



# EAGLE GLOBAL ADVISORS

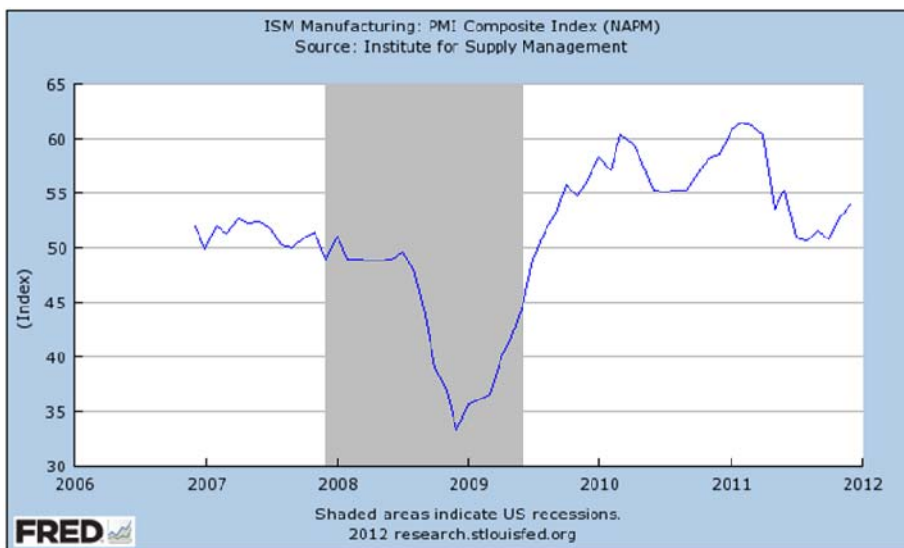
## MARKET REVIEW AND OUTLOOK—4<sup>TH</sup> QUARTER 2011

### MARKET OVERVIEW

Markets in the U.S. rebounded as the economy showed surprising resilience while fears of a European sovereign default and banking crisis held back international equity markets. In the U.S., the S&P 500 rose 11.7% for the quarter bringing its year-to-date return to 2.2%. Equity markets outside of the U.S., as measured by the MSCI EAFE index only rose 3.3% in the quarter, bringing their year-to-date decline to 12.1%. Interest rates fell slightly during the quarter leading to modest positive returns for fixed income instruments. For the year, fixed income provided good returns as investors sought safety and interest rates fell significantly.

### ECONOMY *U.S. economy demonstrates slow growth.*

Fears of a recession in the U.S. failed to materialize as the economy showed a slight acceleration in the quarter. Still, the outlook for the U.S. economy remains quite uncertain with the economists at the Economic Cycle Research Institute noting the U.S. economy is in a “window of vulnerability” to external and internal shocks that may tip it into recessions. GDP estimates showed a pick up in growth in the third quarter of this year to 1.8% from below 1.0% in the first half, which probably persisted into the fourth quarter. The job market has shown continued gains and the unemployment rate has decreased, although much of that was due to people leaving the labor force rather than finding jobs. Consumer sentiment has risen from the lows it hit last summer but remains at a depressed level. The Purchasing Managers Index, compiled by the National Association of Purchasing Managers, has recently rebounded from levels close to 50, which is considered the dividing line between expansion and contraction in manufacturing. (See figure.) While commodity prices have fallen, they have stabilized at current levels.



