

C O U N T E R | P O I N T

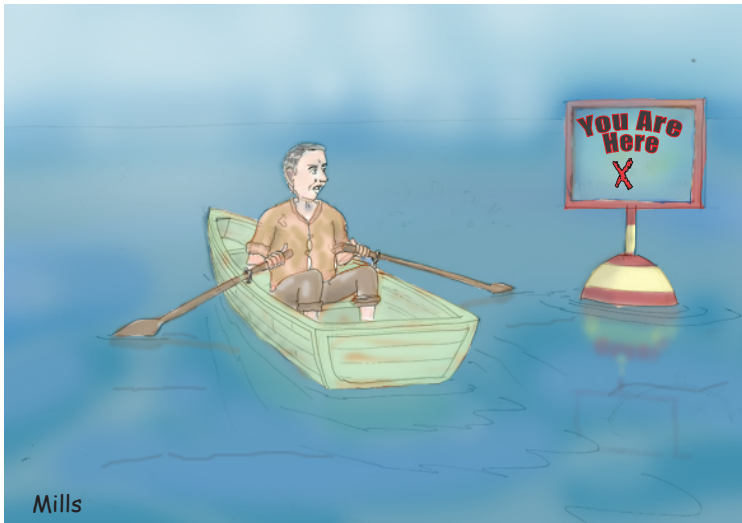
The Quarterly Commentary of Jurika, Mills & Keifer LLC

FIRST QUARTER:
JANUARY 2012

IN THIS ISSUE:

FOUR THINGS
THAT MATTER

CURRENT
OUTLOOK AND
STRATEGY



You Are Here:

Feeling lost? As the New Year begins, it is hard to remember a time with greater awareness about our challenges, and yet more uncertainty about where we are headed and where to invest.

There is no shortage of analysis and opinion. Much of it focuses on Europe and its ongoing problems. Some, focuses on the U.S. and our own economic and political challenges. Some focuses on Asia and whether or not China and emerging/developing markets are in for a hard or soft landing.

The common and related threads are *debt, growth and politics*.

We will discuss these issues in detail, but think there are four things that really matter this year in determining the direction of the financial markets:

1. European Sovereign debt and economic growth.
2. U.S. economic growth, debt and politics.
3. Economic growth and stability in emerging/developing economies.
4. Geopolitical risks and surprises from left field.

This all makes for a continually challenging investment environment, with outsized risks but also attractive opportunities. There are large economic imbalances, large amounts of debt to be restructured, and large amounts of capital looking for opportunity.

For now, we see signs of marginal progress in most of these areas, especially in the U.S., which should make for a more favorable investment environment. But there is a wide range of potential outcomes and we expect another eventful and volatile year. For a discussion of all this and more, *read on*.

CHART I

Before looking forward, let's take a quick look back at the year that was.

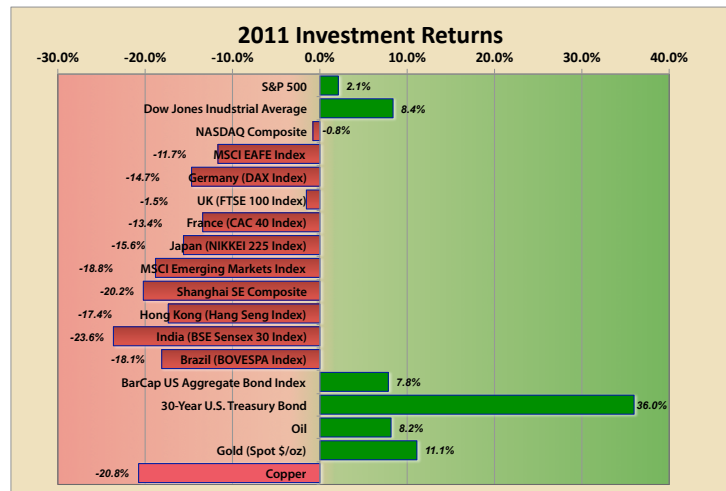
2011 was an eventful and tumultuous year, defined in part by the following events:

