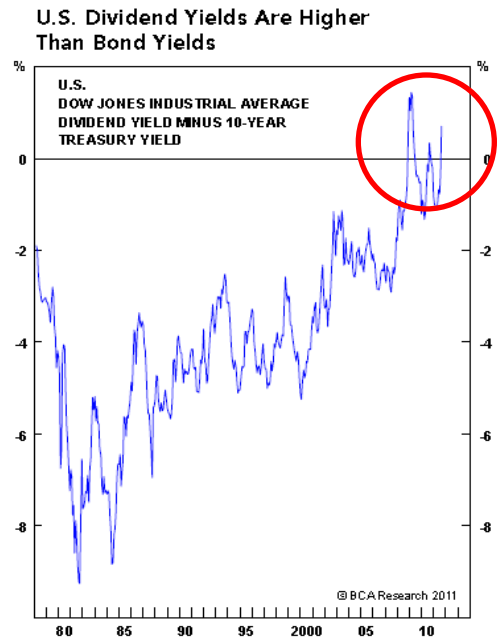
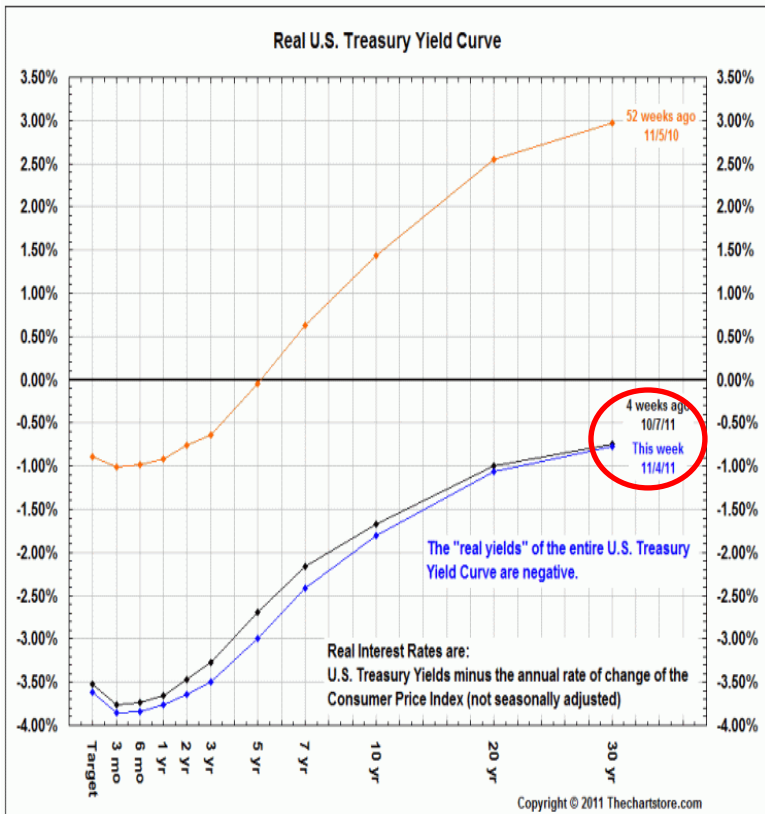


