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In a country well governed, poverty is something to be ashamed of.

In a country badly governed, wealth is something to be ashamed of.

— Confucius 551-479 BC

2012: Navigating Dangerous Waters

2011 ended on a muddled note with the stock market, as measured by the S&P 500 Index, closing at just about breakeven. The bond market had an excellent year as central bankers everywhere united to push down interest rates and raise bond prices to unprecedented levels. We will review what happened during the year past and look ahead to 2012 through the lens of the following themes and concepts.

Secular bear market – We are now about 12 years into a secular, or long-term, bear market that could run as many as 20 years. To analyze and monitor this long-term trend, we use the “Shiller PE,” named for its creator, Dr. Robert Shiller of Yale University. He compares this 10-year moving average of real (inflation-adjusted) earnings compared to the “real” price of the S&P 500 Index. The long-term chart for this ratio is found below. The market is much less overvalued than it was in 1999, but is still above its long-term mean and far above the typical secular low. Until this PE reaches single digits, substantial market advances will be difficult to achieve, even when the economy recovers.

S&P 500 PE Ratio



Equitable Trust Quarterly Review and Outlook

2012 ... *(continued)*

Political Gridlock – The markets, particularly the credit markets, have a jaundiced view of the efficacy of our current political establishment. Standard & Poor's downgraded treasury debt last summer when Congress and the President failed to agree to a long-term deficit reduction program. The same players will be involved throughout 2012. The year ends with a presidential election, and all seats in the House of Representatives (unless they have announced their retirement) and about one-third of the Senate seats are up for grabs. It is far too early to know if this election will break the gridlock or firmly establish it for at least two more years.

Balance sheet recession – Whether or not the Economic Cycle Research Institute (ECRI) ever recognizes the current period as an official recession, a balance sheet recession is most definitely taking place, notably in the banking system. When corporate and household assets (e.g. impaired bank assets or the family home) decline in value and liabilities don't decline, the private sector suffers a serious reduction in net worth or even negative equity. This wealth destruction causes both consumption and corporate investment to decline. Together, consumption expenditures and investment represent more than 75% of our economy.

Financial repression – In our last Quarterly Review and Outlook, we commented on the negative real interest rates found in the investment-grade sector of the bond market. We believe this deliberate policy of the Federal Reserve Bank and other central banks, known by some as Financial Repression, will last for many years until the nominal value of outstanding debt is inflated away to a sustainable level. At Equitable Trust, we will continue to seek higher real returns in high-yield and emerging-market debt markets and in dividend-paying stocks.

Expectations for the stock market – As we expect the stock market to gyrate over very broad ranges, we will not hazard a guess as to where the S&P 500 Index will be on December 31, 2012. Rather than try to predict the market, we will try to discern where the opportunities and risks are for the entire range of liquid assets from which we choose. Overall, we remain very risk-averse, given the previously-mentioned secular bear market. We are inclined to buy lower-risk assets on selloffs and sell higher-risk investments when we deem the market to be overbought. We continue to favor lower-volatility, higher-yielding equities and multi-strategy funds.

We wish you all a happy, safe and profitable new year!

Market Diary Period Ending December 31, 2011

	CLOSE	RATES OF RETURN				
Equities	12/31/11	Last 3 Mo.	YTD	1 year	3 years	5 years
U.S. Stock Market (S&P 500)	1257.60	11.82	2.11	2.11	14.11	-0.25
U.S. Mid-Cap Stocks (S&P 400 Mid-Cap)	879.16	12.98	-1.73	-1.73	19.57	3.32
U.S. Small-Cap Stocks (S&P 600 Small-Cap)	415.07	17.77	1.02	1.02	17.01	1.94
International Stocks (MSCI EAFE)	1412.55	3.38	-11.73	-11.73	8.16	-4.26
Emerging Markets Stocks (MSCI Emerging Markets)	916.39	4.03	-18.42	-18.42	20.07	2.40
Alternatives	12/31/11	Last 3 Mo.	YTD	1 year	3 years	5 years
Gold (London Precious Metal Fix)	15.31	-5.49	8.93	8.93	20.74	19.36
Crude Oil (West Texas Intermediate)	98.83	24.79	8.15	8.15	30.37	10.11
Real Estate (Dow Jones REIT)	179.94	12.41	1.68	1.68	13.98	-7.56
Commodities (Dow Jones UBS Commodity)	422.97	2.49	-8.12	-8.12	17.92	7.87
	YIELDS					
Fixed Income	12/31/11	9/30/11	12/31/10	12/31/10	12/31/08	12/31/06
U.S. Treasury Bills 91 days	0.01	0.02	0.12	0.12	0.11	5.02
2 Year U.S. Treasury	0.25	0.25	0.61	0.61	0.76	4.82
10 Year U.S. Treasury	1.89	1.92	3.30	3.30	2.25	4.71
Investment Grade Taxable Bonds (Barclay's Aggregate)	2.24	2.35	2.97	2.97	3.99	5.34
10 Year AA Municipal Bonds (Moody's)	2.35	2.62	3.93	3.93	3.99	3.81

Rates of return for equities and alternatives for periods longer than 12 months are annualized. Data provided by Bloomberg L.P., The Chart Store, Interactive Data Corp. and U.S. Treasury Department.

Tennessee "Death Taxes" - Let's Get This Straight

A recent article in The Tennessean discussed the Governor's position on the Tennessee "death tax." The Governor acknowledged that the state's "death tax" and Hall income tax are disadvantages to attracting businesses to Tennessee. We think it is important to attempt to clarify the issue at hand without addressing the relative positions of the political parties to the debate.

For purposes of this comment, we shall focus only on the "death tax." The confusion that often enters into the discussion is that Tennessee technically has

two distinct "death taxes," the Tennessee Inheritance Tax and the Tennessee Estate Tax. The Federal "death tax" is an estate tax, so commentators often refer to ALL "death taxes" as an estate tax, but in Tennessee the Inheritance Tax and the Estate Tax are two entirely different beasts.

The recent newspaper article, for example, referred to the contrasting positions of the Governor and certain members of the General Assembly with respect to the state "estate tax." The article made sense and was accurate as long as the reader interpreted the

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Tennessee “Death Taxes” ... (continued)

reference to the state “estate tax” as really meaning the Inheritance Tax. As if that wasn’t enough to muddy the waters, the article closed with a brief definition of the Tennessee Estate Tax from the code. The definition was correct, but the problem is that all of the discussion in the rest of the article was really about the Tennessee Inheritance Tax. The Tennessee Inheritance Tax is imposed at a rate from 5.5% to 9.5% and applies to taxable estates of over \$1,000,000. The Tennessee Estate Tax, on the other hand, is based upon provisions of the Federal Estate Tax that have since been so changed that for all practical purposes it almost never applies to the death of a Tennessee resident, at least not in recent years. Therefore, there

should be no debate about losing revenue from the Tennessee Estate Tax because that provision has not generated revenue for some time. If that is not confusing enough, the real Tennessee Estate Tax may well be revitalized in 2013 if federal law reverts to previous statutory structure.

Now, we’re glad that we got that straight!

If you are interested in reading the original December 10, 2011 article in The Tennessean, it can be found on their website (Haslam says now is not the time to eliminate Hall, estate taxes).

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