- * The Arab Spring uprisings and overthrow of Mubarak in Egypt, Ben Ali in Tunisia, Gaddafi in Libya, and civil unrest in Syria, Algeria, and elsewhere.
- The Japanese Fukushima Trifecta – Earthquake, Tsunami, Nuclear Disaster.
- U.S. Debt ceiling fiasco and downgrade.
- The spreading European Sovereign Debt Crisis. New leaders in Greece and Italy.
- The piercing of the Chinese Real Estate bubble and slowing growth in China, India and other emerging/developing market economies.
- The surprise collapse of MF Global.
- The Occupy Wall Street movement.
- Major floods in Australia, Thailand and the Philippines.
- The End of U.S. involvement in Iraq.
- The Kardashian divorce!

Despite all the turmoil, the major U.S. stock market indexes finished the year roughly flat, after an admittedly wild ride.

But as **Chart I** above shows, the U.S. stock and bond markets were more the exception than the rule, with long-term U.S. Treasury Bonds being the real standout, up a whopping 36%. Most global stock indexes were down between 10% to 20%, with emerging/developing markets underperforming Europe, despite a superior fundamental outlook.

There were also extreme moves in sovereign interest rates and currencies, reflecting a tale of haves and have nots. Greek bond yields jumped a whopping 20% in the year, but Italian yields



SOURCE: BLOOMBERG AND JURIKA MILLS & KEIFER

increased from under 5% to over 7%. Meanwhile, debt stress in Europe led to strong demand for Treasuries and ever lower borrowing costs for the U.S.

Finally, commodities started the year on a strong footing, but then faded sharply as conviction in global growth and inflation gave rise to fears of global recession and deflation. The exception to this was Gold, which we view more as a currency than economically sensitive commodity. Even after a sharp decline in the final months of the year, Gold finished the year up 9%, its 11th straight year of gains.

Four Things that Matter:

1) European Sovereign Debt:

First some context: The European debt saga is part of a larger debt problem for the developed world, also including the United States and Japan.

This isn't something that happened overnight, but rather accumulated over the past 30 years in what some have called a debt "super cycle," where economic growth has been largely facilitated by ever greater amounts of private and public sector borrowing.

The super cycle is now reaching its threshold of sustainability where the laws of economic gravity start to take hold, where economic growth is restrained and economies lose their ability to finance their debt load.

Historically, this normally occurs when a country's debt to GDP level exceeds 90%. Most of Europe and the United States have now exceeded this limit. Japan's debt to GDP is over 200%. This process plays out differently for different countries depending on a variety of circumstances, and it can be gradual at first, usually taking the form of repressed growth, such as in Japan. But once *confidence* is eroded, a *tipping point* is reached where borrowing costs rise quickly, and the economy can no longer sustain itself without taking significant and credible steps to reduce its debt burden. This is more easily said than done.

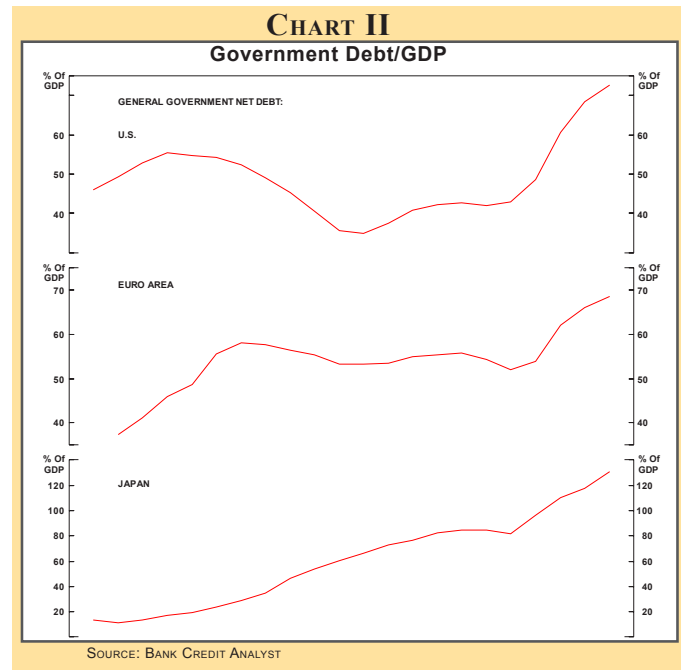
Continental Europe reached the tipping point last year, starting in Greece and spreading through Spain, Portugal and Italy. For the time being, the U.S. and Japan are actually benefitting from Europe's problems with lower borrowing costs. But this is a temporary condition. If we don't take action to address our own fiscal imbalances, our time will come as well. It is not a matter of whether, only when.

