



# MARKET WATCH

Fourth Quarter 2011

THE  
NAPLES  TRUST  
COMPANY

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# PORTFOLIO REVIEW & STRATEGY

In the third quarter of 2011, investors were continuously bombarded with gloomy headlines, particularly those coming out of Europe, along with the realization that our politicians were more concerned with winning elections than with finding solutions to our fiscal problems. This finally took its toll on the financial markets in the third quarter, and while these depressing reports hammered the equity markets, very few asset classes were spared this time around. The daily Greece bankruptcy watch and the lack of a unified strategy in the Euro-Zone spilled over to the U.S. stock market, with a -14% total return for the Standard & Poor's 500, including dividends, in the three months ending September 30th.

Digging deeper into the equity returns reveals that performance by sector really tells the story of what concerned investors most. Financial companies were the worst-performing sector in the quarter, losing more than 23% of their value due to tepid loan growth and the potential for more mortgage write-downs. We have been, and will continue to remain, underweight banks in favor of companies with more predictable income streams. The Energy, Industrials, and Materials sectors fared only slightly better as GDP estimates were ratcheted down across the globe. Utilities and Consumer Staples companies were the best performers in the quarter, and remain positive for the year. That was not surprising, as these "defensive" businesses hold up better in turbulent times and reward investors with oversized dividend payouts. We would not expect these companies to outperform in the next 12 months or so, as the valuations have been stretched by safety-seeking investors.

Companies in the Technology sector held up better in the quarter, although they were still down 5%. We feel that their high historic growth rates, along with extremely low current valuations, still present an excellent long-term opportunity, even in a slower-growing economy.

The CRB commodities index fell 12% in the quarter, led by a 17% drop in crude oil prices, as speculators, at least temporarily, abandoned the emerging market-led global growth story. The return of the U.S. Dollar to its safe-haven status may also have contributed to the sell off with the U.S. Dollar Index rising 5% in the third quarter. We are watching closely as a higher greenback can hurt the exports of our U.S. based multinationals. On the positive side, lower energy prices will help companies with their input costs and act as a tax break for consumers as well.

The fixed-income market has been an incredible (and confusing) asset class ever since the United States suffered the first downgrade to its credit rating in history, on Aug. 5. The Standard & Poor's rating reduction from AAA to AA+ actually spurred massive waves of buying of the very debt that was downgraded! This most likely occurred because the rating change was essentially based on the inability of Congress and the White House to reach a broader plan to rein in the deficit anytime soon, and not based on the ability of the U.S. to pay its bills. This shift by investors out of equities and into bonds pushed the Barclay's U.S. Treasury Index up more than 4% in the quarter and knocked the yield on the 10-year treasury below 2%.

With bond yields at historic low levels, we would look to high-quality dividend-paying equities for a bond substitute, as investors may experience principal risk in bonds if they are not held to maturity. We are, however, able to build laddered corporate or municipal bond portfolios for those clients looking for moderate income and an offset to the volatility of holding equities.

# CURRENT OUTLOOK

The U.S. economy's 2011 "soft patch" (not to be confused with the 2010 "soft patch") that we first mentioned at the start of summer seems to be persisting, frustrating many long-term investors. Reasons abound and pundits from both the political and economic spheres are only too quick to place blame. Higher energy prices, natural disasters, and Euro-Zone financial issues were highlighted initially as reasons for the stall in the first and second quarters of this year. Now, however, we are seeing more intractable issues dominating the headlines, such as loss of confidence in government leaders, concern about possible increased regulation, and a slowdown in international business flows. It now appears that projections at the start of 2011 of world-wide economic growth in the 5%-6% area may turn out to be as much as two percentage points too high. The consensus for U.S. growth this year and next has come down from 3%-4% to less than 2% for both years.

We expect the major drivers of asset valuations for the balance of this year to reflect weak employment growth, slowing profit growth, and continued unusually low interest rates. The probability of the U.S. economy slipping back into recession after less than three years of growth has increased materially since the start of the year as the self-sustaining nature of the recovery is being challenged by continued weak lending activity and a rising savings rate. The fiscal condition of many countries is also prompting discussion of austerity measures rather than pro-growth policies. Clearly, the profligacy on an international scale of the past 10 years is coming home to roost.

We will be watching various data points over the coming months to best judge what the ultimate outcome will look like. The budget discussions in Washington D.C. will create many headlines, and winners and losers will become more clearly visible by Thanksgiving. Europe's debt crisis discussions will drag on into the winter with Greece and Italy in the spotlight. A Greek debt default is a "When?" not "If" event, in our opinion. Monetary policy on a world-wide basis is probably destined to stay extremely accommodative for the next year or two. Areas of relative strength in the world economy will center on business spending and exports, while areas of weakness will show up in consumer spending (due to higher than average unemployment) and construction.