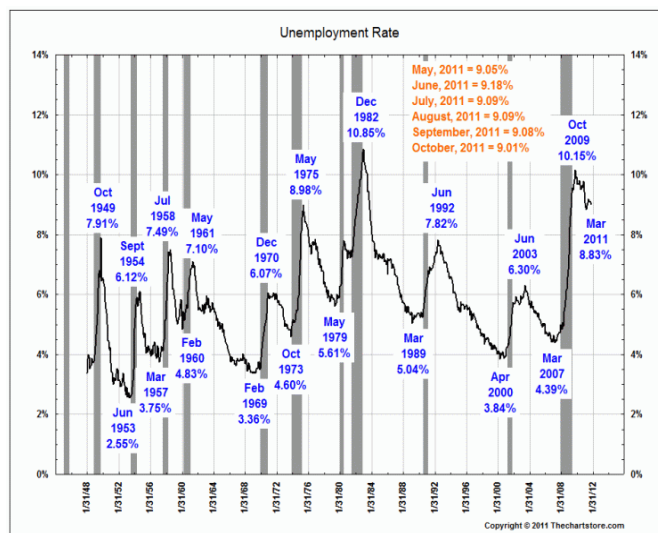
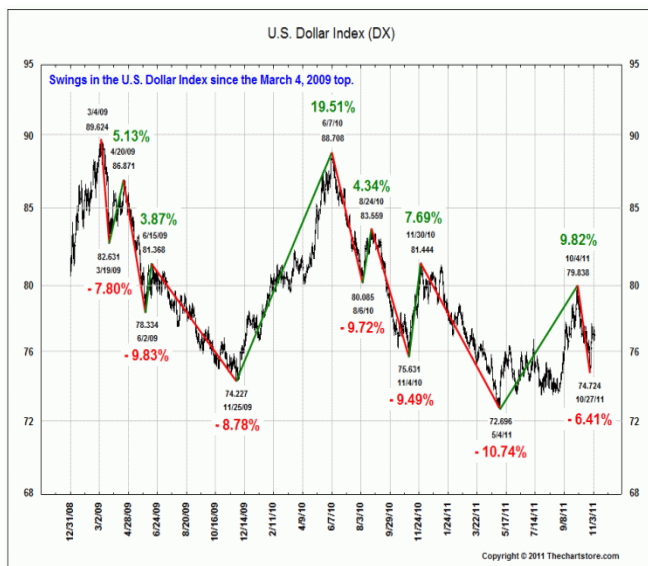
NOVEMBER 2011

Investment Thoughts: We need a global positioning system (GPS) for markets

The recent 10+ year returns for stocks from the high P/E levels of 2000 to the lows of 2009 have not endeared stocks as an asset class to private investors. During this time, interest rates have also declined each year, culminating in the near zero interest rates today. Near zero yields are a penalty to savers and a huge problem for retired persons trying to live off their accumulated capital. One would expect that, as rates declined, more money might migrate towards stocks, but the market crash of 2008-2009 along with increased geo-political fears, unresolved wars and a sovereign debt crisis in Europe have kept bonds strongly bid-- even when *real* interest rates are everywhere deeply negative. In the chart of U.S. Treasury yields below, one can see that the entire blue line highlighted by red is below zero after adjusting for inflation. We have now reached a point where the yield on a ten year U.S. Treasury bond is less than the dividend yield of the Dow Jones Industrial Averages.



Due to weakness in many economies, central banks will likely keep interest rates low for a long time. This global monetary policy is, however, supportive of asset prices for stocks, real estate, gold and commodities, especially those assets denominated in U.S. dollars. Asset prices, as differentiated from real value after inflation, move up in response to the inflationary impact of a weak currency. Under the gold standard, credit was limited by the amount of gold a country had. There was often a link between the supply of gold and commodity prices. When we devalue the dollar today it is another way of raising the price of gold or other assets. Just as in the time of Roosevelt, we are implementing bank rescue packages and are experiencing stimulation of asset prices from a weak dollar in an effort to get the economy moving. The appearance of rising prices is meant to build confidence. Our Federal Reserve has suggested that it will maintain current policy until the unemployment rate drops below 7%. This is likely to be several years hence. Since 2008, money has moved (both domestic and foreign) into U.S. Government bonds at the expense of corporate bonds and stocks. Given the now negative real returns of Government bonds and the weakening of the dollar as a currency, we would expect that investors will once again embrace stocks. The persistent conditions of expansionary policy will one day show up in higher inflation. Bond investors can't be satisfied for long to accept low yields when bond prices start to fall with higher inflation expectations.