What is important to know is that despite all the talk of solutions, and actions taken thus far to mitigate its consequences, the core problem, too much public debt in the developed world, continues to grow. (Chart II).

Until meaningful steps are taken to actually *reverse* this core trend, moving debt levels back into a sustainable balance, highly indebted economies will have an ever larger ball and chain restraining their growth and making them vulnerable to ever greater economic shocks.

Europe, in particular, has three separate but related components. The first component is the debt itself.

This year alone, it is estimated that the Eurozone economies need to roll over approximately \$2.5 trillion in debt. It is unclear who is going to buy all these new bonds issued and at what price. Countries like Italy, Spain and France need long-term access to cheap credit to maintain their current debt loads. This is a make-or-break year for them and for the Eurozone.



The second component is the European banks. They are highly leveraged and under pressure from the European Central Bank and governments to reduce leverage ratios.

Unlike U.S. banks, European banks did not raise capital several years ago, when it was readily available and affordable. Now, new capital comes with a prohibitive price and the only other way to reduce leverage is to sell assets and shrink their balance sheets. This means that European banks

need to be large net sellers of existing loans, rather than issuers of new loans, and that credit conditions in Europe will remain very tight, creating a further drag on economic growth.

The final component is the level of European growth or recession that will or won't result from government-directed austerity measures, a deleveraging banking sector, large structural differences between member countries, untenable borrowing costs, and a high degree of political theatre and uncertainty.

The range of potential outcomes is wide, from slow growth all the way to a collapse of the Euro. It is also unclear what impact weakness in Europe will have on the U.S., and other economies outside the Eurozone.

What is clear is that while the leaders in Europe are reluctantly headed towards a solution, they are taking a very different route than the U.S. took several years ago, emphasizing fiscal austerity for member countries and a limited role for the European Central Bank, rather than massive coordinated fiscal and monetary stimulus.

We doubt this path will work. Austerity measures need to be balanced by measures to maintain growth. Otherwise, an economy risks falling into a deflationary spiral where economic contraction begets further contraction.

At current debt levels, monetary debasement – i.e. printing more paper money–, combined with credible spending cuts *and* growth initiatives is the only viable option for the developed economies to put the debt genie back in the bottle.

For the time being, Europe's problems accrue to the benefit of the U.S.

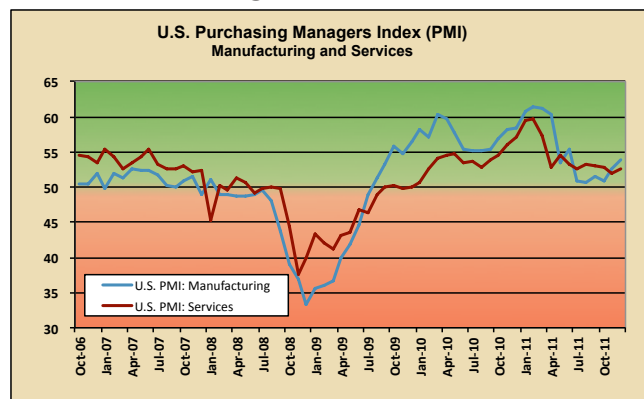
2) The U.S. Economy and Politics.

The U.S. economy came back to life in the Fall and is growing again, more or less under its own power, after a bit of a scare last Spring and Summer.