To add to the uncertainty, we are now 13 months from another U.S. Presidential election. There is general agreement that the results of that election will be both consequential and unpredictable. Many are expecting that the debate will focus on the preferred size of government and how it should be financed. The winners of the debate will be the law-makers who will determine the fate of the Bush-era tax cuts, spending on healthcare and defense, and the regulatory framework for American business. These are also important data points we will be examining closely. Ultimate asset valuations will depend importantly on all of these issues.

## ON-LINE NEWSLETTER NOW AVAILABLE

You can now receive future newsletters via email. By joining our email mailing list, you will also receive periodic bulletins regarding events and news stories that shape our investment outlook and strategy. Please email us at [astarkey@naplestrustcompany.com](mailto:astarkey@naplestrustcompany.com).

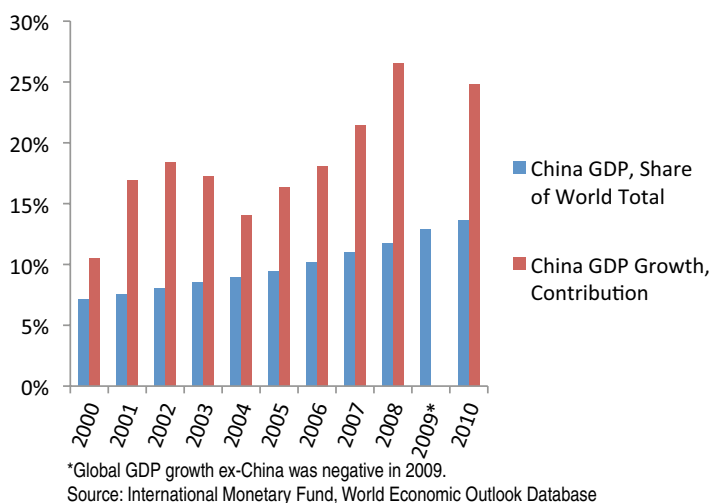
# CHINESE TAKEOUT

Some things are easy to take for granted. The sun will rise, the tides will turn, Dick Clark will host a rockin' New Years' Eve— and China's economy will grow at 8%-10% rates. For the past 30 years, China's GDP has advanced with clockwork regularity, resulting in a jaw-dropping 30-fold rise in GDP per capita.

This growth has lifted hundreds of millions of Chinese citizens out of poverty, and provided a lucrative new market for thousands of companies. And of course, 30 years of economic expansion at two to three times the rate of global growth means that China is now large enough that the world may catch cold when it sneezes.

China's economic heft is often expressed in terms of the size of China's economy as a percentage of the global economy (the blue bars in the chart below). While that data is impressive – China's share of the global economy has doubled from about 7% a decade ago to 14% in 2010 – it actually *understates* China's economic impact on the world.

The red bars show the proportion of global *growth* represented by China. For example, in 2008, the global economy grew by about \$3.3 trillion while China added \$880 billion in economic output. So, 26% of the growth in the global economy in 2008 came from China. As you can see, the proportion of additional global output attributable to China has been 20%-25% recently – and in 2009, the global economy ex-China shrunk, while China grew by about 10%. In aggregate, China contributed fully one-fifth of the world's new economic output over the past decade.



Why does this matter to us at the Trust Company? Because some cracks are starting to appear in the Chinese economic edifice. Rising inflation has pushed the Bank of China to cool the economy by raising interest rates, and by increasing major banks' reserve requirements. With less money available for loans, many smaller companies have been forced into un-regulated private credit markets where interest rates can be as high as 8% per month. It seems probable to us that tighter credit will hurt economic growth.

Moreover, there are increasing signs that the Chinese property market is becoming overheated. A slowdown in construction should not hurt the Chinese financial system as badly as the housing bubble hurt ours – property buyers in China use much less debt – but a slowdown would seriously crimp demand for a lot of imported commodities. And since China consumes over 40% of the world's iron ore, coal, steel, aluminum, and copper, global commodity markets will be hit hard by reduced Chinese demand.

We're not making a prediction that the Chinese economy is going to hit a wall next month. After all, Beijing has enormous financial firepower at its disposal to mitigate the effects of a slowdown, and it's possible that tighter credit will reduce inflation without slowing growth too much.

