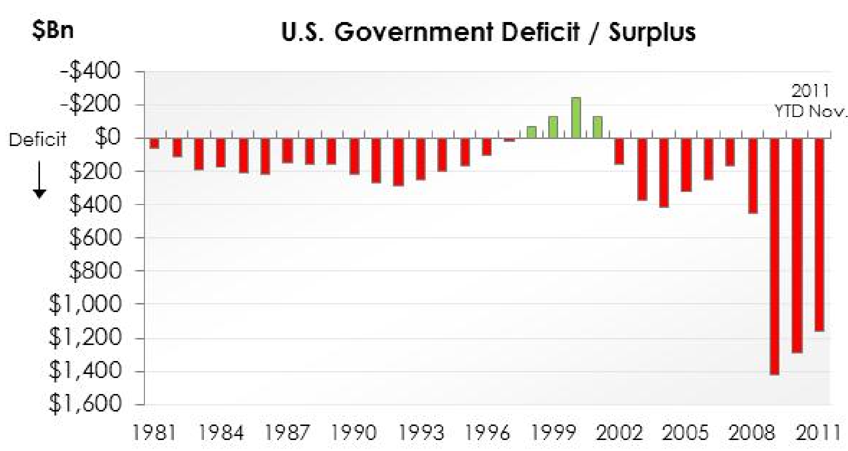
Q2 2011 – Fiscal Problems

By the second quarter of the year, investors were focused on the fiscal problems facing the United States. A potential downgrade to the outlook for U.S. debt by Standard & Poor's and the looming "crisis" of hitting the debt ceiling by the end of the summer had everyone wondering what would happen if the U.S. no longer sold the safest debt in the world. In May we wrote:

> Longer-term fiscal concerns have lingered in the political background for some time, especially the ability of entitlement programs like Social Security and Medicare to absorb the retirement of the Baby Boomer generation. Politicians have shied away from addressing the problems facing these programs, however, since most Americans hold the social safety net near and dear to their hearts. The recession, budget shortfalls in states and municipalities, and the very real possibility of default by several European countries all have called attention to fiscal issues in general. A downgrade to the outlook for U.S. debt by one of the largest rating agencies raised questions about the U.S. federal government in particular. Now, American politicians are forced to address the situation.

As it turned out, American politicians were *not* forced to act. Unfortunately, seven months later, not much has happened to address the situation. There have been some minor fixes, such as an agreement to raise the debt ceiling to avoid a short-term default, but nothing meaningful has been accomplished. Even the bipartisan "Supercommittee" tasked with finding $1.2 trillion in spending cuts failed to agree on a plan by their appointed deadline. Without a bipartisan blueprint for correcting the government's shortfalls, automatic spending cuts are scheduled to begin in January 2013. Pain will be inflicted on both sides of the aisle, with half of the cuts coming from Democrat-backed domestic programs, and half from Republican's sacred cow of Defense. Despite calls from these programs' supporters for a repeal of the automatic cuts, President Obama has pledged to veto any attempt to roll back the measures. As we move into an election year, this issue is becoming a high-stakes game of chicken. It is improbable anything will be resolved before November, so we will likely be watching the hourglass run down on these cuts a year from now.

The graph at right shows just how deep the spending cuts must be to return to even pre-recession deficits.



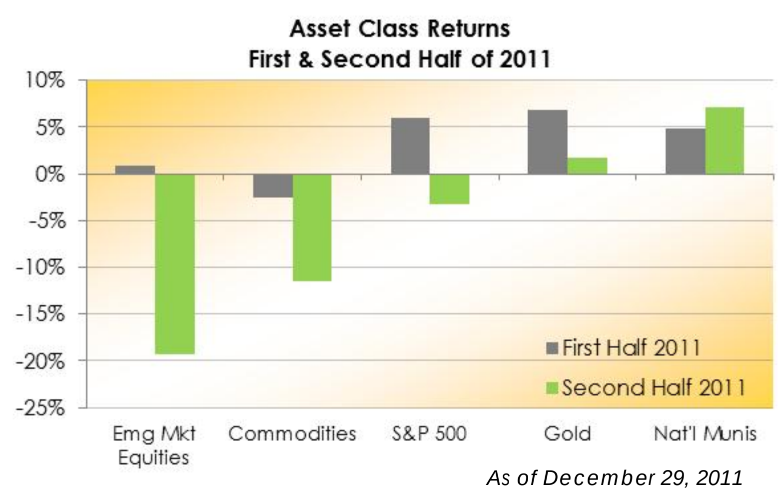
Source: "Monthly Receipts, Outlays, and Deficit or Surplus," fms.treas.gov

Q3 2011 – The Slowdown

The old adage "sell in May and go away" would have been pretty good advice in 2011. The S&P 500 index put together a string of five successive negative-return months beginning in May. In our opinion, this was the inflationary slowdown brought on by the second round of quantitative easing. In our June 2011 publication, we compared the first half of 2011 with the slowdown that had occurred just a year before:

> After a bout of deflation during the recession in 2009, headline prices began to bounce off of their lows in the fall of '09. Inflationary pressures take time to filter through the supply chain and impact the end-consumer, which means that the dampening effects of higher prices usually hit the economy with a lag of roughly six months. Not coincidentally, equities peaked in April 2010 about six months after the Consumer Price Index (CPI) posted its first positive annual growth rate since the recession. In the several months that followed, equities struggled as inflation took its toll on growth. The negative impact of inflationary trends then started to ease again in the late-summer - not coincidentally around the August 2010 bottom in equities and the Fed's announcement of QE2.
>
> We rehash the 2010 episode not as a history lesson, but to contrast it with the current backdrop. Stocks continued their late-2010 rally into the beginning of the new year as inflationary pressures had eased six months earlier, and this favorable backdrop happened to coincide with additional monetary stimulus. The high from round two of quantitative easing did not last for long, however, as the QE2-weakened dollar pushed up oil and food prices. High commodity prices gradually flowed through the supply chain and began impacting U.S. consumers both directly through food and gas, as well as indirectly through the prices of imports. The lagged effects of these pricing pressures hit the headline CPI numbers toward the end of 2010, resulting in the lagged effect hitting consumers around June of this year - again, coincident with equities taking another breather. With lagged inflation trends accelerating through at least the fall, the backdrop today looks much less supportive for equities than it did a year ago; and today additional stimulus is unlikely.

We went on to say that macro-driven markets had led to a very cyclical approach to investing. With U.S. monetary policy fixed at zero, and an economy in which the consumer accounts for 70% of GDP, inflation has become one of the most important indicators for growth and markets. More aggressive, cyclical assets perform well when inflation is low and/or improving (falling) and defensive assets perform better when inflationary pressures are rising. Our views on the economic environment led us to believe that more aggressive areas like Emerging Market equities and commodities would falter, and defensive assets like municipal bonds would continue to perform well. This indeed turned out to be the case in the second half of 2011, as shown in the graph, at right.



As of December 29, 2011

Q4 2011 – Renewed Optimism

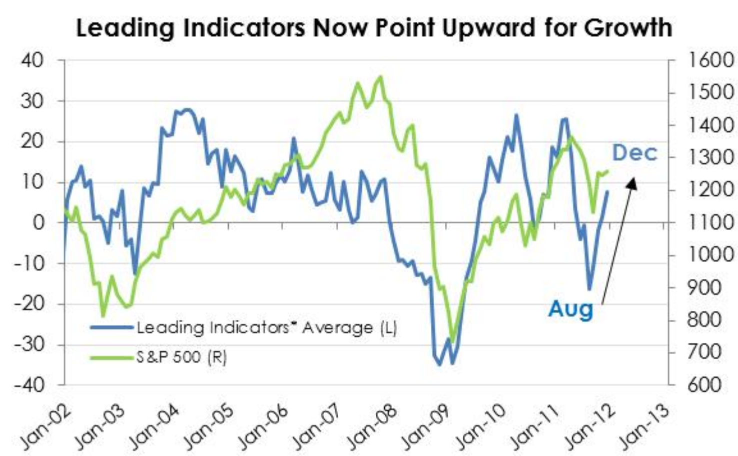
Economic data in the final quarter of 2011 has given us some reason for hope. We are far from solving longer-term structural problems such as debt and employment, but on a cyclical basis conditions have improved. After two extremely negative months in August and September, investor sentiment was decidedly pessimistic. Europe was dominating headlines, and calls for a double-dip recession had become commonplace. Few noticed the improvement in leading indicators sprouting up amidst all of the gloom. In late September we wrote:

> Stocks act as a leading indicator of the economy, which means that the equity market prices in expectations for economic growth well in advance of when it occurs - normally by about six months. Continued easing of inflation trends would create tailwinds for consumer spending, and equities could begin to price in this recovery by early 2012. Better economic data would likely follow a few quarters later. Unfortunately, we believe that a weak outlook for the rest of 2011 is already baked in the cake. Leading indicators of the economy have moved from a slower pace of expansion into actual contraction territory - both in the U.S. and abroad - but this is a sign that the final phase of the downturn is approaching. The worst part of a cycle is the last part of a cycle, but the upside is that it does pave the way for a recovery.

The following three months have shown that that period may indeed have been the final phase of the downturn – at least from an economic perspective. Since that time, most leading indicators have turned up, heralding improving conditions in the next six months. We also have seen a change in sector leadership from defensive areas like utilities and consumer staples toward more growth-oriented sectors like energy and industrials. This is a very positive sign for the equity market if this trend continues. At the end of October we wrote:

> Many economic data points – including the ISM Manufacturing and Services leading indicators - have surprised on the upside of expectations in October, but it is still unclear whether the market will hold up in the near term. We do believe, however, that the rotation in favor of more pro-cyclical sectors should remain intact, and we are making changes in the Opportunistic portion of our portfolios to reflect this shift.

We sold our defensive holdings, and positioned the Opportunistic area of our portfolios to benefit from an improving economy and market. The last several months have delivered an increasing number of upside surprises on the economic front, even in the downtrodden employment area. The graph at right shows the improvement in leading indicators since August. If this trend continues, we could see equities perform well in early 2012.



Source: Wolfe Trahan, bea.gov, regional Federal Reserve banks
**Avg of Empire Manuf, KC Manuf, Philly Fed, & Richmond Fed Indexes*

Looking Forward

The year ahead surely holds a new set of challenges – some expected and some not. Currently, we believe that the backdrop is supportive for equities in the first quarter of 2012, despite the structural problems facing the world's developed economies. Inflationary pressures have eased, global central banks have increasingly adopted looser monetary policy, and leading economic indicators have been strengthening. There is always the possibility of an unforeseen event(s) derailing the recovery, but as of now all of these trends point toward a tailwind for equities. We are cautiously optimistic for the quarter ahead.

We wish you and your family a very happy and healthy new year!

December 31, 2011

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