Most leading economic indicators have turned positive, showing improvement (**Chart III**), and employment is back on the upswing. As **Chart IV** shows, of the 8.8 million jobs lost during the credit crisis, we have regained 3.3 million. There is still a long way to go, but it is movement in the right direction.

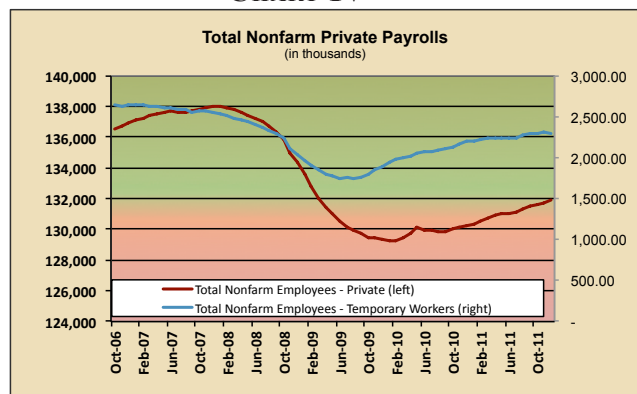
Despite a high degree of ongoing uncertainty, American consumers are consuming and American businesses are investing and hiring.

CHART III



SOURCE: INSTITUTE FOR SUPPLY MANAGEMENT AND JURIKA MILLS & KEIFER

CHART IV



SOURCE: BUREAU OF LABOR STATISTICS AND JURIKA MILLS & KEIFER

Even the moribund housing market appears to be showing signs of new life.

We have often remarked that *companies* are in better shape than *countries*. They are sitting on record amounts of cash, have taken advantage of low borrowing costs to refinance their debt, and are experiencing record levels of corporate profitability. In fact, aggregate profits for the S&P 500 companies are now higher than they were before the credit crisis.

It is worth noting that more of this profit growth has been driven by aggressive cost-cutting and productivity improvements than by robust sales growth. Current profit margins and productivity levels may be peaking. But this is a relatively high class problem and should there be another downturn, companies are in better position than before to weather the storm.

Finally, American businesses remain at the forefront in global innovation, in technology, communications, biotechnology, manufacturing, media and entertainment and other industries. Politics aside, the United States is still a good place to start and build a business.

Which brings us to politics. The debt ceiling debacle last June and failure of the Debt Supercommittee to achieve its goal in December underscores just how partisan and dysfunctional our political system has become.

This dysfunction undermines confidence and does real economic damage. In the absence of clarity about the future, about tax rates, regulations, and benefit costs, individuals and companies hold back.

Election year politics are now in full swing, but so far, there are few bold, forward-looking ideas coming from the right or the left that show a path forward: a way to restore growth, address our debt problems, invest for our future, and advance

our competitive position in a changing world.

We believe that such a path exists, but it involves making fairly obvious, but politically difficult decisions. It also involves the majority of the electorate supporting candidates willing to make them, rather than those who tell us what we want to hear.

That being said, any sense of movement in this direction, and towards a more centrist and business-friendly, growth and solutions-oriented economic environment would be a strong positive for the economy and markets.

3. Economic growth and stability in the emerging/developing economies.

Economic growth has also been slowing in China, India, and the rest of the emerging/developing economies. This slowdown is the result of deliberate government efforts to curb inflation levels, as well as declining demand from Europe and the United States, and reduced lending from wounded European banks.

The key question in investors' minds is whether developing economies are in for a "hard" or "soft" economic landing.

In addition, investors have been focused on the bubble in the Chinese residential real estate sector. They have come to equate emerging/developing markets with vast tracts of empty apartment buildings in China and housing bubbles with economic collapses.

To be sure, China overstimulated its economy two years ago and too much of this money found its way into real estate construction.

But it is important to keep things in perspective. **China may be an economy prone to bubbles, but it is not a bubble economy.** In the context of a \$5.8 trillion GDP economy, the bubble in

high-end residential real estate can be fairly easily absorbed.

