

Another volatile year has passed and the U.S. stock market, as measured by the S&P 500, was the picture of relative strength. Close to unchanged for the year, the S&P 500 outperformed every major developed market and nearly every developing market. While the showing by the S&P 500 was not as strong on an absolute basis as many had wished, it was a stalwart showing in the face of double-digit percentage declines for most other major markets.

The year certainly started on an optimistic note. The S&P 500 jumped 2.3% in January and was up 8.4% by the end of April. By early August, however, the S&P 500 was down 11.0% for the year. The marked reversal of fortune was precipitated by a string of caustic events that included a spike in energy costs related to the Arab Spring, the after effects of the Tohoku earthquake and tsunami that hit Japan, the Eurozone's sovereign debt crisis, and the debilitating debt ceiling negotiations that ultimately prompted Standard & Poor's to downgrade the U.S. debt rating from AAA to AA+.

In brief, 2011 was a year that saw highly correlated and extremely volatile trading action. Fundamental factors provided a base layer of support throughout the year, but they ultimately took a back seat to macro developments that drove large, headline-driven swings in the capital markets.

Below are several of the key developments that contributed to the volatility.

- **Middle East Tensions Evolving into Arab Spring:** The first obstacle to a smooth 2011 was the escalation of tensions in the Middle East. This began in late 2010 with Tunisia and gained steam in January/February with Egypt. The civil uprisings were heavily covered by the media and quickly spread through the region. Libya ended up being the most dramatic and drawn-out revolution, deteriorating into an all-out war between rebels and a defiant Gadhafi, who met his death in autumn at the hand of rebel forces. While the transition to freer societies is a positive, the uncertainty in the biggest oil-producing region in the world temporarily sent oil prices drastically higher, leading to equity market volatility and economic concerns. Although the price spike in oil eventually subsided, the shock from the Middle East was one of the major volatility events of the year.
- **Japanese Earthquake/Tsunami:** As the Middle East situation was unravelling and debt concerns were rising across Europe, the massive Tohoku earthquake and tsunami hit Japan on March 11. This was reported to be the most powerful earthquake ever to hit Japan, and the nuclear crisis that followed led to a global scare. Volatility levels surged. This event derailed Japan's economy and had a negative impact on the global economic recovery as well.
- **European Debt Problems:** Europe was by far the biggest volatility factor of the year. The problems for the European Union were a nettlesome factor all year long, as market concerns moved from Greece and Ireland to Italy, Spain and even France. Fears intensified in the autumn as EU leaders hemmed and hawed over crafting a solution that could prevent a systemic banking crisis. The rancour in the eurozone had a severe impact on the U.S. market along with the U.S. debt debacle. The S&P 500 suffered a sharp 17% selloff in late-July/early-August. This had a damaging effect on confidence and the resulting economic outlook, which ultimately resulted in higher risk premiums and lower prices for risky assets such as stocks (and the debt of risky European countries). While European debt yields have come off of their highs, yields on Italian (6.89%) and Spanish (5.24%) debt remain at historically high levels and present problematic funding costs. The immediate fears about the impact of Europe have receded, but the consensus view is that Europe is already in or will experience a recession in the near-term. While a recession in Europe would drag on global growth, the U.S. economy should still be able to manage modest growth. Europe's ability to deal with its solvency problems and the depth of the economic

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weakness there remain big unknowns for 2012, and will continue to be volatility factors for the foreseeable future.