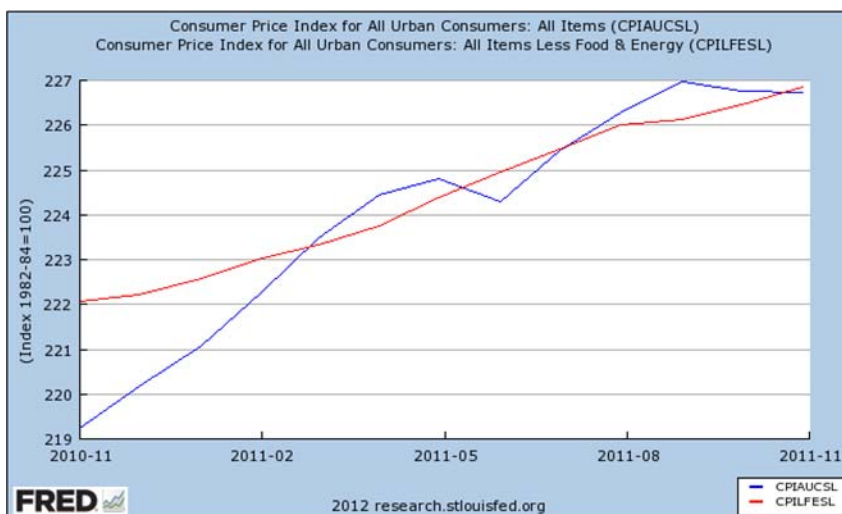
If the U.S. economy does fall into a recession, there are reasons to believe that it might be a shallow recession. Consumption may stay relatively stable since households have rebuilt their net worth through higher savings rates the past 3 years. Cyclical sectors like housing and autos are still depressed with consumption at or below a normal replacement rate. Corporate investments have been very disciplined since the financial crisis with some estimating that the current investment rate is merely “replacement capex” which would be harder to cut in the event of a downturn. Unfortunately, if foreign economies also fall into a recession, then exports, which have been a source of strength, would be negatively impacted.

### INFLATION *Inflation pressures are in check.*

Prices, which were rising at a quick pace at the beginning of the year mainly due to rising commodity and energy prices, recently look to have slowed or slightly fallen. Core inflation, excluding food and energy prices, is rising modestly at a steady 1% to 2% rate. This can be seen from looking at a graph of the Consumer Price Index for All Items (blue line) versus the Consumer Price Index ex Food & Energy (red line). Since September, the CPI for all items has actually fallen slightly, reflecting the moderation in commodity prices, while the core CPI has continued to rise moderately.

Given the great increases in the monetary base due to many of the new programs by the Federal Reserve to fight the financial crisis and its aftermath, many observers have warned that this would eventually result in significantly higher inflation in the U.S. To date this has not come to pass, and the Economic Cycle Research Institute opines that near term inflationary pressures are waning. This is reflected in a moderate 2% annual rise in wages and salaries reported by the Labor Department as well as other independent measures of prices. High unemployment (8.5%)

should keep wages in line and since labor is the largest factor in costs, especially in our service-based economy, this should help keep prices in check. The Federal Reserve Open Market Committee expressed its opinion in its latest statement that “The Committee anticipates that inflation will settle, over coming quarters, at levels at or below” the Committee’s target. We also expect inflation will moderate in 2012.



### CORPORATE PROFITS *Profits outlook is cloudy.*

While earnings are expected to be up this quarter 24.1% as companies in the Finance, Energy and Materials sectors post rebounds from a year ago, the earnings outlook is clouded by a number of concerns. In contrast to many earnings seasons in the prior two years, this earnings season has seen a number of negative pre-announcements and analyst downgrades. In the last 30 days analysts have downgraded earnings estimates for the current quarter an average of 2.0% for S&P 500 companies and the number of analyst downgrades has outpaced the number of upgrades by a 2-to-1 margin according to Starmine. Still analysts expect the S&P 500 to grow earnings 10.5% next year. On current consensus bottom up estimates from Starmine Research, the S&P 500 at 1277 is only 11.8 times expected earnings for 2012. But if earnings stall out or if a recession occurs in the U.S. or abroad, this may prove optimistic. Citigroup estimates that 25% of S&P 500 profits come from overseas. Companies such as Intel earn 85% of its revenues from overseas; IBM earns 64% abroad; McDonalds earns 66% from overseas; GE 54%; Ford 51%; Amazon 45%; Boeing 41%; and even Wal-Mart earns 26% overseas. A recession abroad would negatively impact profits in the U.S.

### INTEREST RATES *Interest rates stay low.*

Interest rates stayed very low during the quarter despite concerns about the U.S. fiscal imbalance. The 10-year Treasury bond yield stayed at 1.9% from the end of September to the end of December. Short rates stayed extremely low as the Fed continued to maintain its target range for the federal funds rate of 0.0% to 0.25%. Despite the downgrade from Standard & Poor's of U.S. debt from its long held AAA to a AA+ rating in August, investors continued to favor U.S. credit in the face of numerous sovereign risk crises abroad. Recent concerns about a weakening economy in Europe, Japan, and the emerging markets have led to a stronger dollar and capital flows into the U.S., which has helped keep bond yields at unprecedentedly low levels.