With over \$3 trillion in reserves, and a government that can quickly make smart and forward-looking decisions, China has a lot of tools at its disposal to manage its way through these near term challenges and keep growth on track. We have recently seen the Chinese government move to a more stimulative economic policy again, encouraging new lending, especially to smaller businesses.

Although we expect slower going in the next year or two, there is a big difference between *slower* growth and *no* growth. We believe growth will still be quite strong. Even in 2008, during the last credit crisis, Chinese growth only slowed to 6%.

Over a longer-term basis, China and the rest of the emerging/developing market economies should continue to grow and prosper, and account for the majority of global GDP growth.

4.) Geopolitical risks and surprises from left field.

Finally, we have learned over years of experience that the greatest risks are usually not the ones you are focused on, but rather, the ones you are not.

While the media cameras are focused on the economy, the upcoming election, and Europe, it is important to keep an eye on Iran and Syria, as well as North Korea.

We also think it is important to keep an eye on Japan. Japan is the most leveraged of the developed economies and the third largest economy in the world. For years it has been stuck in a low-growth, debt-laden zombie state. Japan does control its own currency and is the main buyer of its own bonds, thereby keeping interest rates in check. Some day, this game will stop working. When

it does, the resulting increase in borrowing costs could be devastating to the Japanese economy. It is the kind of situation that could go from benign to bad very quickly.

Investable Conclusions:

And so our baseline investment outlook calls for slow to negative growth in the Eurozone, moderate growth in the United States (2% to 3%), and moderate to improving growth in the emerging/developing economies (5% to 8%).

We expect another volatile, bumpy ride in the financial markets, with attractive opportunities, but where outsized risks remain.

Our strategy, as always, is to construct client portfolios around our five pillar principles:

- 1) **Conservation of Capital:** *Try to avoid catastrophic loss.*
- 2) **Balance:** *Balance offense and defensive strategies, as well as near-term tactical opportunities with longer-term strategic thinking.*
- 3) **Diversify:** *Diversify invested capital among multiple asset classes and strategies.*
- 4) **Focus:** *Focus within each asset class and strategy on investments that offer most favorable potential return relative to risk.*
- 5) **Flexibility:** *Remain flexible and able to make adjustments along the way as conditions change.*

We believe that a well constructed portfolio, like a well-built home, designed around these principles has the best potential to participate in global growth while providing appropriate defense against the various economic and market hazards that exist. When and if the Big Bad Wolf comes huffing and puffing, we want to feel secure.

We started out by saying that there is great awareness of our problems and challenges. We have read thousands of pages of analysis about European debt and various outcomes. These problems are well known. That does not mean that they are not real and don't matter. We have seen that they do. But as we look at them in the context of the investment markets and valuation levels, we do believe that they are discounted, to some extent, in asset prices.

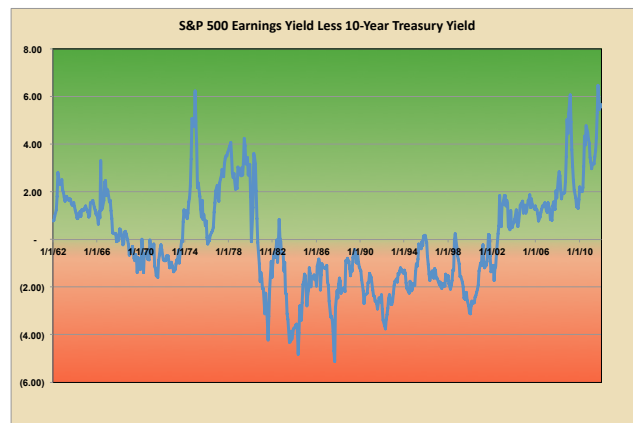
Many investors are hedged and holding higher cash balances, waiting for the next shoe to drop. There is a fairly high level of pessimism and risk-aversion. Although it is harder to find a consensus expectation this year than it was last year, we do sense low expectations for stocks, especially in Europe and emerging/developing markets, and an irrational fondness for Treasury bonds.