- **U.S. Debt Debacle and Subsequent Downgrade:** Although Europe's fiscal problems are much more of an immediate concern than the issues the U.S. is facing, this year's messy debt ceiling debate and eventual increase turned out to be a highly disappointing process. The U.S. debt deadline in early August had been known for quite some time, and it didn't cause initial concern since the debt ceiling had been raised in lockstep with U.S. debt levels in the past. Most market participants had given lawmakers the benefit of the doubt that they would again find a solution in time. However, the drawn-out process chipped away at the confidence in U.S. lawmakers and the uncertainty around the event led to a decrease in stock prices. Although a temporary deal was eventually reached, Standard & Poor's downgraded the U.S. credit rating to AA+ from AAA on August 7. S&P said the downgrade reflected its opinion that "the fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what would be necessary to stabilize the government's medium-term debt dynamics." Despite the unsurprising nature of the information contained in the historic downgrade, it came at a time of severe weakness for markets and global equities were met with further selling pressure. The poor handling of the debt ceiling negotiations created a volatility shock for the markets and represented another setback for the year.

Other Factors/Themes of 2011:

- **Earnings Growth Remained Strong, Market Valuation Attractive:** S&P 500 earnings estimates on an adjusted basis for 2011 are up 3.2% over the last 12 months as companies continue to exceed Wall Street's expectations. Earnings growth is now expected to come in at 11.7% for the year after recording 38% growth in 2010. Earnings are expected to grow 8.8% in 2012... Looking at valuation, the S&P 500 currently trades at 12.2x adjusted FY12 earnings estimates. One year ago, with the S&P 500 trading at nearly the same price level, the market traded at 13.6x FY11 earnings estimates.
- **Monetary Policy Changes Form but Remains Accommodative:** 2011 saw the official end of QE2 in June. That policy was replaced with more unconventional policy in September, with the announcement of Operation Twist. The "twist" involves selling shorter maturity issues and purchasing longer-dated bonds in order to keep long rates low and extend the maturity of the Fed's portfolio. The Fed has stated it wants to keep rates low until at least mid-2013, so policy should continue to support that goal as long as economic conditions allow it to do so.
- **IPO Market Stymied by Volatility; 2012 Pipeline Strong:** The IPO market took a step down from 2010 in terms of the number of IPOs and the amount of capital raised. In all, there were 334 global offerings, down 30% from last year, with about \$134.5 billion raised. The IPO market fizzled out in the second half as concerns about Europe came to the forefront, causing investors to shift away from riskier assets. The slowdown actually can be described as more of a shutdown, with only two IPOs between August 17 and November 3. The average return for a U.S. IPO was about -13%, and about two thirds of the deals priced this year are now trading below their offer prices. If 2010 was the year of the Chinese IPO, 2011 was the year of the internet IPO. There were 24 internet companies that went public in the U.S. alone – including highly touted companies like Groupon, LinkedIn, Pandora Media and Zynga. This was the highest total of internet IPOs since the later stages of the "internet bubble" about a decade ago. Looking ahead to 2012, the pipeline of U.S. deals looks very strong, with around 200 companies filing papers to go public – the highest amount since 2000. There are a number of prominent companies included in this pipeline, including Yelp, The Carlyle Group, Toys R Us, and Ally Financial, among others. Of course, the IPO everyone will be watching for is social networking giant Facebook. Although

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Facebook has yet to formally announce plans, an IPO in 2012 seems like a given. At this point, 2012 looks to be an active year for IPOs, but much will depend on the headlines coming out of Europe and their impact on risk appetites.

- **Occupy Wall Street Gains Steam:** “Occupy Wall Street” protests spread around the world and demonstrated that many people are not satisfied with the status quo of widening income disparity. The movement was initially disregarded given its lack of direction and focus, but many became sympathetic to the various messages of resentment that the movement symbolizes. The power of the individual’s voice has been unlocked through social media networks and the instant dissemination of the mass media over these channels has made all of this discontent highly visible. So while the media has moved onto other things and the winter will thin out the Occupy encampments, this movement may gain steam again in the spring and have some broader political/societal implications as the presidential election draws closer.