### INTERNATIONAL *Uncertain growth prospects abroad.*

Europe has continued to dominate the headlines with its sovereign debt problems. Mario Draghi took the helm at the European Central Bank and has prompted some new policies. In November and December, the ECB reversed its rate increase from last summer with a 25 basis point decrease in the policy rate. Also in December, the ECB announced a long term refinancing operation (LTRO) for European banks. Under this program, banks can get loans with a three year term from the ECB secured by a wide range of collateral at an interest rate of 1.0%. While this removed some near term fears regarding financing of European banks, the underlying problems of the sovereign debt crisis remain. New governments took over in Italy and Spain; however, while both new governments announced new austerity measures meant to combat government budget deficits, deteriorating economic prospects in Italy and Spain look to be undermining these efforts. Our outlook for Europe is for economic prospects to stay weak. In Asia, Japan also looks to be slowing from its burst of rebuilding activity in the wake of the earthquake and tsunami last spring. While inflation pressures in India, China, and Brazil appear to be falling, the effects of the inflation fighting policies are still being felt in slower economic activity in the emerging markets. It remains to be seen if China in particular will avoid a "hard landing" in the wake of government measures to dampen property speculation. Currently our outlook is for growth in China to slow but remain above 8% for 2012 which is certainly healthy relative to other parts of the world.

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## INVESTMENT STRATEGY

### DOMESTIC EQUITY *U.S. equities rebound.*

U.S. equities rallied hard in October from the lows of last summer, but then the market drifted as data was unclear on the prospects of the economy. Eagle portfolios slightly outperformed the market averages mainly due to some good stock selection across the board, especially in the Industrial and Energy sectors. The main blemish was our allocation to cash which held back the portfolios in an up market. During the quarter we increased our holdings in Cash, Technology, and the Materials sectors while we reduced our exposure to the Energy, Consumer Discretionary, Finance, and Industrial sectors. Most recent purchases/additions: American Water, Newmont, Texas Instruments, McDonalds, Philip Morris, Cisco, and Motorola Solutions. Most recent sales/trims: Arch Coal, Las Vegas Sands, Manitowac, Ford, Kansas City Southern Railroad, Omnivision, Weatherford, Veeco, Prudential, and Harmon.

*Continued on page 4.*

### INTERNATIONAL EQUITY *International equities search for direction.*

International equities also rebounded in October but then fell during the last two months of the quarter on concerns about a possible global recession. Foreign currencies generally fell and the dollar rallied which also diminished foreign equity returns in dollars. Eagle portfolios strongly outperformed their benchmarks due to good stock selection across the board. Portfolio performance was helped by our underweights to Financials and Utilities. Emerging markets exposures slightly added to performance. During the quarter we increased our exposure to Telecom Services, Health Care, and Utilities and reduced our exposure to Technology, Consumer Durables, and Financials. Most recent purchases/adds: Nippon Tel, Royal Dutch, Sanofi, KPN, National Grid, BAE Systems, and Roche. Most recent sales/trims: Sony, Vale, Precision Drilling, Infineon, Volvo, UBS, and Focus Media.

### FIXED INCOME *Rates stay low.*

Long-term interest rates, as measured by the 10-year Treasury, ended the quarter where they began at 1.9%, down significantly from the beginning of the year. While the government deficit and debt provides a reason for rapidly rising interest rates at some point, higher savings rates by individuals, excess cash at corporations, and excess savings abroad looking for a safe haven in U.S. Treasuries appear to be keeping rates low. Even the failure of the super committee charged with finding measures to improve the government finances failed to disturb traditional U.S. bond buyers. Despite the low rates on short debt, we are maintaining a relatively short duration in our bond portfolios and emphasizing exposure to high quality corporate securities. Municipal bond yields are still attractive relative to U.S. Treasury yields and also represent value. Concerns recently have been raised about the fiscal health of some states and municipalities, but we remind our investors that the default rate on municipals has been an order of magnitude below that of corporates even in prior periods of fiscal distress.