While stocks feel risky and Treasury bonds feel safe, especially during a storm, at current valuation levels, high quality, dividend paying stocks are likely to be a better store of value.

Chart V shows the earnings yield of the S&P 500 less the yield on the 10 Year Treasury Bond. The current spread is as high as it has been since 1974. Granted, Treasury yields are artificially depressed by a variety of factors, but it underscores the premium people are willing to pay to own Treasuries versus stocks.

Given the improvement in the U.S. economy and the move towards monetary easing in China, we have *increased* our allocation to U.S. and emerging/developing market equities. Overall, global equity valuation levels are fairly attractive, both on an absolute basis and, in particular, relative to U.S. government bonds and other alternatives.

CHART V



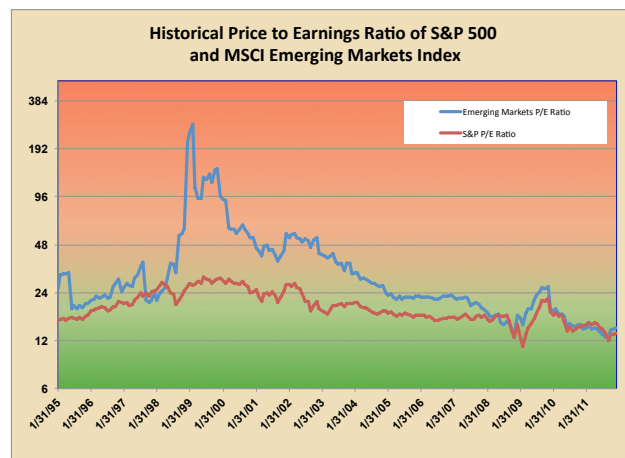
SOURCE: BLOOMBERG AND JURIKA MILLS & KEIFER

We think the risk/reward for emerging/developing economies is now especially compelling. Emerging markets have historically sold at much higher valuation levels than the developed markets, reflecting their higher potential for growth.

As **Chart VI** shows, the Price to Earnings (P/E) ratio of the *MSCI Emerging Market Index* is now roughly at parity with the *S&P 500*, at the historical low end of its valuation range on both an absolute basis and relative basis.

Our allocation to alternative assets includes gold, absolute return funds, and volatility hedges. We continue to like gold, and will likely add exposure to economically sensitive commodities

CHART VI



SOURCE: BLOOMBERG AND JURIKA MILLS & KEIFER



if we see continued improvement in emerging/developing market economies.

Our bond portfolios are primarily allocated to U.S. and global bond managers, largely focused on high quality, shorter-maturity corporate and Treasury bonds.

Finally, we are maintaining a moderate cash position to provide liquidity and a source of funds for new investment.

Although much about the future remains uncertain and unsettling, we are not lost at sea. There are things to do.

The challenges and risks are large, real and related, but not monolithic. They will play out at different times and in different ways, in different places. They may have large unexpected consequences.

But problems will ultimately beget solutions. The global economy is not an even, nor a static playing field. There will be winners and losers. Investment portfolios need to be designed to succeed in this kind of dynamic, differentiated, and potentially volatile environment.

Against this backdrop, meanwhile, with low investor expectations and valuation levels, we have started to feel that the best defense, may actually be a stronger offense and have started to tilt in that direction with slightly higher exposure to risk-oriented assets.

On behalf of our entire team here, we send you our own best wishes for the coming year. And, as always, we welcome your comments, questions and referrals.

Jurika, Mills & Keifer, LLC
January, 2012

Jurika, Mills & Keifer is a private investment advisory firm, providing investment management and counseling services to a select group of individuals and families.

Our firm is built on a core set of values and investment principles that have been central to our identity and success for more than a quarter century.

Our objective is to preserve and build the purchasing power of our clients' capital over time through effective planning and investment management.

We think for ourselves and are often willing to challenge conventional wisdom. In our experience, unconventional wisdom often leads to uncommon opportunity.

Our offices are in San Francisco, California, and we are registered with the SEC.

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