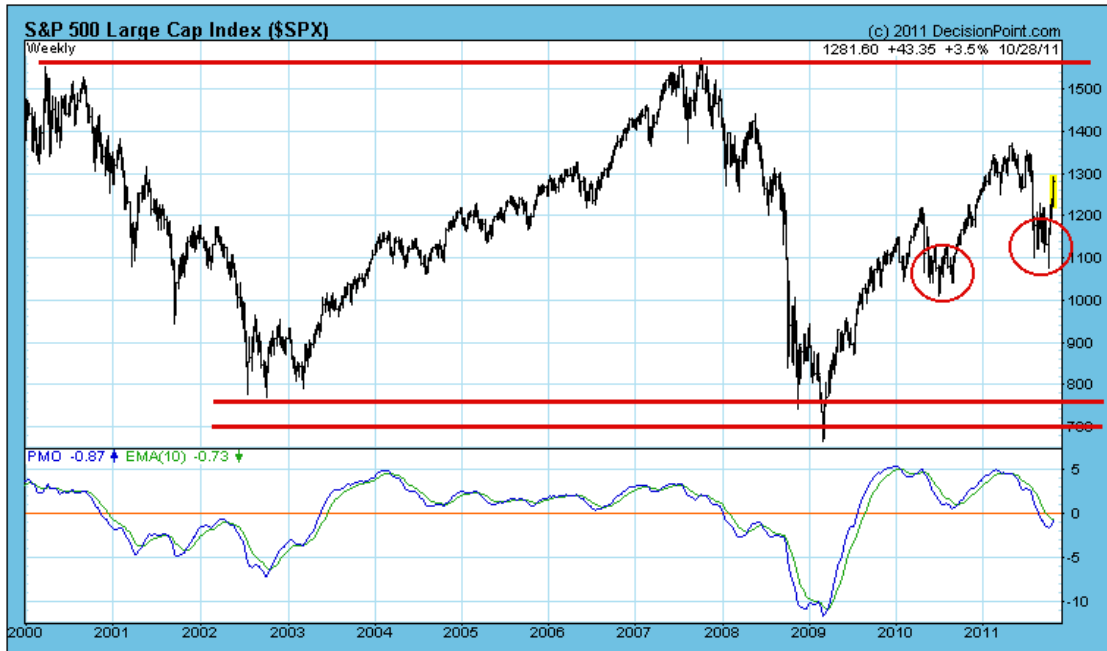
While the U.S. awaits more Federal Reserve action and assaults on monetary discipline, the politics of the day are delaying other necessary fiscal actions to protect our economy (spending and revenue issues) until after the elections. Americans like to work under pressure, it seems, to get things done. I have confidence we can work things out without further recession if the Punch & Judy show we call the European Union can avoid systematic failure due to sovereign debt issues. The world used to look to Italian bankers to

finance everything from commerce and property to wars. Now, Italy, the third largest economy in the Eurozone, is feared in danger from a Greek default. For their part, the Greeks, if allowed to vote in referendum on accepting bailout terms, would vote “no”. Either way they will have debts equal to 130% of GDP and severe austerity. Lenders to Greece know there is to be a default, but want to call it something else so as to avoid damage to their own balance sheets as they would mark down the value of loans. U.S. banks and hedge funds have been keen to sell credit default swaps on this debt (MF Global) and a “no” vote basically triggers the obligation to pay. If Greece accepts the bailout terms, lenders can agree on a “haircut” on losses and say there is no default. Our stock market has moved day by day, week by week to the changes in confidence for a resolution to Europe’s trouble.



The investment recommendations that flow from these observations begin with the first objective of preserving capital. Consequently, we believe in de-risking a portfolio’s exposures to Europe and financial stocks. Over the past few months we have brought equity exposure down to the more conservative end of policy ranges and built tactical cash to take advantage of sell-offs offering up high quality stocks at discounts from our fair value estimates. We emphasize cash flow for portfolios using stocks and corporate bonds to achieve a 3-4% cash yield as distinguished from price changes. This provides an absolute component of return while the capital markets are showing such volatility. During the years of deleveraging and as we bring down unemployment, global growth will be slower without the tailwind of new credit. This may give us a stock market that travels up and down in a sideways channel where having

a good yield on one's portfolio will be important for total returns. Endeavoring to rebalance stock/bond proportions when stocks move to the tops and bottoms of the channels should do better than a buy and hold strategy straight through the period of recovery.



J.T. Underwood, Chief Investment Strategist
j.t.underwood@ledyardbank.com



2 Maple Street, Hanover, NH 03755 (603) 643.0044 • 178 County Road, New London, NH 03257 (603) 526.9251