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RIVERPOINT
CAPITAL MANAGEMENT
INVESTMENT ADVISORS

UNCERTAINTY REIGNED IN 2011 – WILL 2012 BE ANY DIFFERENT?

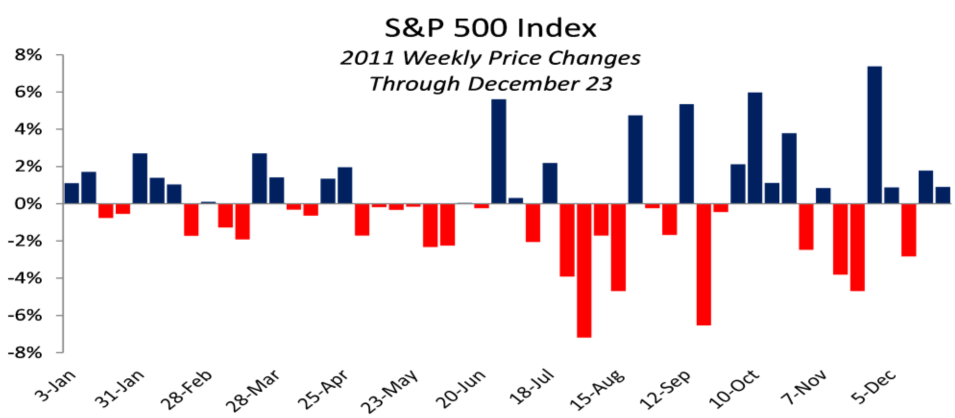
Late-December political brinksmanship in Washington? Bah, humbug!

It's only fitting that Washington lawmakers went through another round of bickering before closing out 2011. This time, the controversy involved the extension of payroll tax cuts that would have lapsed on January 1, 2012. With a vote tally of 89-10, the Senate emphatically passed a two-month extension of the payroll tax cut that kept the Social Security tax at 4.2%, 2% lower than normal. Assuming that their colleagues on Capitol Hill would follow suit, the Senators left Washington for the Holidays. Instead of agreeing to the previously discussed solution, Congress chose to invoke a procedural maneuver whereby they requested a "conference" with members of the Senate in order to work out a compromise. That way, the Republicans would have effectively rejected the bill without going on the record as voting against it. Of course, Senate leaders steadfastly refused to summon members back to Washington.

A deal was finally reached before Christmas, but the episode further damaged any credibility that Capitol Hill had left. If this was Washington's idea of Holiday cheer, we say "Bah, humbug!"

The RiverPoint Team
Valerie L. Newell, CPA
Leon H. Loewenstine, CPA
Victor R. Lassandro III
Pamela F. Schmitt, CFA
Ryan L. Brown
Anthony Roberts III, CFA
Kirk M. Koppenhoefer, CFA

Of course, investors have been dealing with uncertainty throughout 2011. The calamity in Europe, the debt ceiling debate in the US (and the subsequent US government credit rating downgrade), the impact of the massive Japanese earthquake and tsunami disaster, and the effects of the "Arab Spring" uprisings produced an extremely bumpy ride for investors. The following chart, showing weekly price changes for the S&P 500 Index, depicts just how wild the market swings have been:



312 Walnut Street, Suite 3120 | Cincinnati, OH 45202 | 1-800-548-1625 | F: 513.421.5948 | www.riverpointcm.com

What's interesting about the chart above is that the year can almost be split in half – a first half that was fairly orderly, and a second half marked by violent swings. The "tame" was the result of strong fundamental corporate performance and an improving domestic economy overshadowing risks brought on by tragedy in Japan and the questions surrounding Europe.

Much of the volatility in the second half of the year can be attributed to uncertainty, beginning with the embarrassing debt ceiling debate in the US and continuing with the public squabbling of European leaders regarding their own debt crisis. The inability to agree on anything really put a damper on what was shaping up to be a pretty good year for stocks. European leaders did a good job imitating their American counterparts in their efforts to resolve the European Union's issues, delaying a resolution and casting doubts on the stability of broader European financial system (*a la* 2008 in America).

10 Year Bond Yields

	Late Nov	*Present*
Italy	*7.52%*	*6.91%*
Spain	*6.67%*	*5.06%*

Recently, markets have perked up on an apparent swing in investor sentiment. Yields on troubled European government bond debt have declined from their late-November highs (see table at left), easing concerns of an all-out financial crisis. Two main drivers are behind this decline in yields:

1. In late November, the Federal Reserve and five other central banks (Bank of Canada, Bank of England, Bank of Japan, European Central Bank, Swiss National Bank) announced a coordinated lending facility that makes US dollars available to banks across the world, easing the strains on the bank funding markets.
2. In December, the European Central Bank (ECB) opened a 36-month borrowing program where commercial banks could borrow funds at low rates (beginning at 1%); these loans can even be used to purchase European government debt, allowing the banks to earn the difference in yields between the loans and the bonds.

These two measures sent significant signals to investors. The coordinated central bank action told investors that the major central banks are willing to take steps to prevent a full-blown financial crisis. The ECB's plan allows banks to borrow against a broad array of collateral, essentially making funds available to any bank that may need it (or that may just want cheap funds). The ECB's plan also has another interesting wrinkle – by allowing banks to use the funds to buy government bonds, the plan theoretically allows banks to boost their capital cushions by earning the 2%-3% spread between bond yields and loan interest. Banks would also lower the cost of borrowing for the troubled governments by creating demand for their bonds.

The European crisis has been driving the markets for months, so any steps towards resolution on that front will improve investor sentiment and make it easier for stocks to rise. This is especially true considering that, aside from Europe, the situation in the US is looking pretty good. The employment

December's consumer confidence report blew away economist expectations – could this be a sign of better things to come in 2012?

picture is improving, with the unemployment rate now below 9% (lowest since March, 2009) and jobless claims continuing their downward trend. Consumer confidence is on the rise, buoyed by falling prices at the pump. Manufacturing in the US also continues to plug along, continuing to expand for the past 2 ½ years. Corporate profits continue to surprise to the upside, and a fresh batch of earnings reports are due in mid-January. Stocks still look appealing, particularly when compared to the low rates offered on bonds.

Steps towards resolution in Europe and stability in the US bode well for financial markets in 2012. However, there are several wild cards in the deck that could shock markets. European leaders have shown the propensity to shoot themselves in the foot – will they do so again in 2012? How will the Presidential election play out? Will the partisan bickering continue to stymie legislative actions in Washington? Will the fast-growing international economies – China, in particular – continue to grow, or will surface cracks turn into large crevices? It appears that the only certainty is uncertainty. As such, we continue to keep our client accounts balanced between stocks and bonds.

THE ENTIRE RIVERPOINT TEAM WOULD LIKE TO THANK OUR CLIENTS FOR THEIR CONTINUED TRUST AND LOYALTY.

WE WISH YOU HAPPY HOLIDAYS AND A SAFE AND PROSPEROUS NEW YEAR!