But given that China now accounts for more than one-quarter of global economic growth, it's pretty clear that if you take out China, the global economic outlook becomes a good deal darker. And with 40% of S&P 500 earnings coming from outside the U.S., the global outlook matters quite a bit for U.S. blue chips.

# THE GREAT AMERICAN JOB ENGINE

Is America's job engine permanently impaired or just badly in need of new spark plugs and an oil change? As anyone knows, the United States is experiencing frustratingly high (for the U.S.) levels of unemployment, stemming from widespread layoffs, business closings, and anemic new job creation. Importantly, job growth and high levels of employment are essential to longer-term economic strength and prosperity (and vice versa).

By taking a look at the chart below you can see that the present dip in job growth is currently deeper and more persistent than prior troughs over the past 30 years.

Many of the conditions for this unemployment "hangover" are now widely recognized: Financial deleveraging and the related real estate bubble hangover, government budget deficits, burdensome debt levels, and the systematic "off-shoring" of U.S. manufacturing. Many or all of these conditions have been festering for years, even decades, so it should not come as much surprise that even a "normal" cyclical economic rebound would likely not have been sufficient to replace all of the jobs lost over the last very substantial recession.

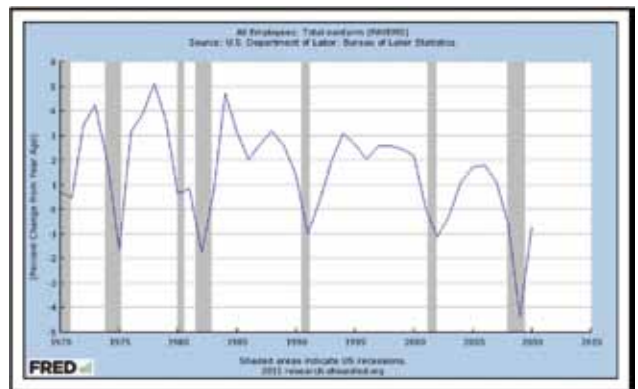
It is therefore essential to recognize that longer-term structural issues are playing a predominant role today and that structural issues require structural improvements. Unfortunately structural solutions do not typically provide a quick fix to any problem.

It is equally important to understand the truly global nature and economic interdependence that characterizes our economy today. Part blessing, part curse depending on your viewpoint, economic globalization is an inevitable outcome in an increasingly "shrinking" world. In today's environment, simply doing things "the way we've always done them" is not a recipe for continued global leadership and prosperity.

The current daily debate about jobs, debts and deficits also encompasses other major structural issues such as funding issues for public pensions, Social Security and Medicare. Structural change -- while ultimately very necessary -- is never palatable (economically or politically) since it usually brings a higher cost and frequently requires a great degree of effort and sacrifice. As painful as this monumental debate is becoming, this could in fact provide a positive catalyst for structural reform by allowing us to finally focus on how we have to begin to change.

A very short list of important reforms aimed at creating jobs would include: Reducing burdensome regulation, overhauling the corporate tax system (including constructive repatriation of foreign assets), implementing entrepreneurial incentives for innovation and job creation, education and retraining to fulfill critical needs and improve workforce qualifications, and modernizing the deteriorating infrastructure that enabled us to become the world's largest economy in the first place.

There is an old saying in the South: "When you are up to your eyeballs in alligators, it is difficult to remember that you originally intended to drain the swamp." Today we *must* possess the spirit and determination to fight the alligators *while* we drain the swamp at the same time.



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Dear Investors,

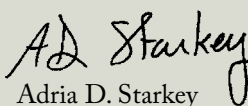
Every Thursday from 10:45 am. - noon, The Naples Trust Company's Asset Management Committee (AMC) meets to discuss investment strategy and how current

events may be affecting the securities we own in client portfolios. These interactive sessions connect our four offices audio-visually, and provide an opportunity to participate in substantive discussions with our investment professionals. Some of our clients attend regularly, and we have found that attending this meeting is an excellent venue for prospective investors to gain insight into how we preserve and enhance the assets with which our clients have entrusted us. We believe transparency – knowing what you own and why you own it – is important, and one of the distinguishing characteristics of The Naples Trust Company.

We hope you will join us soon to hear more about why The Naples Trust Company is uniquely suited to help you accomplish your personal investment objectives. Please call 239-774-4000 to reserve a seat at the conference table for one of our upcoming meetings.

Hoping to see you soon at an AMC meeting,

Warm Regards,



Adria D. Starkey  
*President*



Richard A. Botthof  
*Vice Chairman*

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