Outlook for 2012: Attractive Valuations Reflect Uncertain Times

The European debt crisis and resulting economic impact are the biggest unknowns/risks for 2012. Despite the anticipated weakness in Europe, the U.S. economy is expected to grow at a sluggish pace around 2% over the next several quarters. While this isn’t an exciting outlook, and is not likely to lead to a big improvement in the employment picture, the relative value argument for equities remains quite strong. As mentioned above, with the S&P 500 trading at 12x forward earnings, the market valuation has gotten more attractive from where we stood at the end of 2010 (14x). The earnings yield of 8.2% is very attractive when compared to a 1.9% yield on 10-year treasuries. Additionally, U.S. corporate balance sheets are strong with record levels of cash. While these factors argue for an investment in equities, the attractive valuations are a reflection of the increased risk premiums being demanded in the face of so much uncertainty.

While the European situation is the biggest potential risk for 2012, it is a known variable the market has been dealing with for quite some time now. The current situation is factored in to market values. Other variables that are likely to play a part in market valuations and volatility include the trajectory of China’s economy, the political dynamics ahead of the 2012 U.S. presidential election, and geopolitical issues that crop up around the world (North Korea, Iran seem like potential areas of concern).

Index	Sept 30th 2010	Jan 2nd	Monthly	Quarterly	YTD
DJI (US Index)	10913.38	12217.56	1.43%	11.95%	5.53%
S&P 500 (US Index)	1131.42	1257.60	0.85%	11.15%	0.00%
FTSE 100 (UK)	5128.48	5572.28	1.21%	8.65%	-5.55%
DAX (German)	5502.02	6075.52	-0.22%	10.42%	-12.13%
CAC (French)	2981.96	3222.30	2.15%	8.06%	-15.31%
Nikkei (Japan)	8700.29	8455.35	0.25%	-2.82%	-17.34%
HangSeng (Hong Kong)	17592.41	18434.39	2.47%	4.79%	-19.97%
S&P/ASX 200 (Australia)	4008.60	4096.60	-0.56%	2.20%	-13.67%
MSCIW (World Index)	1104.06	1186.07	0.12%	7.43%	-7.34%
Baltic Dry Index	1899.00	1738.00	-5.85%	-8.48%	-1.97%
Volatility Index(vix)	42.96	23.40	-15.83%	-45.53%	31.83%
Euro Stoxx 50	2179.66	2370.20	1.71%	8.74%	-15.13%
Commodity Prices USD	Dec 30th 2010	Jan 2nd	Monthly	Quarterly	YTD
Oil	101.07	100.3	-0.76%	-0.76%	9.68%
Gold	1567	1573.7	0.43%	0.43%	11.66%
Silver	27.87	28.22	1.26%	1.26%	-8.70%
Palladium	629	654	3.97%	3.97%	-18.59%
Gas	3.024	2.97	-1.79%	-1.79%	-32.65%
Copper	3.4305	3.48	1.44%	1.44%	-21.61%
Corn	638	646.5	1.33%	1.33%	2.86%
Cotton	91.38	91.8	0.46%	0.46%	-36.61%
Exchange Rates	Dec 30th 2010	Jan 2nd	Monthly	Quarterly	YTD
GBP/USD	1.55235	1.55342	0.07%	0.07%	-0.50%
EUR/USD	1.2959	1.29777	0.14%	0.14%	-3.08%
EUR/GBP	0.8348	0.83595	0.14%	0.14%	-2.54%
USD/YEN	77.115	76.8623	-0.33%	-0.33%	-5.25%
USD/AUD	0.97967	0.97254	-0.73%	-0.73%	-0.50%
GBP/MYR	4.9194	4.92088	0.03%	0.03%	2.19%
10 Year Bond Yields	Dec 30th 2010	Jan 2nd	Monthly	Quarterly	YTD
US	1.88	1.88	0.00%	0.00%	-43.12%
UK	1.98	1.98	0.05%	0.05%	-41.76%
German Bund	1.83	1.91	4.20%	4.20%	-34.59%
Japan	0.98	0.98	-0.31%	-0.31%	-14.78%
Australia	3.67	3.80	3.57%	3.57%	-31.28%
Brazil	11.31	11.26	-0.42%	-0.42%	-7.17%

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